Revenue Based Financing

A new alternative for venture capital

CAPITAL MILLS

Introduction

This is the story of a typical business owner – let's call him 'Pete'. Pete and his friends have created a new app that allows independent contractors to easily keep track of their hours and create and send invoices. The app catches on, which is not surprising as there are millions of independent contractors and most of them hate spending their evenings doing admin. Questions from users soon start pouring in: is there an Android version, can I integrate the app into my accounting software, and so on. The app needs to be upgraded, and they need to start providing customer support. Customers from outside the country start showing an interest in the app, and Pete spots new opportunities. Unfortunately, his brand-new company is clean out of cash.

Practical and enterprising like the business owner he is, Pete decides to make a pitch deck. Fortunately, it doesn't take him long to get two investors on board. Pete is happy, it's a nice little ego boost, and he decides to take his company to the next level. Fast-forward two years, and the relationship with his investors has soured. Investor 1 is not pleased that there needs to be a second investment round, while investor 2 thinks this second round is far too small – he wants the company to grow a lot faster. Pete has acquired a minority stake in his own business at this point, and he spends his days keeping the shareholders happy rather than running his company.

This is a pretty common thing to happen to new business owners, so Pete is by no means an exception. And these business owners always come to the same conclusion: the decision to start working with investors was an emotional one – based on a gut feeling – without giving any proper thought to the options available and their implications.

Since Capital Mills invests on a deal-by-deal basis, we can provide customized solutions in venture capital and sometimes come up with an individual solution for Pete. But we too inevitably had to deal with the regulations relating to venture capital. Aggressive growth and large investment rounds are essential to how venture capital firms operate, whereas for most startups these types of moonshot strategies are misguided or even impossible. We have launched a new product called Revenue-Based Financing, which offers all the pros of venture capital and none of the cons. Flexible growth capital in the form of a loan and advice and support rather than a complex shareholder structure are just two of those pros.

To get back to Pete's story, it's essential that decisions to get investors involved should be informed and rational decisions. You need to feel comfortable with the idea, but you should also think just as carefully about financing your business as about your actual product. We have created this eBook to help make these important decisions easier for you.

Team Capital Mills

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In a nutshell

Revenue-Based Financing (RBF) is new in Europe and still largely unknown in our part of the world. The United States, however, has seen the emergence in the past five years of a thriving RBF industry, and for good reasons: RBF offers a number of major advantages over venture capital. RBF is a loan provided as growth capital, with limited collateral and no personal guarantees. The loan is repaid by a fixed percentage of the company's monthly revenue. These monthly payments continue until a repayment threshold (cap) has been reached.

What does this involve?
A loan that can add up to approximately four times the company's monthly revenue. For software companies, the monthly recurring revenue (MRR) is used as a basis. For other types of companies with a recurring revenue model, the monthly gross margin is used. The repayment period is up to 5 years, with a monthly repayment rate of between 3% and 8%. Although RBF is more expensive than bank financing, compared to issuing shares (equity) it is significantly cheaper, faster and more efficient to organize – as well as being highly flexible. You can't raise substantial funds, but you can take out several consecutive RBF loans.

Who is it for?
RBF is recommended for growing businesses looking to manage their assets efficiently. Since you must be able to make your monthly payments, you need to have positive (or nearly positive) cash flow. This is the preferred growth trajectory for the vast majority of startups. RBF is not really advisable for startups that require a large amount of capital for their development and for those operating in a winner-take-all market.

How can you get started with RBF?
The first step is to get in touch with us. If we feel we can work together, we'll schedule an orientation meeting. After signing a mutual NDA, we'd like to receive further information about your company and its plans for growth. Once we have received the documents, we will develop an initial analysis into a specific proposal within five business days, unless RBF is not an option for whatever reason. This means the initial stage of the process can be completed in virtually no time at all. If you accept our proposal, we will conduct a brief due diligence investigation and start preparing the draft proposals. The entire process can be completed within just 4 to 6 weeks.

What else do you get?
The knowhow and experience of our investment team and Capital Mills' investment partners. While we will not be a shareholder in your business (and your reporting requirements will be limited), we'll always be available to provide advice on your request or to use our network to give you access to the right people.

Startup financing

From idea to IPO

Every new business starts with an idea and a plan. The next step is to start thinking about raising funds. And while launching a new software product in the market is a lot less expensive these days than it was 15 years ago, there's fierce competition out there and you need to be on the ball. This does mean you need to attract funding to cover your expenses. A pattern has emerged in the development process of startups over the past 15 years. Startup founders tend to think there is only one path to success: a moonshot, with the ultimate objective of launching an IPO. They start by raising capital in the market: first with informal and/or private investors, and subsequently with professional financiers. We have been seeing an increase in venture capital investment rounds in recent years, while at the same time the initial investment rounds for startups are less likely to be venture capital rounds. The figures on the next page illustrate these trends. There are several alternatives available for all startups for which venture capital investment is not the best solution – these options are listed below.

The following options are available to startups:

Bank Financing

One financing method worth exploring is bank financing. Current-account facilities tend to fall into the 'every little bit helps' category. In some cases, loans are also provided. The only drawback is that banks are not known for their flexibility, so if a company falls behind on its loan payments or exceeds the parameters set (often in the form of covenants), bank financing demands a huge amount of time and attention. An important piece of advice we can give you is therefore to avoid issues with banks as much as possible.

Government Funding

Whereas when dealing with banks it is important to pay close attention to the securities and covenants to be issued, government funding is typically provided in the form of advance payments, which only become final once all (administrative) requirements have been fulfilled. Government funding can only be used for specific purposes, and there's a risk of the business strategy being adapted to the funding programme rather than the other way around. If there are loans involved, the interest on these loans tends to be high.

Factoring

This includes working with a factoring company that immediately covers your outstanding debt balance. This type of financing comes with its own pros and cons, which we will not cover here because it does not have much practical applicability for internet and SaaS companies. This is because these companies' customers often pay in advance, and the expenses tend to be higher than the equivalent of 20% per year for the liquidity acquired, which also happens to be fairly limited.

Revenue-Based Financing
This relatively new type of financing involves the provision of a loan which is repaid based on a percentage of the monthly revenue. This is of interest as a financial instrument mainly to growing businesses looking to accelerate their growth with limited additional funds.

Venture Debt & Mezzanine Loans
For startups at a more advanced stage of development, there are options to obtain loans from venture capital firms operating in this market. This is another costly form of financing, sometimes at high interest rates and sometimes with equity kickers, but there is always some degree of risk involved, clearly making them a hybrid of equity and loan capital.

Equity
As noted above, startups generally choose to increase their equity. The table below summarizes the various options available at the various stages of development.

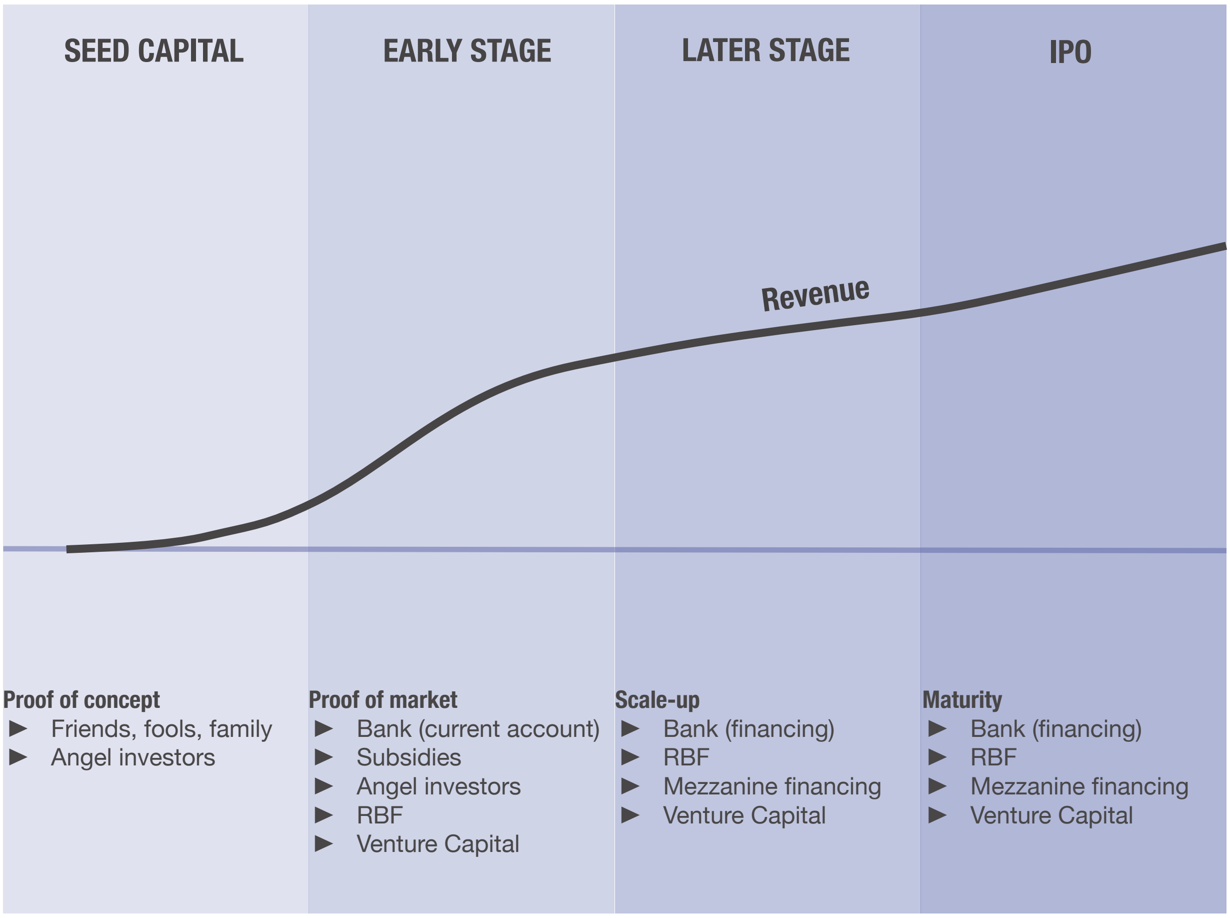


Figure 1: Available financing options at startups' various stages of development.

In the next section, we will take a closer look at the relationship between your company's growth strategy, the risks involved and the returns generated.

VC deals (#) based on size

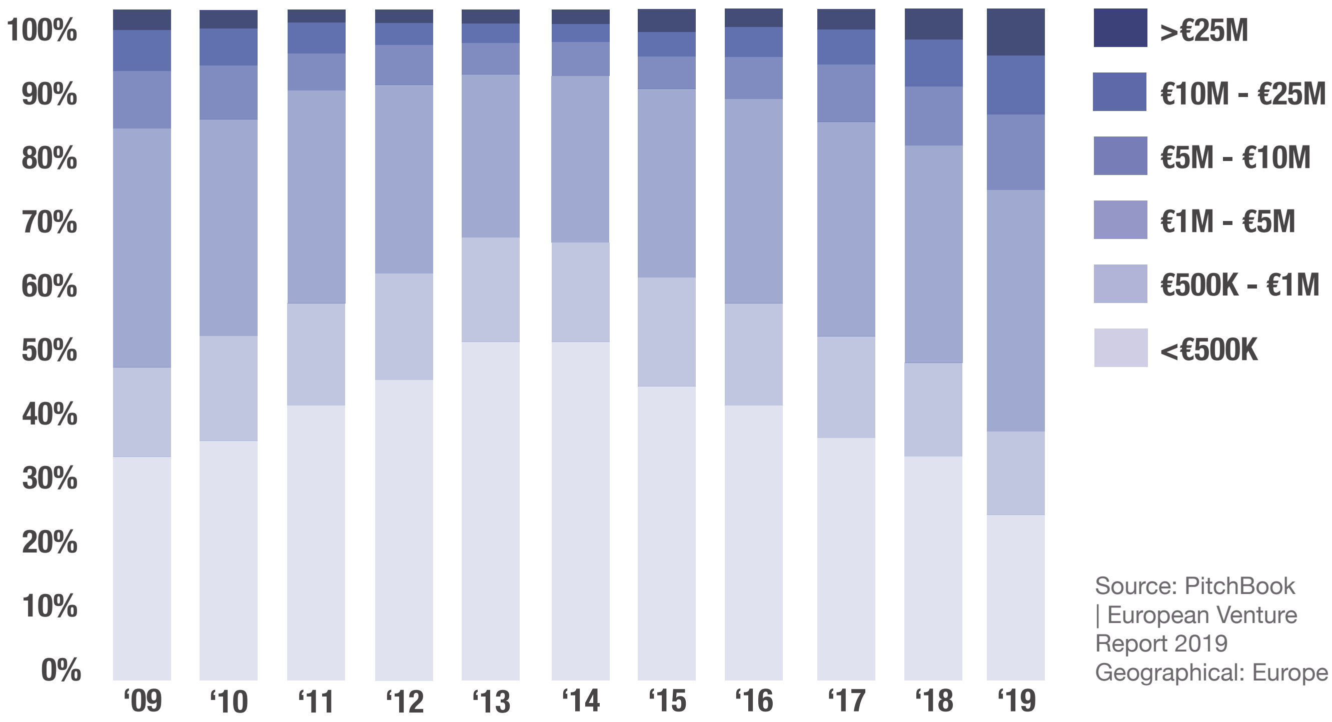
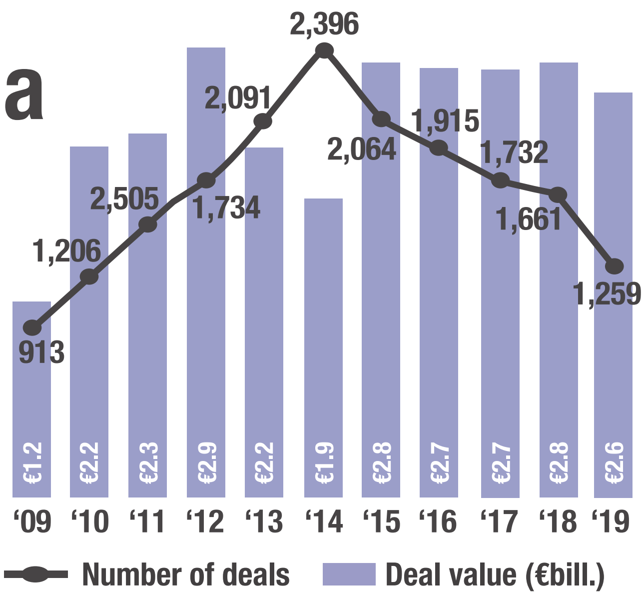


Figure 2: The number of transactions involving amounts smaller than EUR 500K has been declining since 2014. Angel and seed investments are becoming less popular as early-stage financing options, mainly due to the number of alternative financing options available, bootstrapped growth and the increasingly lower costs involved in developing a startup.

VC deal activity in a company's initial financing round

Figure 3: The data shows that fewer VC deals are being closed as first-time financing solutions at startups, but the rounds are growing larger. Since the first round, venture capital investors have been looking for larger investments in moonshot startups.

Bron: PitchBook | European Venture Report 2019
Geografisch: Europa



Strategy, risk, return

A good goal for any startup is to build a company where investments and hard work result in a positive cash flow and profit – and preferably your company should make a positive social impact in the process. If your business is funding its growth from the positive cash flow after an initial private investment, we refer to this as a 'bootstrapped business'. Amid all the excitement around the emerging internet and the success of online startups over the past 15 years, the practice of developing a bootstrapped company has not been especially popular.

However, we believe this could turn around completely over the next 15 years for the following reasons:

- Starting a new business costs a lot less money than even five years ago;
- The number of homeruns (professional jargon for highly successful startups such as Adyen, Uber and Facebook) is very limited. You can choose to go for broke – or err on the side of caution;
- The sheer market power of the likes of Google, Facebook, Microsoft, Apple and Amazon – to name the most high-profile companies – is immense. The question of whether the monopolies of these giants will prevent new startups from competing – knocking them out of contention – is very topical;
- Discipline in execution helps businesses to improve. Disciplines is essential if you're lacking in growth capital.

In the previous section, we described that venture capital financing is changing and that business founders have more options available to them. A recent study conducted by Invest Europe (see Figure 4) shows that around 8% of the startups funded with venture capital achieve superstar status, making them excellent venture capital investments.

Does this mean all other startups are losers? No, not by a long shot. Around 75% of startups that completed an initial investment grow significantly and end up becoming solid companies. However, this creates a situation where the venture capitalist does not achieve the returns it had hoped for and ends up with too small a stake in the company. This inevitably raises the question of whether an alternative growth trajectory would have been preferred.

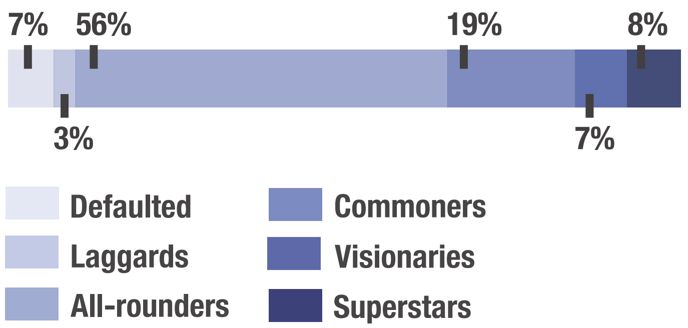


Figure 4: The cluster analysis conducted by Invest Europe (2020) suggests that the bulk of VC portfolio companies operate in the 'Commoners' or 'All-rounders' section and turned out to be unsuitable for the typical venture capital growth trajectory. However, these companies can achieve strong year-on-year growth through a modest investment.

Source: Invest Europe & EIF | The VC Factor| Geografical: Europe

A 2019 survey focused on early-stage and later-stage startups based in Europe which raised venture capital financing. The sample consists of 9,000 European companies that received funding between 2007 and 2015 and are analyzed based on their characteristics and performance up to 4 years later.

Financing options must be selected based on a model for the growth strategy. We can broadly identify two types:

1. A ‘moonshot’ venture capital strategy
2. A strategy focused on cash-positive growth

A moonshot venture capital strategy also means that the scaling up of the business is funded by a large investment in technology, marketing and employees. This can only have potential if it is clear, for example, that every euro spent on marketing will result in a more than proportional increase in sales. Even if this requirement is met, the risk associated with this type of strategy remains substantial. The growth of a business by 100% a year comes with its own set of risks (including growth risks). This includes the structure of the organization, process monitoring, creating an organizational culture, and so on.
If the market says it’s all systems go, you have the confidence needed and are backed by a talented team, the returns can be dazzling. In all other cases, a cash-positive growth strategy is the preferred option, as the risks associated with this type of strategy are significantly smaller. There is also the fact that you can always choose to pursue a moonshot strategy down the line. Figure 5 shows both strategies in a diagram, including the options for funding the growth.

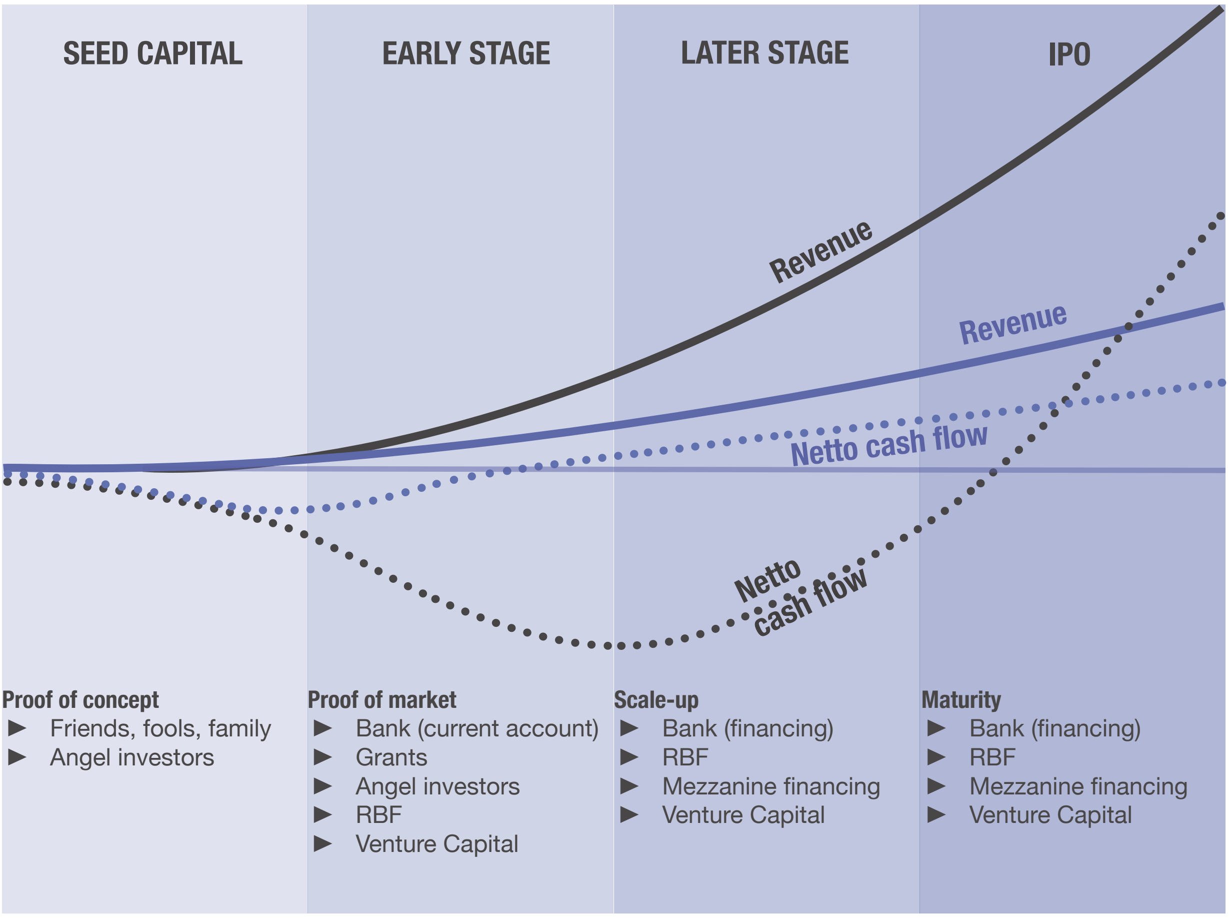


Figure 5: A model for two different growth strategies.

Cash positieve growth strategy

Venture Capital Strategy

Cost of capital

Capital invested in a company costs money. In business economics, we distinguish between equity and loan capital. Equity, also referred to as shareholders' equity (or owners equity' for privately held companies), represents the amount of money returned to a company's shareholders or owners. The company's loan capital is defined as its total debt. Loans, working-capital financing and the current-account facility at the bank are the main examples of interest-bearing components of the loan capital.

Mature companies can maximize profits for their owners or shareholders by facilitating an efficient capital structure. This is best illustrated by the following straightforward example:

	A		B	
Revenue	€	1200	€	1200
Earnings before interest and taxes (EBIT)	€	175	€	175
Interest	€	-	€	-20
Taxes	€	-44	€	39
Net profit	€	131	€	116
Equity	€	450	€	200
Debt		-	€	150
Total Capital Employed	€	450	€	350
Return on Capital Employed		29%		33%
Return on Equity		29%		58%

Figure 6: Cost of capital

In this scenario, A and B are two direct competitors that generate exactly the same amount in profit and earn the same amount in revenue. There are two things we notice right off the bat in this scenario:

1. Company A needs more capital to earn its profit than company B: in other words, company B has higher **capital efficiency**;
2. The company's **leverage** (i.e. the ratio of total debt to net assets) has a large impact on the return on equity (ROE).

In the past, startups did not need to think about leverage and the ratio of total debt to net assets. It was very difficult to secure loans at this time, but times have changed. And as this example shows, it can really pay off to fund the company efficiently and based on the right mix.

RBF: How does it work?

RBF is structured as a loan. The loan is repaid through monthly payments, which are determined based on a percentage of the cash revenues. The monthly payments continue until a repayment threshold (cap) has been reached.

The payments are flexible and change in tandem with the company's cash revenues. The faster a company grows, the sooner a loan is paid off. The returns for the loan provider are directly linked to the company's performance. While RBF may be similar to equity in these respects, it remains a loan, and as such is classified as loan capital in the balance sheet.

Its main features include:

- The current and future (estimated) cash flows determine whether a company qualifies for RBF, as there must be enough credit available to make monthly payments;
- RBF is perfect for – relatively – modest capital rounds. Examples: 4x Monthly Recurring Revenue or one-third of the gross margin. Since RBF is a loan, it will appear in the balance sheet as a liability (debt). The balance-sheet ratios will remain healthy due to the relatively small amount of the loan;
- The repayment cap depends on the monthly repayment rate and the risks involved and typically represents 1.5 to 2.5 times the principal of the loan. Growing companies can apply for follow-up RBF funding;
- No need to provide personal guarantees; only securities to be provided on request, subordinated to the bank;
- Interest charges are tax-deductible

This is all set out in a single contract. The main strengths of RBF:

- Established quickly and efficiently
- Flexible, both in terms of repayment and in terms of the option to obtain follow-up RBF funding
- No dilution of shareholder interests
- No discussions on valuation
- No need to establish a board
- The investor's interests and the company's interests are aligned: the faster the company grows, the faster the RBF is repaid and the more value the business owner creates;
- Capital Mills provides support and advice as needed

The benefits and limitations of RBF are best explained by comparing them with the available alternatives; this is detailed in the next section.

RBF compared with

bank financing en Venture Capital

As stated earlier in this eBook, it is important for company founders to pursue a funding strategy that ties in with your commercial growth strategy. The table below shows the three main types of financing available to startups, and compares the key feature of each.

	Bank Financing	Revenue-Based Financing	Equity growth capital
Classification	Debt	Subordnated debt	Equity
Size	Dependent on balance sheet, collateral and guarantees	Up to 4 times MRR, or 40% of gross margin. Easy follow-up funding	Stage and businessplan dependent
Redemption	Fixed repayment schedule	Monthly % of cash revenue. Typically 3 - 8%	Contractual exit triggers
Guarantees	Asset dependent, personal guarantees	Limited collateral, no personal guarantees	Personal commitment through investment, vesting, good/bad leaver clauses
Cost of capital	Typical interest rates start at 6%. Closing fees apply.	Repaymentcap typically 1,5 to 2,5 x loan amount. Limited closing fee.	Value of sold shares (to be estimated at 5 x Money on Invested Capital minimum) and substantial transaction costs, up to 10% of investment
Time investment by management	Limited	Limited	Substantial
Business support	None	Regular and on demand, dependent on provider	Regular when everything goes according to plan. Investor dependent when things do not run smoothly.
Time to funding	2 months	4 weeks	3 to 9 months fundraising

Figure 7: Comparison of the main features of three main forms of financing available to startups

Benefits of Revenue-Based Financing at a glance:

1. Cheaper than equity
Investment funds from venture capitalists and angel investors are the most expensive money you can use to fund your company, not just in terms of annual return costs, but also in terms of transaction fees and governance costs (shareholder meetings, etc.).

2. No dilution
The use of RBF ensures that the interests of existing shareholders will not be diluted.

3. Can be combined with other forms of funding
As explained above, there are many benefits to taking relatively small steps – particularly at the earlier stages – until you know you've found a tried-and-tested growth model. You also have the option to:

- Decide at a later stage to raise a venture capital round
- Postpone your company's runway until a future venture capital round
- Sell the company without needing to factor in the venture capitalist's reserved matters (i.e. not likely to sell within five years);
- Not sell the company, because you're not bound by an exit term agreed with a venture capitalist (often between 5 and 7 years).

RBF does not offer benefits alone. RBF is recommended for companies with revenues. It is not possible to work with RBF on a pre-revenue basis. While having a positive cash flow is not a requirement, it is, of course, advisable that the company becomes cash-flow positive during the term of the RBF. Steady revenue flows and long-term contracts with customers or clients are preferred. These elements make RBF ideal for SaaS and eCommerce companies with high gross margins.

A dynamic RBF industry has emerged in the US, which has been growing rapidly every year. Multiple providers are offering RBF financing products, in a market estimated at €100 billion+. While still a niche product, it is expected to grow further over the next few years. In Europe, too, we expect that SaaS and internet companies in particular will start using RBF more often. RBF is effective for rapidly growing startups, as well as – especially – for startups that may not achieve the 100%+ growth per year needed in order to qualify for venture capital, but that are well on the way to getting there, with growth rates of 15% and higher.

about Capital Mills


Gijs den Hartog


Erwin van der Veen


Barry de Kock


Rene Delsing


Anneke van der Meer

Capital Mills is a venture capital firm and network of investors dedicated to providing venture capital and RBF loans to early-stage-growth companies.

Our investor network includes around 25 entrepreneurs, many of whom have an IT background. This network has proved to be very valuable to the companies in which we invest or to which we provide RBF loans, by putting them in touch with the right people or providing advice.

Our investment team supports businesses on a day-to-day basis. When making venture capital investments our role is more formal than when providing RBF, but we aim to be a partner to our portfolio companies and add value as investors.

Interesting in meeting us or receiving a quote?
The easiest way is to complete the contact form on our website. We will respond quickly and phone you so we can learn more about each other and take things from there.

Lead time
The RBF process can be completed quickly: from one month to 6 weeks. Venture capital investments take more time, with there typically being three months between the initial meeting and the signing of a binding agreement.

We are Team Capital Mills