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An Introduction to Revenue Participation Financing

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Revenue Participation: The Concept

In a ***Revenue Participation financing*** a business (Newco) offers an investor (Investor) a percentage of Newco's future gross revenues in exchange for a capital investment. In its simplest form, Newco offers to give Investor y% of future gross revenues until such time as Investor has been paid "x" times the amount of capital invested. So, for example, in exchange for $100,000 of capital, Newco could agree to pay Investor 20% of future gross revenues until Newco has paid Investor 3x the $100,000 capital investment, or $300,000.

Foundational Issues of Revenue Participation Financing

Unlike a traditional risk capital equity investment, the Investor in a Revenue Participation financing does not thereby become an equity stakeholder in Newco. Nor does the Investor become a creditor in the traditional sense: that is, there is no promise by Newco to "pay back" Investor except to the extent Newco achieves gross revenues sufficient to fund the revenue participation promise. That said, and as will be further discussed below, in any particular Revenue Participation transaction the parties may negotiate terms that in effect give the parties some of the rights and obligations they might typically have in a more traditional equity or debt investment transaction.

Typical Candidates for Revenue Participation Financing

Candidates for Revenue Participation financing typically share three key characteristics: high gross margin, relatively predictable and near-term revenue streams. They are typically expansion stage firms. Thus, most high impact startups, and even later stage companies without established revenue streams, are much more likely to seek venture capital or other high risk equity investment, while well established companies with hard assets, a strong earnings history and modest growth objectives will often qualify for more traditional and cheaper debt financings.

Some Finer Points of Revenue Participation Financing

The "simple" Revenue Participation transaction – as for the earlier example where Investor provided Newco with $100,000 in exchange for Newco's promise to pay Investor 20% of future gross revenue until Investor had been paid $300,000 – is subject to numerous permutations. For example, the gross dollar return can be varied depending on how long it takes to achieve that return (e.g. in the simple example the required return could go up based on the time needed to achieve the return). One could indeed pick a desired compounded annual return target and fine tune the required return multiple to rise over time so that the targeted return rate is hit when the designated return in dollars is achieved.

Some Key Contractual Considerations for Revenue Participation Financing

While a Revenue Participation financing is a substantially different animal than a typical venture capital equity financing involving convertible preferred stock, an investor in a Revenue Participation financing will have several of the same concerns, in terms of monitoring the business and in some circumstances limiting the management prerogatives of the owners of the business. At a minimum the Revenue Participation investor will want information, including accounting information, sufficient to ensure that the business is properly recording and

distributing revenue. Revenue Participation investors may look for venture-capital like board representation as well, and similarly will look for many of the same protective covenants that venture investors in traditional convertible preferred financings typically seek. Indeed, a Revenue Participation investor might reasonably seek redemption like features, including change of control provisions, that some venture investors seek in appropriate circumstances. Finally, Revenue Participation deals can include subsidiary agreements common in venture transactions, for example voting agreements that promote stable management teams and policies.

Revenue Participation: Some Words of Caution

Revenue Participation financing can be very attractive for investors and businesses alike – *when the business fits the Revenue Participation paradigm of relatively predictable (timing and magnitude) high gross margin revenues*. Most companies that are good candidates for venture capital investment don't fit that paradigm, and investors and entrepreneurs alike should be careful not to let the attractions of the Revenue Participation – primarily a first call on revenues and "promised" return multiple/rate for the investor; primarily the lack of any equity interest and related pressure for an "exit" event for the entrepreneur – color their analysis of the future performance of the business in terms of size, magnitude and timing of future high margin revenues. Yes, as discussed, Revenue Participation investors can build in some of the downside protections found in more aggressive convertible preferred venture capital financings. In almost 30 years in and around the high impact entrepreneurship and venture capital space, however, I have yet to meet a venture capitalist (or a counterpart entrepreneur) who considered an investment where those protections kicked in an investment they would want to do again. I very much doubt I will ever meet a Revenue Participation investor who, in similar circumstances, would not share the venture capitalist's pain.

Finally, while a well-structured Revenue Participation financing can be fair and equitable to investor and business alike, these transactions are, like pretty much all investment transactions, including the ubiquitous convertible preferred stock financing, subject to abuse. Entrepreneurs, particularly, but even investors less experienced with Revenue Participation transactions, should look for advice from counsel familiar with the ins and outs of Revenue Participation investments before they settle on a term sheet, much less prepare final documents.

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