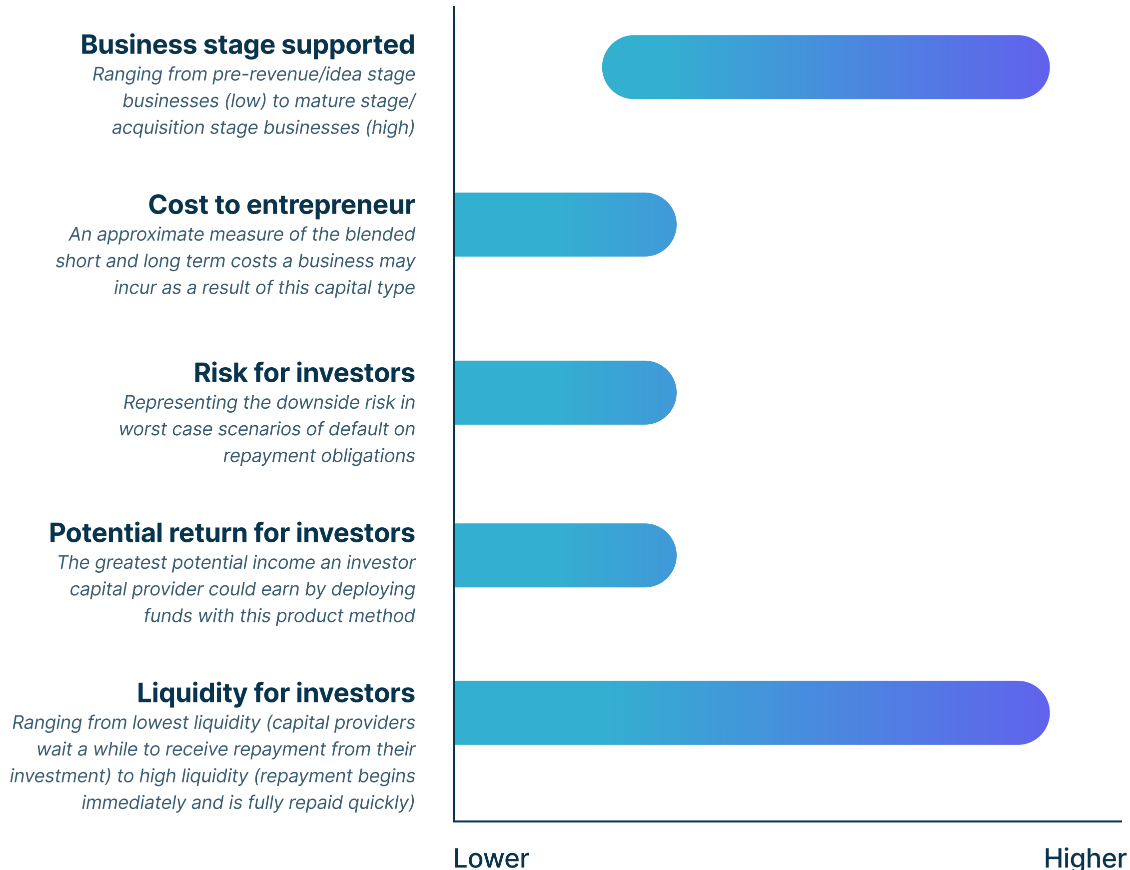
Revenue-Based Loans

TL;DR

A revenue-based loan is a more flexible funding model than traditional debt financing, with payments tied to a percentage of revenue instead of an interest rate.



What is a revenue-based loan?

A revenue-based loan is like a flexible loan with no fixed interest rate. Revenue-based investors give a company capital in exchange for a percentage of the company's ongoing revenues. Similar to traditional debt financing, investors collect monthly or quarterly payments. Rather than payments set at an interest rate, revenue-based payments fluctuate with revenue. If revenue slows down, then the payments will be lower; if the revenue is higher, then the loan is repaid more quickly. Payments are made until the investor receives a predetermined multiple of the original investment or return cap. Typically, the company does not have to provide collateral for a revenue-based loan because its revenues are essentially collateral.

A revenue-based loan blends features of bank debt and venture capital, and founders should expect the cost of capital to fall within that range. Revenue-based loans are non-dilutive growth capital to bridge the path to sustainable profitability for revenue-generating businesses that do not fit the VC model.

Revenue-based financing (RBF), also known as revenue-based investing (RBI) and royalty-based financing, was used by oil investors in the early 20th century to finance oil and natural gas exploration, and later by the pharmaceutical, media, and energy industries. VCs began applying it to early-stage, life sciences companies in the 1980s and more recently to technology sectors. FinTech lenders, such as Lighter Capital and Clearbanc, have focused on bringing RBI to the Software-as-a-Service (SaaS) space, but there are a number of emerging investors offering it across other sectors.

What are the typical characteristics of an RBF loan?

- Structured as a loan
- Principal amount is fully funded at closing
- Monthly payments equal a set percentage of monthly revenue (typically 2-8%)
- Monthly payments continue until a set dollar amount has been paid back, usually 2-3x the amount of the financing (this multiple is called the "cap")
- At maturity, which is typically 3-5 years, any unpaid amount of the cap is due
- No collateral or restrictive covenants

Capital Fit

What types of businesses are a *good* fit for a revenue-based loan?

Revenue-based loans are common among companies that use a subscription model (particularly companies selling SaaS), but they are also useful for nontech businesses, like food and manufacturing, where revenue can fluctuate. Advocates of revenue-based loans are increasingly encouraging businesses and funders to consider this model for a variety of industries. For a business growing at a moderate pace with recurring revenue in need of growth capital (like hiring, buying inventory, or conducting a big marketing campaign), revenue-based loans can be a good option.

Profitability: Businesses do not need to be profitable, but investors like to see a path to profitability within three to five years. Businesses need to be at least EBITDA positive.

Recurring Revenue: Businesses need to average at least $10K in monthly recurring revenue (MRR). Investors like to see somewhat predictable revenues with repeatable or recurring customer contracts and customer diversity.

Annual Revenue Growth: 25%+

Gross Margins: 40%+

Financials: 2+ years of financial statements

When is a revenue-based loan *not* a fit for businesses?

Too Young: If a business does not have at least two years of financial statements, then it is difficult for a revenue-based investor to underwrite and make an investment.

No Revenue: If a business does not have any revenue, then it is difficult for a revenue-based investor to underwrite and make an investment. Most investors like to see $10K+ in MRR for several months.

Heavy R&D: Businesses that are capital intensive and require a large amount of upfront funding to build large-scale projects or bring breakthrough technology to market.

Blitzscalers: Businesses that require rapid growth to take over an entire market or create a new market and need large amounts of VC funding to scale. These "Blitzscalers" typically focus on speed and growth over cash flow and profits.

Fundraisers: Founders always focused on raising the next round of funding for their businesses. Investors want to write checks to builders, not fundraisers, and do not want to have to spend a lot of time convincing founders not to take the traditional VC funding path.

Misaligned Cap Table: If founders have raised $5M+ in traditional VC funding, then their existing investors most likely will be focused on raising another VC round at a larger valuation. Revenue-based investors do not want to compete with the different return and fundraising expectations of prior or potential co-investors. On the debt side, investors do not like to navigate a crowded and complex cap table with a bunch of lenders who are more senior to them and have expensive rates and warrants.

Why would founders want to ***choose*** a revenue-based loan?

Non-dilutive & More Control: Founders maintain more ownership and control over their business than traditional VC. Once the investment is paid back by founders, the investor is not on your cap table permanently. Investors typically do not take a board seat.

Flexible Payment Schedule: A revenue-based loan provides more flexible payment terms based on a percentage of revenues than term loans (containing fixed payments that do not fluctuate with revenues). Payments scale up and down along with revenue growth.

No Restrictive Covenants: Unlike traditional bank loans, revenue-based loans typically do not require the borrower to agree to any restrictive covenants where the borrower must manage their business in a specific way—such as maintaining minimum liquidity levels or hitting revenue milestones. For example, venture debt lenders will require borrowers to also agree to stock warrants for upside participation in exit scenarios. Factoring or merchant cash advances also come with more restrictions and need to be paid daily or weekly compared to monthly or quarterly for a revenue-based loan.

Cheaper than VC: A revenue-based loan is often cheaper for founders than selling preferred equity to VCs. Founders may believe that traditional equity costs less with no expected payments until an exit, but a revenue-based loan is most likely cheaper over the long-run on both total dollar amount and IRR basis. Revenue-based investors cap their investment at a ~2x return instead of aiming for 10x+ returns like VCs.

Fundraising Optionality: Founders do not need to follow the VC funding path of raising larger follow-on rounds of dilutive equity capital. Revenue-based loans offer cheaper, non-dilutive growth capital that can enable businesses to scale and eventually raise VC funding or access cheaper bank debt. These loans provide founders the optionality to pursue the funding journey that makes the most sense for their business.

Access to Capital: Revenue-based loans are more accessible for underrepresented founders because the underwriting process is based on the company's revenue, margins, and other financials, not the owner's credit score, income, or personal real estate assets. Traditional debt financing continues to use outdated and discriminatory lending practices that limit access to capital and increase the cost of capital for underrepresented founders. Revenue-based loans have improved the investment process with a more inclusive underwriting approach.

Financing Options

Benefits	Bank Loan	Revenue Financing	Venture Capital
Retain Equity	✓	✓	
Maintain Control	✓	✓	
No Personal Guarantees		✓	✓
Flexible Repayments		✓	
Ease of Access to Capital		✓	
Large Funding Amounts		✓	✓

What should businesses *be aware of* with a revenue-based loan?

Less Predictable Payment Schedule: Revenue-based payments fluctuate with revenues, which can provide flexibility for founders but also be harder to predict for financial projections than traditional loans, with their fixed monthly payments. Revenue-based loans have a variable interest rate instead of a fixed interest rate.

More Expensive than Bank Loans: Most founders seek revenue-based loans because they cannot access bank loans or VC. Revenue-based loans usually cost between 10% and 20% IRR compared to bank loans at <10% IRR and VC at 50%+ IRR. If revenue grows quickly, then payments will also. This leads to a shorter payback period but also a higher cost of capital. Founders need to be comfortable with the fixed return cap or total payment, regardless of their revenue growth rate.

Gross Margins > % of Revenue: Founders need to be comfortable giving up the percentage of revenue to pay back the investment. Gross margins need to be sufficiently high enough to support the financing costs or else the investment will start to reduce the growth potential of the business.

Personal Guarantees & Collateral: It depends on the revenue-based lender, but founders may need personal guarantees and potentially pledges of personal collateral. However, revenue-based loans tend to have more founder-friendly terms than traditional bank loans.

MCA Disguised as RBF: There are a rising number of FinTech platforms and lenders that claim to make “revenue-based” investments for founders, but their products are closer in structure and costs to merchant cash advance (MCA). These FinTech platforms offer speed and access to capital for small businesses but can be misleading on the actual costs and financing terms for founders. Typically, these “revenue-based” products appear to be much cheaper than a revenue-based loan with return caps around 1.2x, but there is no grace period, and businesses are making daily or weekly payments instead of monthly or quarterly. The APR likely is 50%+ compared to revenue-based loans at up to 30% APR. Founders may end up taking on expensive debt that does not actually help them grow.

Benefits for Capital Providers

Why would fund managers *choose* to offer revenue-based loans?

Payment Flexibility:
Repayment flexibility can be a benefit for funders as well as for entrepreneurs. Affixing payments to revenue results in borrowers who are more likely to make their payments.

Liquidity:
RBF loans can provide consistent returns and liquidity with a lower risk profile for funders that do not want to spend all their time and energy searching for "unicorn" businesses.

Risk/Reward:
RBF represents a class of investment that typically offers greater returns than traditional debt financing but lower risk than VC investing, offering a potential sweet-spot of risk/reward.

Founder Alignment:
Greater alignment between entrepreneurs and RBF capital providers based on shared goals of revenue maximization and profitability can lead to potential for follow-on investments and cheaper debt capital.

What should capital providers *be aware of* with revenue-based loans?

- By fixing returns at a cap, RBF investors experience limited upside on their investments, potentially missing out on the exponential VC-like returns.
- Lack of collateral from RBF borrowers reduces the likelihood of capital providers collecting on nonperforming loans or bankruptcies.
- Lack of familiarity with RBF terms may keep entrepreneurs from applying for RBF funding.
- Accounting nuances: In US law, revenue-based loans are subject to 26 CFR 1.1275-4 - Contingent Payment Debt Instruments, thus requiring Noncontingent Bond Method (NBM) of accounting. The NBM accounting method when applied to early stage companies makes it likely that investors would have to pay income taxes before they receive income from the company, as the accounting method requires the investor to recognize the yet unrealized income, similar to bonds with an original investment discount (OID). Interest is not computed and paid in regular intervals or at least annually.

Terms

What do investors typically *charge* businesses for revenue-based loans?

Investment Size (Principal): Up to 1/3 of annual revenue or up to 3x monthly revenue (typically $50K to $3M check sizes) *This is the total amount invested in the round.*

Ownership (Equity): 0%

Percentage of Revenue (Payment): 2-5% (though it can go as high as 10%)
Revenue can be defined as Total Revenue (Gross Revenue), Net Revenue (Net Cash Receipts), or Revenue minus COGS (Gross Profit).

Return Cap (Total Payment): 1.5x to 2.5x principal

Payment Schedule: Monthly or quarterly

Grace Period: 0 to 12 months
This is the date founders will begin making revenue-based payments. These start dates can range widely given the intent of the founders and investors. Some investors might choose to set the start date to begin immediately, while others may set it at 12 months post-investment.

Maturity (Term): 3 to 5 years
This is the due date by which time the total payment (return cap) must be paid. If the company still owes capital at the due date, then investors typically have the option to either demand payment or to convert any unpaid capital into equity.

Equity Warrants: None

Personal Guarantee: None

Financial Reporting: The investor has access to the company's financial statements, including monthly balance sheet (plus YTD), monthly cash flow statements (plus YTD), monthly bank reconciliation report, monthly bank statements, and monthly compliance certification—certifying the information delivered.

Board Seats: None

FAQs

How expensive are revenue-based loans?

They are often cheaper than selling equity, but more expensive than bank loans. They typically cost 10-20% IRR compared to <10% for bank loans and 50%+ for VC. If founders can get access to a cheaper fixed-rate bank loan and are willing to secure the loan with personal guarantees and collateral, then they should take it.

What are the tax implications of revenue-based loans for investors?

A revenue-based loan is a debt product. Similar to traditional loans, taxable investors—including family offices and high net worth individuals—will have their gains taxed at their ordinary income rate, not the long-term capital gains rate.

If the company plans to raise more capital, there may be difficulty with S Corp and LLC business structures. LLCs take on the tax liability and collect 1099s annually. Investors have a strong preference for C Corps.

What are the legal considerations of revenue-based loans for investors?

There are potential usury law issues for revenue-based loans depending on the state jurisdiction.

Why would investors be interested in revenue-based loans?

RBI provides equity-like returns with better liquidity than traditional equity. Investors do not need to rely on an acquisition or public exit because of the self-liquidating returns for RBI. Founders pay back the investment from their company's revenues until reaching the return cap.

Revenue-Based Loan Case Studies

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Novel Co-Founders & Managing Partners:
Keith Harrington (left) and Carlos Antequera

Overview

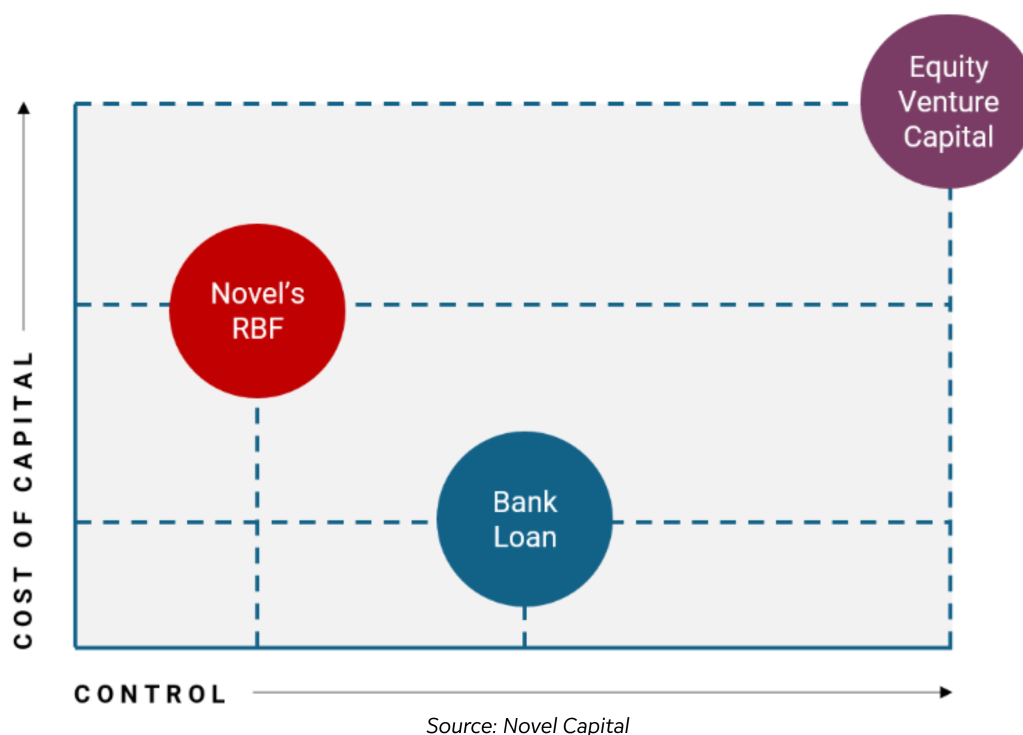
Novel Capital (Novel), formerly known as Novel Growth Partners, is an Overland Park, Kansas-based RBI platform that provides flexible financing to early-stage, B2B software companies in the Midwest. Novel provides companies up to $5M in revenue-based growth capital and leverages the operational expertise of its team to provide strategic planning, sales growth, and talent support to founders via its Revenue Acceleration Platform. Novel invests in entrepreneurs focused on growing revenue and building a near-term profitable company.

Novel, founded in 2017, closed its first fund at over $12M in 2019. Its co-founders are Keith Harrington, a former VC and Kauffman fellow, and Carlos Antequera, former CEO of education technology (EdTech) company Netchemia, acquired in 2015 by PeopleAdmin. The two wanted to bring the RBI model to the software space as an alternative to traditional VC for startups. The team has grown from the two founding partners at inception to 16 members as of March 2022.

In 2022, Novel closed $115M in equity and debt financing from investors including Community Investment Management, Nueterra Capital, and Tenzing.vc. The team decided to move away from the traditional GP/LP fund structure that they used for their first fund and scale their RBI platform with a debt facility. This Fintech platform approach, similar to Founders First Capital Partners, enables Novel to make more and larger revenue-based investments for entrepreneurs without continuously raising smaller funds from LPs.

Investment Strategy

Novel makes revenue-based loans in early-stage, B2B SaaS companies in the Midwest. Novel provides growth capital out of their fund and direct operational support for entrepreneurs from their Revenue Acceleration Platform. The team seeks companies with $500K+ annual revenues, 40%+ gross margin, and 30% year-over-year growth rate. Fund I will invest in 40-50 companies over its five-year investment period with an initial check size of $100K to $2M or up to 30% of a company's annual revenue with reserves for larger, follow-on investments. Novel is targeting a 25% gross IRR and 2.0 gross MOIC for the fund.



Source: Novel Capital

Revenue-Based Products: Based on their own entrepreneurial journeys and VC investment experience, Novel's founding partners knew the super-high growth and high failure rate of the traditional VC model overlooked a large number of entrepreneurs. They wanted to offer a different type of capital product that enabled them to help as many entrepreneurs scale their businesses as possible. Novel decided to use the RBF approach to serve as an alternative to traditional VC or bridge to the next round. Instead of buying equity and waiting for a public or M&A exit like the VC approach, Novel generates self-liquidating returns with a monthly revenue-based payment based on the company's sales. The company stops making revenue-based payments to Novel once it hits the return cap.

Novel offers two revenue-based capital products:

1. **RevShare Capital** is patient growth capital for companies with flexible payment options. It is designed for SaaS companies with a mix of recurring and nonrecurring revenue streams. Novel provides funding of up to 30% of a company's total annual revenue structured with 4% to 9% royalty of gross cash receipts, return cap of 1.2x to 1.9x, and six- to 60-month payment schedule. If the capital is paid back earlier, then a lower return cap is used.

2. **Upfront Capital** is essentially invoice factoring for companies that turns future subscription revenue into immediate capital to help fund short-term needs. Companies can trade up to 30% of their subscription revenue for capital. Novel makes Upfront Capital investments from $100K to $5M in exchange for a one-time upfront fee of 8% of the company's monthly contracts over a 12-month payment schedule. The cost of capital is an 18% APR. This RBF product is a good fit for subscription-based SaaS companies with recurring revenue streams.

Novel's RBF model produces faster growth funding for companies within two months compared to a traditional VC, which typically takes at least six months. However, they can partner with VCs and lenders if it makes sense for their companies.

RBI Product Terms

	RevShare Capital™	Upfront Capital™
Minimum Qualifications	Company with predictable revenue $500,000 in TTM revenue Revenue growth of 30% YoY	Company with predictable revenue $350,000 in ARR Revenue growth of 10%+ YoY
Revenue Model	Companies with a mix of recurring and non-recurring revenue	Subscription companies with recurring monthly, quarterly or yearly payments
Repayment Period	Variable 6-60 months	12 months
Available Funding	Up to 40% of your company's total annual revenue (both recurring and non-recurring)	Trade up to 40% of your subscription revenue for capital today
Payment Model	Variable monthly revenue share payment based on monthly gross cash receipts	Fixed monthly
Repayment	4% to 10% monthly revenue share, performance discounts and no early payoff penalties	Companies with monthly subscriptions: One-time fee of 8% of the annual value of contracts
Equity Share or Warrants	None required	None required
Personal Guarantees	Not required	Not required

Source: Novel Capital

Track Record

Novel Growth Partners Fund I (2017, $12M): Novel has fully invested the fund across 50+ portfolio companies as of Q1 2022.

Portfolio companies include:

ABODO (Madison, WI) delivers a new, better way to find apartments.

Branching Minds (NYC) is an EdTech company that helps teachers create personalized interventions for students.

DivvyHQ (Kansas City, MO) provides a content planning and production workflow tool for high-volume content teams.

Elevate K-12 (Chicago) is a live streaming learning system focused on impact and outcomes for K-12 students across the country.

Gremlin Social (St. Louis, MO) is an integrated social media solution for financial services companies.

MyMajors (Kansas City, MO) is an EdTech company that assists students in identifying a major, career, and college through student friendly assessment technology.

OpenReel (NYC) provides virtual production studio technology that allows teams to direct and capture 4K video remotely through a user's phone, replacing the need for a camera crew.

Passage (Detroit, MI) is an online and at-the-door provider of ticketing and payments for specialty events.

Precise Telehealth (Timonium, MD) is a MedTech company that provides telemedicine to patients with highly complex conditions or multiple comorbid chronic conditions.

Wisboo (Palo Alto, CA) provides an all-in-one solution for education businesses in Latin America to easily create a self-branded online academy.

Zype (NYC) empowers video operations teams to build DTC video streaming services across the web, mobile, connected TV, and social media.

More Reading & Listening

https://novelcapital.com/category/resources/

https://www.forbes.com/sites/lizengel/2019/12/10/revenue-based-financing-firm-will-increase-its-tech-investment-in-the-midwest/#355cf20f0838

https://podcasts.apple.com/us/podcast/pearls-of-potential-with-keith-harrington/id1468541404?i=1000502750082

https://www.youtube.com/watch?v=kesbLZVf2mU

https://www.bizjournals.com/kansascity/news/2022/03/17/novel-capital-raises-115m.html

https://news.crunchbase.com/news/novel-capital-capchase-pipe/

https://news.crunchbase.com/news/vc-equity-alternative-funding

For more tools and resources, visit innovative.finance/resources.

Overview

Sage Growth Capital (Sage) is a Boise-based RBI fund that provides flexible growth capital to companies throughout the United States.

Sage was founded in 2019 by Denise Dunlap, Molly Otter, and Kevin Learned. The three co-founders and partners bring private equity, revenue-based, and angel investment experience along with angel group administration. Dunlap and Learned have deep angel investor networks given their work at the Angel Capital Association (ACA) and Loon Creek Capital Group. Otter brings significant experience in the revenue-based space since she served as the CIO for five years at RBF lender Lighter Capital and is currently a member of their board.

In late 2019, Sage raised $2.1 million for their first fund primarily from local angel investors. In June 2022, they closed their second fund at $7.7 million.

Investment Strategy

Sage makes revenue-based investments in early- and growth-stage companies throughout the US. The team seeks companies with $300K+ annual revenues, 40%+ gross margin, and 25%+ growth rates. They wanted to provide a more flexible capital product for founders who did not fit traditional funding models, and increased options for liquidity for angel investor portfolios. Sage is industry agnostic and will invest in companies that have recurring or “recurring-like” revenue streams.

Fund I invested in seven companies over its two-year investment period, with two follow-on investments. As of June 2022, Fund II has invested in four companies. Sage will invest up to 1/3 of a company’s revenue over the previous 12 months. Check sizes range from $100K to $1M with reserves for larger, follow-on investments for companies who achieve their growth projections.

Revenue-Based Note: Sage offers a revenue-based investment product for growing businesses with the following terms.

Variable			
Amount of Investment	Revenue Rate	Investment Return	Time to Repayment
Typical Range			
up to 33% of previous annual revenue	3-8%	2X to 3X	3 to 5 years

Source: Sage Growth Capital

The “Revenue Rate” is the revenue share or percentage of the company’s cash receipts (i.e. customer payments) for monthly repayment. Sage charges between 3% and 8%.

The “Investment Return” is the return cap. Sage charges between 2x and 3x based on the risk profile of the company.

Additionally, Sage offers a grace period of up to three months and does not require personal guarantees or collateral for founders.

Track Record

Sage Growth Capital Fund I (2019, $2.1M) was fully invested across seven companies as of June 2022.

Portfolio companies include:

Killer Creamery (Meridian, ID) makes keto-friendly ice cream products.

Prosperity Organic Foods (Boise, ID) produces plant-based butter and cheese products for North America, South America, and Australia.

Unity Laundry Systems (Bedford, NH) produces essential and affordable appliances for the commercial laundry industry.

Refactr (Seattle, WA) is a DevSecOps software startup founded in 2017 by military veterans and industry experts in cloud and cybersecurity (paid off early).

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eTT Aviation (Boise, ID) is a software engineering company that provides airlines a fully automated and customizable air operations suite of tools (paid off early).

CPR Construction Cleaning (Gilbert, AZ) provides construction cleanup needs in every vertical of construction.

Native English Institute (Seattle, WA) is transforming language learning through a data-driven AI and natural language processing solution.

Sage Growth Capital Fund II (2022, $7.7M) has invested in four companies as of June 2022.

Portfolio companies include:

Unity Laundry Systems (Bedford, NH) produces essential and affordable appliances for the commercial laundry industry (follow on to Fund 1 investment).

Naked Sports (Vashon, WA) produces a line of high performance gear for outdoors endurance runners.

CyberReef (Shreveport, LA) SaaS mobile data bandwidth management and secure private networking software.

Mign (Charlotte, NC) builds personalized, digitally tailored medical wearables in the orthopedics field to enhance recovery of musculoskeletal injury.

Fund Structure & Terms

Fund I

Management Company: Sage Growth Capital, LLC (Idaho LLC)

Fund: Sage Growth Capital Fund I, LLC (Idaho LLC)

Fund Type: Rule 506(b)

GPs: Denise Dunlap, Molly Otter, and Kevin Learned

Terms

Fund Size: $2M

GP Commitment: 7.5% of fund size

Investment Period: 2 years

Fund Life: 7 years with 3 one-year extensions

Management Fee: 2% of distributions until 1x DPI; 0% thereafter

Carried Interest: 10%

Preferred Return: None

Key Persons: Denise Dunlap, Molly Otter, and Kevin Learned

Fund II

Management Company: Sage Growth Capital, LLC (Idaho LLC)

Fund: Sage Growth Capital Fund II, LLC (Idaho LLC)

Fund Type: Rule 506(b)

GPs: Denise Dunlap, Molly Otter, and Kevin Learned

Terms:

Fund Size: $7.7M

GP Commitment: 2.25% of fund size

Investment Period: 3 years

Fund Life: 7 years with 3 one-year extensions

Management Fee: 2% of committed capital

Carried Interest: 20%

Preferred Return: None

Key Persons: Denise Dunlap, Molly Otter, and Kevin Learned

More Reading & Listening

Sage Advice: The True Cost of Equity Webinar
Game Changers Podcast: Show Me the Startup Money!
The Angel Next Door Podcast
Angel Capital Association Webinar: Revenue Based Finance, Another Option for Angel Investors

For more tools and resources, visit innovative.finance/resources.

Overview

OnShore Technology Group (OnShore) is an independent Chicago-based consultancy founded in 2004 specializing in Independent Validation and Verification (IV&V) software services and solutions for the life science industry.

Why a Revenue-Based Loan?

Founder & CEO Valarie King-Bailey wanted to take the company from a core service-based business to a tech-enabled, service-based business. She had taken on small amounts of traditional debt, like a bank line of credit and MCA, but needed a better financing solution to help the company grow.

King-Bailey joined the 2020 May FastPath cohort at Founders First. Her company received a $250K revenue-based loan from Founders First in September 2020, along with a coinvestment from revenue-based lender Novel Capital, and leveraged that investment to raise another $250K follow-on investment from Founders First in July 2021. The $500K in growth capital enabled her to add five new team members, expand marketing, and increase annual revenue by 53% to $3.8M. Additionally, OnShore was able to expand her team and build her own proprietary technology platform. The revenue-based funding unlocked meaningful growth for the company, and King-Bailey did not have to give up any of her ownership.

Founders First still provides post-funding advisory support as the company continues to scale to $10M+ in annual revenue.

Deal Terms & Performance

As of Q3 2021, OnShore has consistently made monthly revenue-based payments to Founders First post-investment and paid nearly 25% of the return cap or loan obligation. The revenue-based payments have exceeded expectations based on the 1.43x return cap ($715K total obligation).