Profit Share

TL;DR

Profit sharing is a flexible funding model with payments tied to a percentage of profits instead of an interest rate.

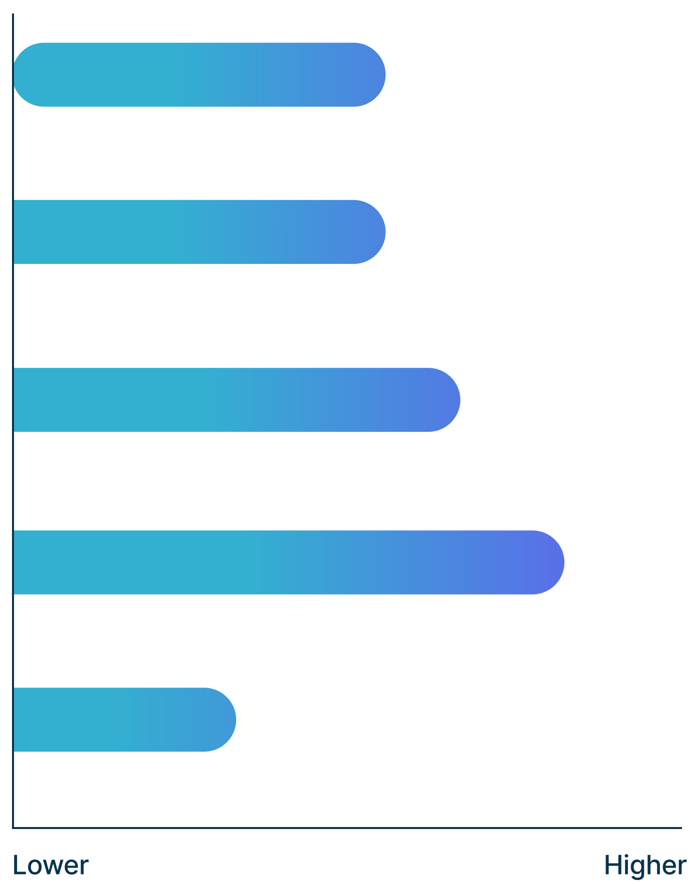
Business stage supported
Ranging from pre-revenue/idea stage businesses (low) to mature stage/ acquisition stage businesses (high)

Cost to entrepreneur
An approximate measure of the blended short and long term costs a business may incur as a result of this capital type

Risk for investors
Representing the downside risk in worst case scenarios of default on repayment obligations

Potential return for investors
The greatest potential income an investor capital provider could earn by deploying funds with this product method

Liquidity for investors
Ranging from lowest liquidity (capital providers wait a while to receive repayment from their investment) to high liquidity (repayment begins immediately and is fully repaid quickly)



What is profit sharing?

Profit sharing is a flexible capital product with no fixed interest rate. Profit sharing investors give a company growth capital in exchange for a percentage of the company's ongoing profits. Similar to traditional debt financing, investors collect monthly or quarterly payments. Rather than payments set at an interest rate, profit-based payments are flexible because they fluctuate with profits. If profits slow down, then the payments will be lower; if the profits are 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 or personal guarantees for profit sharing because its profits are essentially collateral.

Similar to revenue-based financing, profit sharing blends features of debt and venture capital, and founders should expect the cost of capital to fall within that range. Profit sharing represents non- or less-dilutive growth capital to bridge the path to sustainable profitability for growing businesses that do not fit the VC model.

The Income Share Agreement (ISA), like the Convertible Income Share Agreement (CISA) created by Chisos Capital, is much closer to profit sharing than revenue-based financing, with the caveat that it more directly relies on founder income rather than business profitability. Another innovative capital product, the Shared Earnings Agreement (SEAL) created by Calm Company Fund, blends features of both profit and income sharing.

Profit sharing is not a novel idea and historically was used to invest in companies with predictable cash flow and high profit margins in the media, entertainment, food & beverage, and restaurant industries. Recently, profit sharing has been adopted by a small number of early-stage investors looking to provide optionality and allow founders to maintain control as they build sustainable and profitable companies over the long term.

What are the typical characteristics of profit sharing?

- Structured as a convertible note or debt
- Quarterly or biannual payments equal a set percentage of profits (typically 10-30%)
- Payments start following a grace period of 6-12 months
- Payments continue until a set dollar amount has been paid back, usually 2-10x the amount of the financing (this multiple is called the "cap")
- At maturity, which is typically 7-10 years, any unpaid amount of the cap is due
- No collateral or restrictive covenants

Capital Product Fit

When is profit sharing a ***good*** fit for businesses?

Profitability: Businesses do not need to be profitable, but investors like to see a path to profitability within three 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%+

Net Margins: 40%+

Exit Value: $50M+ business within 10 years

Financials: 1+ years of financial statements

When is profit sharing ***not*** a fit for businesses?

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

No Revenue: If a business does not have any revenue, then it is difficult for an 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. Profit share 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* profit sharing?

Less-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: Profit sharing provides more flexible payment terms based on a percentage of net income, rather than term loans with fixed payments that do not fluctuate with net income. Payments scale up and down along with net income growth.

No Restrictive Covenants: Unlike traditional bank loans, profit sharing investments 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. Factoring or merchant cash advances also come with more restrictions and need to be paid daily or weekly compared to monthly or quarterly for profit sharing.

Cheaper than VC: Profit sharing 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 profit sharing is most likely cheaper over the long-run on both total dollar amount and IRR basis. Profit share investors cap their investment at a 2-5x return instead of aiming for 10x+ returns like VCs. Also, profit sharing enables startups to leverage more of the investment capital to scale during the early years than RBI. Depending on the grace period, revenue-based products typically require faster and larger repayments upfront than profit sharing since they are linked to top-line revenue and do not factor profitability into the deal terms.

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

Access to Capital: Profit sharing is 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. Profit sharing has improved the investment process with a more inclusive underwriting approach.

What should businesses *look out for* with profit sharing?

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

More Expensive than Bank Loans: Most founders seek profit sharing investments because they cannot access bank loans or VC. Profit sharing usually costs between 15% and 30% IRR compared to bank loans at <10% IRR and VC at 50%+ IRR. If net income grows quickly, then payments will also do so. 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 net income growth rate.

Net Margins > % of Profits: Founders need to be comfortable giving up the percentage of net income to pay back the investment. Net 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.

Equity Warrants: It depends on the investor, but founders may need to agree to equity warrants in addition to the profit sharing. The equity warrants provide upside participation for investors and are typically tied to hitting revenue and/or net income milestones and exit scenarios. Profit sharing with equity warrants will drive up the cost of capital for founders, but it will likely remain cheaper than traditional equity and tends to have more founder-friendly terms than bank loans or venture debt.

Further Down the Income Statement than RBI: Profit sharing can lead to more potential conflicts of interest between investors and founders than RBI. Net income is further down the income statement than revenue, which means more line items that impact the repayment amount to investors. Gross revenue is an easier, top-line metric to measure and track than bottom-line net income. There needs to be an ever greater level of transparency and trust between investors and founders.

Terms

What do investors typically *charge* businesses for profit sharing?

Investment Size: up to 1/3 of ARR rate (typically $25K to $3M check sizes)

Initial Ownership (Equity): 0%	**Percentage of Net Income (Payment):** 10-30%

Return Cap (Total Payment): 2-10x

Payment Schedule: Quarterly or bi-annually

Grace Period: 6 to 12 months
This is the date founders will begin making profit-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.

Equity Warrants: Up to 15% ownership based on predetermined milestones

Personal Guarantee: None

Financial Reporting: The investor has financial data 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 is profit sharing?

It is often cheaper than selling equity but more expensive than bank loans. They typically cost 15% to 30% IRR compared to <10% for bank loans and 50%+ for VC. However, profit sharing can be as expensive as traditional equity if the founder chooses to raise follow-on VC funding, triggering the conversion of any outstanding debt to equity. 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 profit sharing for investors?

Profit sharing instruments like SPACE, SEAL, and CISA are structured as a convertible note with a mix of debt and equity-like features. Unlike traditional debt, they do not have a fixed repayment schedule, maturity date, or personal guarantee. These innovative capital products are structured as equity, which means taxable LPs will likely have their investment returns taxed at the capital gains rate. However, royalty-like, profit sharing products without a convertible equity mechanism likely fall into the debt category where returns will be taxed at the ordinary income rate.

Why would investors be interested in profit sharing?

Profit sharing 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 profit sharing. Founders pay back the investment from their company's net income until reaching the return cap.

Profit Share Case Study

collab

Collab Managing Partners: Justin Dawkins, Jewel Burks, and Barry Givens (left to right)

Overview

Collab Capital (Collab) is an Atlanta-based, early-stage investment firm backing Black founders building innovative, high-growth companies. Collab was founded in 2019 by Managing Partners Jewel Burks, Justin Dawkins, and Barry Givens, who bring a complementary mix of entrepreneurial, operating, and technical backgrounds. Jewel was the CEO and founder of Partpic, a computer vision startup that made it easier to find industrial parts; she sold it to Amazon in late 2016 before becoming the US Head of Google for Startups. Barry founded and developed Monsieur, an automated bartender startup, before licensing his IP and leading Techstars as the managing director for its social impact accelerator. Justin is a 20-year software developer and co-founder of Goodie Nation, the entrepreneur development program focused on social good.

In May 2021, they successfully closed their oversubscribed first fund at $51M with the support of 99 LPs, including the Mellon Foundation, Capital Access Lab, Goldman Sachs, Mailchimp, Bank of America, Google, Apple, Foot Locker, PayPal, and Carta Ventures.

Investment Strategy

Collab makes early-stage investments in Black-owned companies in the US Collab creates growth opportunities for its companies by connecting founders to growth partners with industry expertise or social capital. The team seeks companies that have a viable path to annual revenues above $1M within one year of their investment and $10M within three years at 40%+ profit margins. The fund will invest in 50 companies over its five-year investment period with an initial check size of $500K to $1M, with the remaining 30% of the fund reserved for follow-on checks of up to $2M. Collab is targeting a 30% gross IRR and 3.0 gross MOIC for the fund.

Collab aims to close the market gap for Black founders who lack the assets to receive traditional lending, lack access to personal, friends, and family capital, and do not fit into the traditional VC investment criteria. Their mission is to create, grow, and sustain wealth in the Black community by investing in and building technology-enabled companies through the development of connections between Black innovators, investors, and influencers.

Collab invests in the top 25 American cities with a high concentration of Black entrepreneurs and a low concentration of risk capital. Their target city list includes Atlanta, Charlotte, Chicago, D.C., Detroit, Houston, Miami, New Orleans, St. Louis, and other cities that fall outside of the most venture funded regions such as the Bay Area, NYC, and Boston.

Collab backs technology-enabled products and services across the following three themes: future of work, future of learning, and future of care. They selected these as themes of interest based on where they believed the team and influencers can make the most impact. However, Collab will also consider companies that may not perfectly fit into these categories. They will not invest in biotechnology, cannabis and tobacco, cryptocurrency and tokens, food and beverage, gambling, liquor and spirits, professional services agencies, and real estate industries.

SPACE

Collab created a novel profit share funding approach called the “Shared Profits and Collaborative Endorsement” (SPACE) agreement that they wished existed when they were raising capital as founders. Collab believes the “binary construction of venture leaves too much value on the table and has the potential to destroy businesses that would otherwise be solid, ‘calm’ businesses.” They want to increase the odds of success for their founders by offering optionality and flexibility baked into the SPACE agreement for their fundraising journey.

The traditional VC model expects at least 80% of their portfolio companies to fail and a couple 10x+ outcomes to generate 3x+ returns for LPs, but Collab wants the majority of their portfolio to become “sustainable, profitable businesses with tens of millions in annual revenue and double-digit year-over-year growth—businesses that create jobs in predominantly Black communities and that founders can pass down to their children.”

Collab expects to generate venture-like returns with a more founder-friendly, resilient portfolio construction approach with self-liquidating, profit share instruments. Pre-investment, Collab works with founders to agree on key success metrics and then identifies a team of influencers, advisors, and service providers to work with the founders. Post-investment, the manager executes on its growth plans to add customers while focusing on profitability.

For their SPACE term sheet, Collab makes investments structured with a profit share and an equity target. Collab starts the 20% to 25% profit share at the predetermined revenue target that produces enough profit to sustain the optimal late-stage operational structure. Collab reserves the right to defer profit share payments and will do that when they believe the money would be better used going back into the business.

Collab also targets a 10% to 15% equity stake, agreed upon with companies pre-investment, to protect their upside for potential exits like acquisitions and IPOs. Companies have the option to redeem or buy back up to 10% of the equity target as the companies return multiples to the fund. For example, if a company has returned 3x the initial investment via profit share payments, it can redeem 3% of the total 15% equity target.

For each SPACE deal, Collab uses a SPV to make an investment into the portfolio company. They cap the growth partner equity stake at one-third of each SPV's ownership in a portfolio company. For example, if Collab has 15% equity in a company, then growth partners can receive up to 5% equity and up to one-third of Collab's profit share rights in the company.

Collab's target SPV structure typically looks like the following:

- **10% to 12% Collab equity target:** The fund will provide all of the capital for each investment with an initial check size of $500K to $1M with reserves up to $2M.

- **1% to 3% Growth Partner equity target:** The Growth Partner(s) will be selected and compensated based on their ability to help the company grow efficiently and rapidly. These partners will commit to specific actions as corporate partners, industry advisors, industry experts, and/or social influencers. The percentage of equity per partner will be determined by factors such as decision-making power, depth of influence on the company's target audience, and time commitment available. Collab manages a performance-based vesting schedule with the Growth Partners.

Here are two SPACE deal examples:

VC Pathway: Collab invests $500K for a 10% target ownership in Company A. They work with the business over the course of a year and see that it is growing 30% month-over-month and is attracting attention of Series A investors. After the first year, Collab determines the business needs more money to continue to grow marketing spend and add more team members. This is a perfect case to continue on the venture path, and in this case they will help the founders raise the next round and then convert into 10% ownership before dilution. In this deal example, Collab operates similarly to a traditional pre-seed VC.

Profit Share Pathway: Collab invests $500K for a 10% target ownership in Company B. They work with the business over the course of the year and see that it is growing steadily, but at 10% month-over-month. The founder is able to keep costs low, and the company's Growth Partner has helped them crack the code on organic growth methods. As Collab learns more about the industry the business is operating in, they see that the opportunity is more narrow than originally thought, and instead of the $30B TAM originally forecast, the market opportunity is more likely less than $1B. Collab and the founder come to a collective decision that it doesn't make sense to raise another round of funding, but instead they should focus on continuing to grow revenue and increase profitability.

Under this scenario, Collab begins a profit share at the point the business is sustainably profitable, meaning it can pay its employees at full salaries and has built up the proper infrastructure. The profit share allows Collab to generate returns on its investment and allows for the founder to redeem his or her equity. For every multiple on investment returned, Collab's equity target goes down by 1 percentage point, until reaching an agreed upon ownership floor across an agreed upon period of time.

Track Record

Collab Fund I (2020, $51M): Collab has invested $15M+ in 24 portfolio companies and made three follow-on investments through June 2022. Collab has made 10 SPACE deals out of the 27 total investments with the remaining deals structured as SAFEs, convertible notes, or equity.

Portfolio companies include (six out of 11 are SPACE deals):

BrightUp (Boston) is an emotionally intelligent financial wellness benefit provider that believes that how people feel about themselves affects how they treat themselves—particularly when finances are involved. They provide a full suite of financial wellness tools, rooted in an uplifting mobile experience. BrightUp's flagship offering is a low-cost loan that is repaid through paycheck deductions.

Boost (Oakland, CA + Detroit, MI) is the Quickbooks for Gen Z side-hustlers. Boost is a platform that combines personal finance, SMB accounting, and business management in a brand-forward, mobile-first experience designed for a fast-growing, yet underserved Gen Z market.

FanFest (NYC) is a platform for creators to host live shows with fans from their website where they can invite anyone, sell anything, and stream anywhere.

Hairbrella (Atlanta) is a reinvented rain hat that combines fashion and function to keep hair dry and style protected no matter the elements.

Healthy Hip Hop (Atlanta) is a platform that infuses technology, music, literacy, and cultural competency to improve student-learning environments and increase classroom engagement.

Jax Rideshare Rentals (Atlanta) is a car rental platform that services rideshare gig workers. By providing tailored benefits and increased flexibility, Jax takes an innovative approach to car rentals and is poised to fill a major gap in the nearly $500B gig economy market.

Music Tech Works (Atlanta) is a B2B SaaS and machine learning company solving the challenge of music licensing in content creation across film, TV, and social media.

Please Assist Me (Washington) is an all-in-one home management service for apartment complexes.

Revry (Los Angeles) is the premier streaming network for the world's LGBTQ+ community.

Safer Management (Dallas) is a software company that accurately tracks student attendance data with the power of AI and Machine Learning. Safer's mission is to provide schools, districts, and states with an accurate and complete picture of student attendance data.

Stack Influence (Miami) is a micro-influencer platform that facilitates user-generated promotional marketing campaigns. Their community of over 50K managed micro influencers are compensated with only products that match their profile and interests.

Fund Structure

Management Company: Collab Capital, LLC (Georgia LLC)

GP Vehicle: Collab GM, LLC (Georgia LLC)

Fund: Collab Fund I, LLC (Georgia LLC)

Fund Type: 506(b)

SPACE SPVs: Each Collab SPACE investment is done through a separate LLC (SPV) managed by the fund. Each member of the SPV is given a percentage of the new Collab SPV based on dollar commitments. Once payouts begin, the company will pay into the respective Collab SPV and then those proceeds will be distributed pro-rata to the members of that Collab SPV. The Collab Fund I portion will deposit into the dividend pool for the LPs of the fund. The fund manager will make quarterly distributions to LPs. Follow-on investments are made through the same Collab SPV.

GPs: Jewel Burks, Barry Givens, and Justin Dawkins

Fund Terms

Fund Size: $51M

GP Commitment: 2% of fund size

Investment Period: 5 years

Fund Life: 10 years with up to 3 one-year extensions

Management Fee: 2% of committed capital

Carried Interest: 20%

Preferred Return: 8%

Key Persons: Jewel Burks, Barry Givens, and Justin Dawkins