Growing Your Diverse-Led Business:

A GUIDE TO REVENUE BASED FINANCING

Founders First
CAPITAL PARTNERS

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Overview

Venture capital equity funding hasn't changed much since it first emerged in the 1950s. Nor has getting a business loan at your local bank, for that matter. But there is one relatively new kind of funding that's different. It's kind of like a loan, but you don't pay typical interest like you would with a bank. And you don't have to give up a share of your company like you do with equity.

It's called revenue-based financing (RBF). In some circles, it's referred to as revenue-based investing (RBI). In others, it's called royalty-based investing. All three are the same thing, so you don't have to worry about the terminology. The key thing to remember is that funding is driven by—you guessed it—recurring or predictable revenues. And that's a gamechanger for a lot of businesses, particularly minority-led businesses that, for various reasons we'll get into, don't have the same kind of access to traditional lending or venture capital.

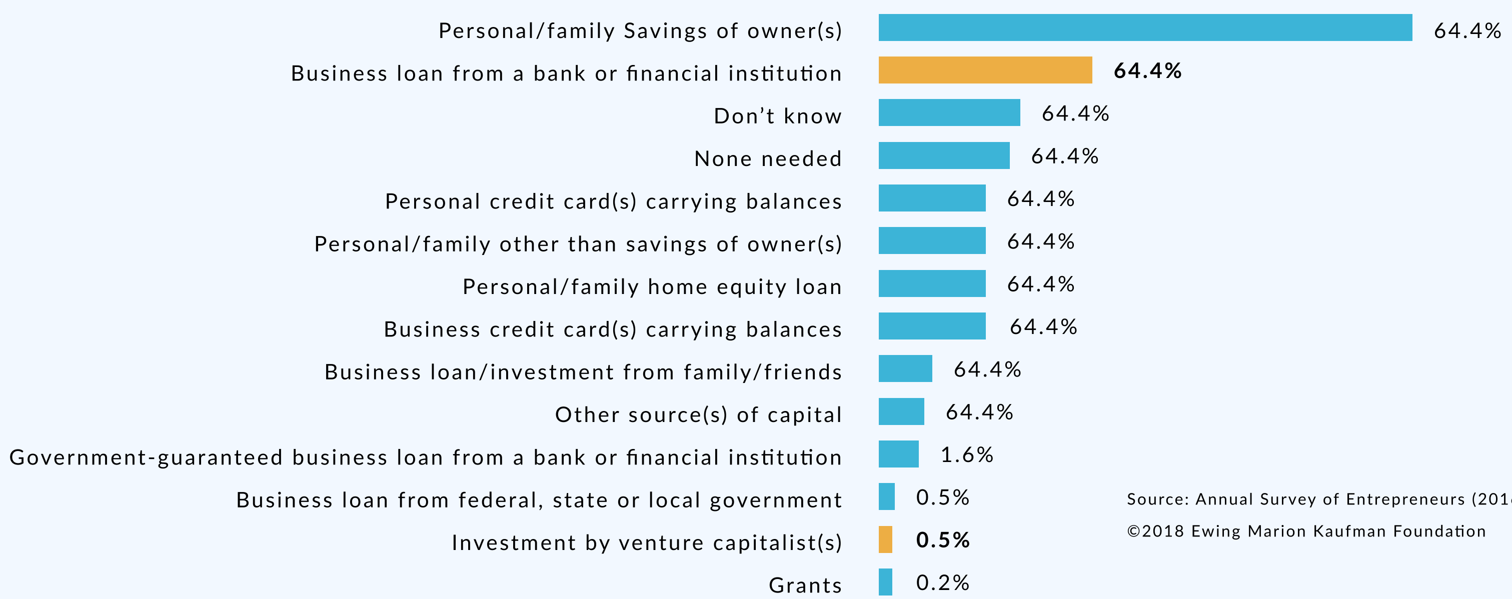
For diverse-led businesses, RBF can be the difference between success and failure, growing your business from 5 employees to 20, or bridging the gap to scale growth until you do get that equity investment at a far greater valuation and go on to change the world.

The fundraising conundrum for diverse founders

Businesses need funding—that's a fact. If you own a business or manage one, and you want to expand, grow, and hire people, you can't do it for free. Unless you have a cash warchest at your disposal—which might eliminate your need to run a business altogether—you're going to have to find it somewhere.

Some 90% to 95% of entrepreneurs that hire require some form of financing to start their business. A lot of them bootstrap. They use their own money, and borrow from friends and family. They might leverage credit card debt. A small amount of them—only 0.5%—get an investment from venture capitalists right out of the gate. A whole lot more—16.5%—get a business loan from a bank or financial institution.

SOURCE OF STARTUP CAPITAL

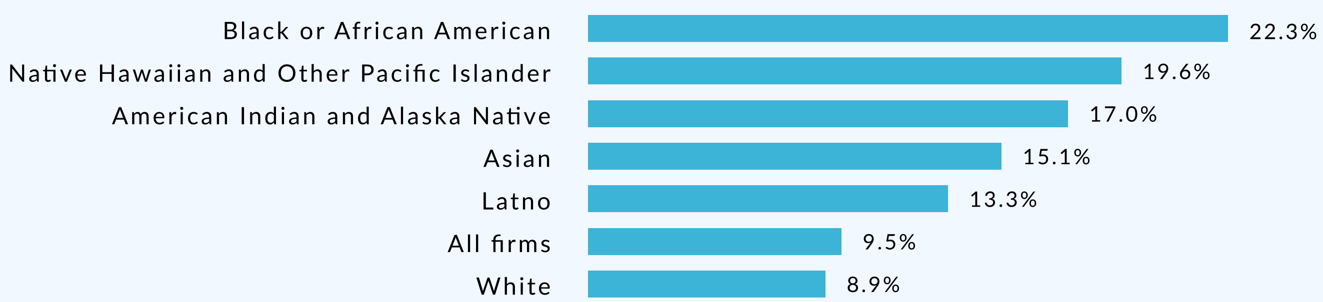


Source: Annual Survey of Entrepreneurs (2016)

No source of funding is perfect. Banks require collateral that startups typically don't have. Fintech merchant financing can give you very fast short-term access to cash, but it's costly. Angel investors are out there, but often they cannot provide big enough investments to scale. Crowdfunding can provide capital for companies that produce consumer packaged goods or other products. Venture capital firms make their largest investments in core tech and life science companies at the highest cost—shareholder dilution and loss of control.

Getting funding isn't simple for anyone, but the problem for diverse-led businesses is that they have less access to all these options. Less than 5% of venture capital funding goes to people of color—and it's less than 2% for black and brown founders. More than 22% of African American entrepreneurs alone report that their profits are negatively impacted because they can't get access to capital. Other minorities suffer from the same problem.

PERCENTAGE OR ENTREPRENEURS REPORTING PROFITS NEGATIVELY IMPACTED BY LACK OF ACCESS TO CAPITAL

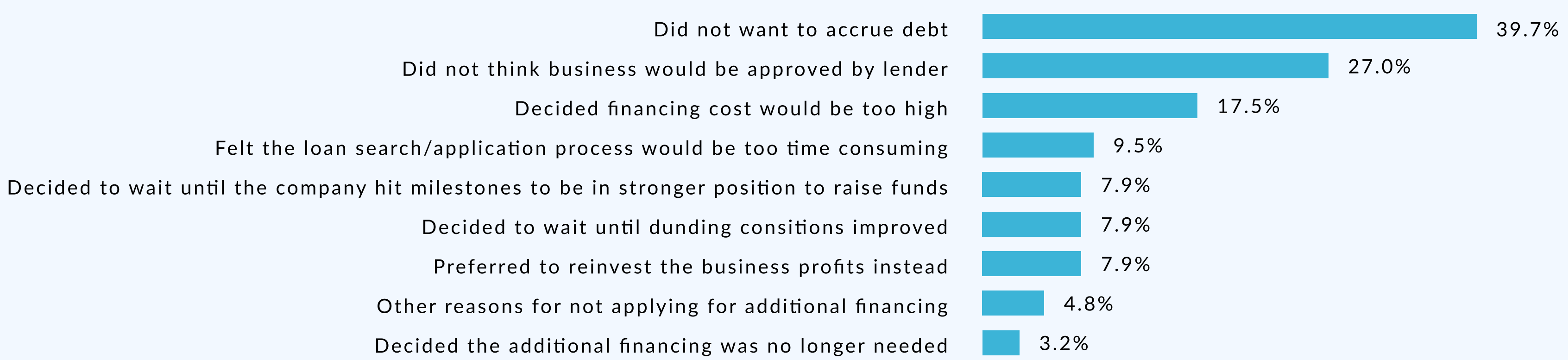


Source: Annual Survey of Entrepreneurs (2016)

That's because minority entrepreneurs face geographic, demographic, and wealth barriers to getting funding. For one, they often don't operate where the money is. Startups that aren't in the hub of the venture capital universe in Silicon Valley or New York City might as well be ghosts. They are not going to be on anyone's radar, and have no chance of getting there without prominent connections. A small business in Flint, Michigan doesn't likely have a venture capitalist as a neighbor. Many diverse-led small businesses are trying to have an impact on the community they live in, hiring locally and generating premium wages. They likely do not have relationships with banks or other sources of capital.

Even if they do, they have difficulty securing funding. Across the board, 27% of entrepreneurs don't even pursue capital because they don't think their business would be approved by a lender.

REASON ENTREPENEURS DID NOT PURSUE CAPITAL DESPITE NEED



Source: Annual Survey of Entrepreneurs (2016)

That challenge is even more prominent for diverse-led businesses. The old cliche is “you need money to make money.” Well, that turns out to be right for minority business owners who have not amassed the wealth they need to get started. This is less about having cash for operations and more about having the personal assets you need—like a home—to personally secure a loan.

Most traditional small businesses use heavy personal-asset-based financing. You need a strong personal financial profile, a great credit score, and personal assets like that house to pledge against it. There is a large wealth gap for businesses led by diverse founders. They don’t happen to have those things. Plus, their credit just isn’t good enough to get financing into the six figures. With traditional financing, errors you made in your twenties can keep you from getting funding in your forties. But with revenue-based financing, you don’t have to keep paying for the sins of your youth.

RBF is more accessible for minority-run companies because the funding deals are based on the company’s revenue, not the owner’s credit history, the value of their personal real estate assets, or even how long they’ve been in business.

What is revenue-based financing?

Here at Founders First Capital Partners, we've seen revenue-based financing work again and again for our clients, who really become our partners. So, what exactly is it?

Revenue-based financing (RBF) is like a loan, but different. With RBF, investors agree to give a company capital in exchange for a certain percentage of the company's ongoing total gross revenues. In that way, it's like debt financing because investors collect monthly payments. Repayments are calculated using a multiple that gives investors a return that's higher than the original investment. The company does not have to provide collateral for revenue-based funding. In essence, its revenues are collateral.

Revenue-based financing is flexible because the amount repaid each month depends on how much revenue the company generates. If revenue slows down, the payments will be lower. If revenue is higher, the debt is repaid more quickly. Usually there is a term that ranges from 3 to 5 years.

Instead of an interest rate, a repayment cap is set, usually 2% to 5% of monthly revenues (though it can go as high as 10%). Loans can range from $50,000 to $3,000,000. Most investors set a maximum loan of up to one third of the company's annual revenue or up to 3x monthly revenue. The debt obligation ends once the total repayment cap has been reached.

Benefits of revenue-based financing

The benefits of revenue-based financing are numerous.

- **Flexibility:** Payments vary depending on monthly revenue.
- **No loss of control:** RBF does not come with a seat on the board or any ability to replace management. You keep control of your company.
- **No or minimal shareholder dilution:** First and foremost, unlike when you give away an equity stake, there is no or minimal shareholder dilution, so you don't give away the future profits of your company.
- **No financial covenants:** Payments depend only on company performance.
- **No pledge of real estate assets:** There's no need to have a home to use as collateral. The guarantee comes from the assets and revenue of the company.
- **Aligned interest:** Due to its revenue-sharing nature, both the interests of the company and the lender are aligned.
- **Advice:** Consequently, the investor is typically available to provide advice to help the business and support its growth.

How it works: An RBF example

Here's a basic example to give you an idea how revenue-based financing works. Say you need $200,000 to invest in the growth of your business—whether that's to build out your technology, increase your sales staff, spend on marketing, or take care of other business needs. You and your existing shareholders are not very keen on diluting your ownership further (as in equity financing) and maybe you're not able to obtain a bank loan because you don't have enough collateral, or you haven't been in business for three years, like many banks require. Revenue-based financing is a viable option.

If you strike a $200,000 deal with a firm that provides revenue-based financing, it could look something like this:

Annual revenues:	**$1 million**
RBF principal:	**$200,000**
Maturity:	**3-5 years**
Payment:	**5% of monthly revenue**
Total repayment:	**1.5x principal ($300,000)**

In this example, you'd pay a $100,000 premium for a $200,000 investment (you pay back a total of $300,000). This is just a loose example. The numbers are going to vary based on the investment, the risk, and reward potential. Typically, what you'll find is a loan maturity of 3 to 5 years with cumulative payments set at 1.5x to 2.0x the principal. There's no set interest rate, payment, or maturity. Monthly payments are a fixed percent of revenue so they can go up and down.

All this would be calculated right off your financial statements, including your monthly balance sheet (plus YTD), monthly cash flow statements (plus YTD), monthly bank reconciliation report, and monthly bank statements. You would deliver all this to the lender along with a monthly compliance certification that certifies the information you deliver.

The importance of recurring revenues

Steady, recurring—and hopefully growing—revenues are the key. This makes Software-as-a-Service (SaaS) companies, with their regular, recurring revenue, particularly attractive to investors. But any other type of company can be eligible, as long as the monthly revenue is strong enough. As one investor recently told us, “We like revenue, no matter what container it comes in.”

RBF investors will frequently do follow-on rounds of funding as well. So, once you get your foot in the door and prove your capabilities, you can expect to continue your relationship with the lender if you choose to. We should also note that RBF and equity financing don’t have to be mutually exclusive. You can get both. RBF could serve as a bridge loan until you’re ready to take the next step with VC funding—or it could be funding in between equity rounds to help you reduce dilution.

Recurring revenue is what evens the playing field for diverse-led businesses. Revenue-based financing is almost like playing sports. You have a very transparent playbook based on the numbers. If you have clear and transparent numbers for revenue, gross margins, and other financials, you always know where you stand and you are less likely to fall victim to a biased situation like with traditional funding. Math is how you can be certain you qualify.

Success Story: OnShore Technology Group

Based in Chicago, OnShore Technology Group (OTG) provides a proprietary compliance platform for pharmaceutical and medical device compliance. Their clients use the OTG platform to evaluate systems controls to support obtaining federal regulatory licenses.

Founder Valerie King Bailey wanted to take the company from a core service-based business to a tech-enabled service-based business. She had taken on very small amounts of traditional debt, like a merchant cash advance, but needed a better solution to help the company grow.

So, she became a Founders First member and joined the 2020 May FastPath cohort. She received a Founders First revenue-based investment of $250,000 and leveraged that to acquire another $250,000 RBF matching investment. Consequently, she was able to add five new team members, expand her marketing, and increase revenue by 1.5x to $3.6 million. OTG was able to add more IT services and became a certified Microsoft solution provider, all the while enjoying the flexibility and non-dilutive aspect of its revenue-based funding.

One of their clients was Moderna, a prominent provider of COVID-19 vaccines. OTG has now also been recognized in the class of 2021 for the Inc. 5000. Founders First still provides post-funding advisory support as the company looks to scale to high seven and eight figures.

Applying for revenue-based financing

When you're applying for revenue-based funding, you're going to need the same kind of components that you'd present to any investor. You need a pitch deck that is clear, concise, and shows RBF investors where your company has been, where it stands now, and where you want to be. Where will the RBF take you? Why should someone invest in you?

You'll also need historical financial statements—your income statement, balance sheet, and statement of cash flows. RBF investors will want to comb through them to really understand your company and what kind of revenue it generates, so make sure they are top notch.

Additionally, a pro forma financial model is helpful to show investors what your projections would look like over the loan period. This will be hypothetical but answer questions about what your income, account balances, and cash flow would look like if you get the RBF investment you're looking for.

Choosing the right lender

This is an important decision for any company. Don't just "take the money" because a lender is offering it. Do your homework. Ensure you're doing business with a company that is reputable and works in your best interest.

Take a look at the lender's portfolio to see what type of work they have done in the past. How will you fit into their portfolio? You can even do reference checks once you know who they have worked with. This is important because a lot of RBF investors also offer some form of advice and support. In fact, you really should look at your RBF funder as a partner. You want them in lockstep with you during the life of the financing with the same mission and goals. Founders First, for example, is the only RBF company that focuses exclusively on helping diverse founders. As diverse entrepreneurs ourselves, we've been in your shoes and can leverage that experience to help you succeed.

Obviously, you're going to want the best terms possible, too. That's not always negotiable, but it doesn't hurt to try, especially if you are considering a couple of different lenders. You want a lender that understands your needs and potential—and one who has a good reputation for funding on time so you're not left hanging. One of the other advantages of RBF is that you can get funded far quicker than through a bank or venture capital firm. It broke our heart once to hear a story of a company that had a $1.5 million recurring government contract in its grasp but couldn't raise the $150,000 in capital it needed for startup costs in time.

Of course, before you sign anything, read all the fine print. Make sure you understand the fees and the real costs associated with your loan. Are there any stipulations that could limit your options in the future? Have a lawyer explain it to you if need be. Doing your due diligence always pays off.

Conclusion

Because it focuses on monthly revenues above all other requirements, RBF is often a more accessible form of funding for many companies, and especially minority-led companies, which may not find options for traditional investments like venture capital and bank loans.

RBF won't dilute your shares or force you to give up any control of your company. You keep a bigger upside for transformational wealth while also improving your chances for steady growth. We'd all love a billion-dollar exit strategy, and we hope you find that if it's your goal. But creating a successful, sustainable business that does well while also doing good, creates premium wage-earning jobs, and improves your community is a worthy goal, too.

As one RBF investor told us recently, his objective was to help companies increase their revenues by 3x to 10x. On the lower end, that might be a single or double compared to the grand slam that many VCs are looking for, but it can be life changing nonetheless. Revenue-based financing can set you up on that steady path of growth that eventually lets you knock it out of the park on your own terms.

In fact, RBF can set you up for a multi-million dollar exit specifically because it doesn't dilute your ownership so drastically. The true cost of the RBF capital investment you receive is far less than what it would be for equity financing, and your payout could be far greater.

Contact us to learn more

Want to learn more about RBF and whether it's a good fit for your company? Talk to us at Founders First Capital Partners. We'll be happy to give you the straight scoop.

Call us at 858-264-4102 or email us.
www.foundersfirstcapitalpartners.com