REVENUE CAPITAL

A GUIDE TO THE UNDERSTANDING, PROMOTION, AND IMPLEMENTATION OF REVENUE-BASED FINANCE FOR FAST-GROWTH SMES IN THE MIDDLE EAST AND NORTH AFRICA

Asia & Middle East Economic Growth Best Practices Program
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ACRONYMS

BPI	Business Partners International
BPL	Business Partners Ltd.
DFI	development financial institution
IPO	initial public offering
IRR	internal rate of return
M&A	mergers or acquisitions
MENA	Middle East and North Africa
NGO	nongovernmental organization
PE	private equity
RC	revenue capital
SA	*Société Anonyme*
SARL	*Societe a responsibilite limitee*
SLI	shareholder loan investment
SME, SMEs	small or medium-sized enterprise, small and medium-sized enterprises
USAID	U.S. Agency for International Development
VC	venture capital

EXECUTIVE SUMMARY

The purpose of this document is to Guide the reader through an incrementally deeper understanding of a type of finance that is being called by many "revenue capital." Revenue capital, or RC, is proposed as another useful tool with the potential to support the growth of small- and medium-sized enterprises (SMEs). The Guide is organized as a series of questions posed in what we hope is a logical sequence, answered in language that is familiar to nonfinancial development professionals, and persuasive to persons working in the financial sector.

The Guide is above all intended to answer a single question often posed in the Middle East/ North Africa (MENA) region: How do we provide access to finance to high-potential SMEs that either have insufficient collateral to obtain a bank loan nor are appropriate candidates for private equity or venture capital (VC)? This is a crucial question for economic growth efforts in all developing and emerging markets. It is particularly significant for MENA's SME sector, given the low level of SMEs' use of banks for business financing and the strong bias of private equity funds in the region toward larger investments.

RC is particularly well suited to established, if often young, SMEs having an identified opportunity to expand. The Guide explains why such businesses need "risk capital" to realize their expansion opportunities. It also explains how risk capital funds can reach far more expansion-ready SMEs by shifting the focus of risk capital from capital gains on equity participations to participations in revenues.

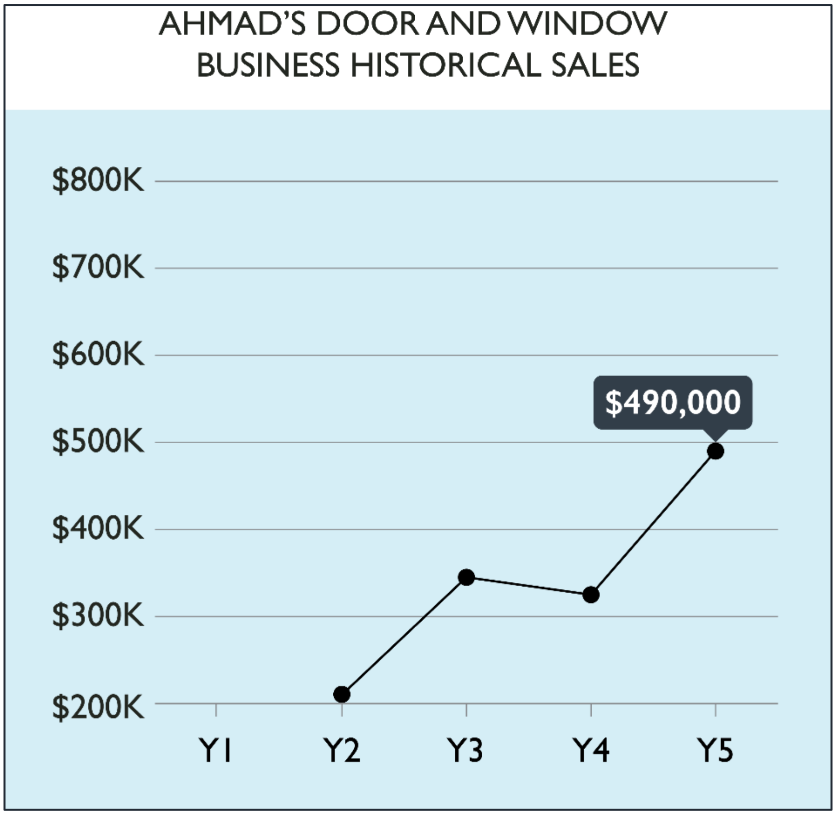
There are few practitioners of RC in emerging and developing markets that have been using RC long enough for us to quantify RC's performance as an asset class. Nonetheless, RC to date provides sufficient logic and evidence to suggest that it deserves attention as a response to the question "What is there between highly collateralized bank loans and the relatively miniscule amount of VC and private equity available to promising SMEs?"

THE STORY OF AHMAD

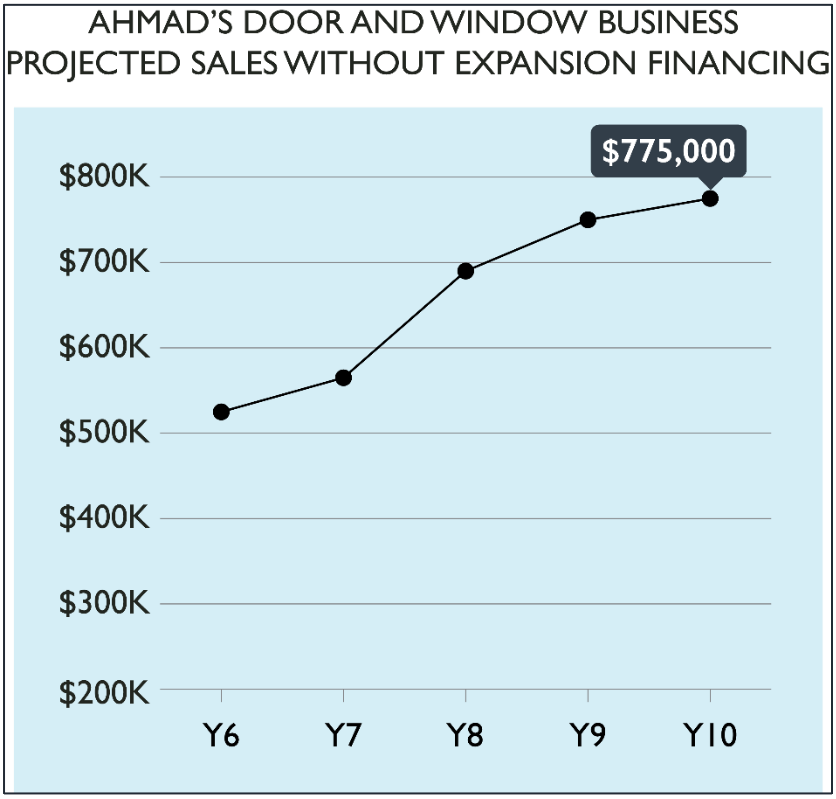
This is Ahmad. He is a small business owner. Although his business is small, they are experiencing growth that will soon bring them to a medium size.

His business makes door and window frames for houses and small commercial buildings - mostly from aluminum but also from poly-viynl chloride.

Ahmad's business has been in operations for 5 years. These are his sales figures from the past 5 years.



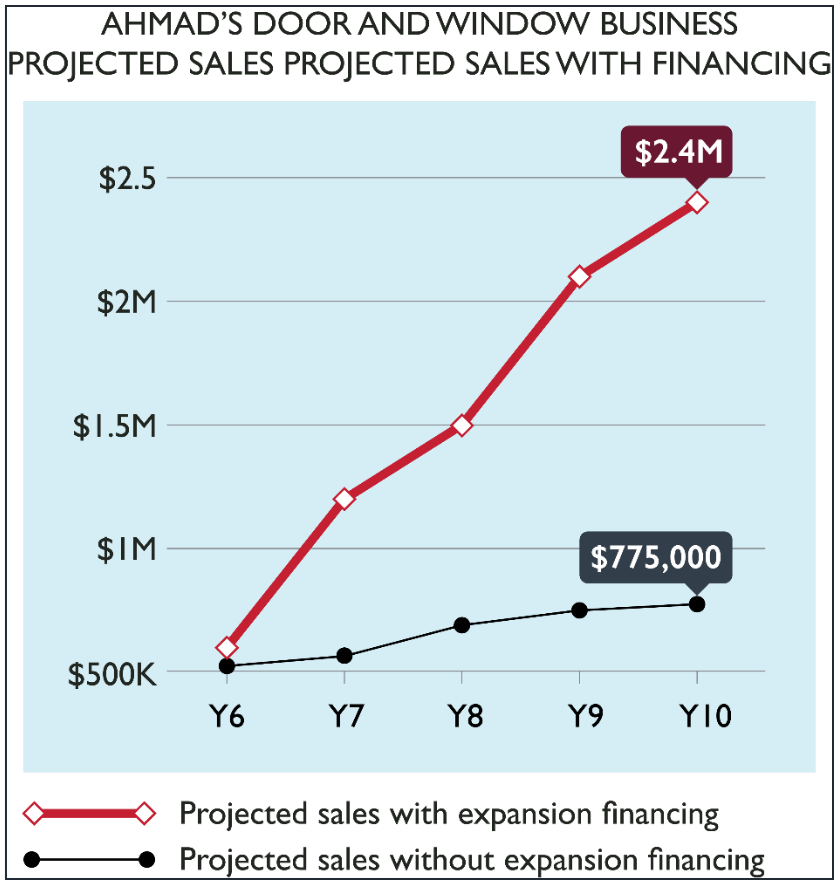
These are his projected sales figures for the next 5 years.



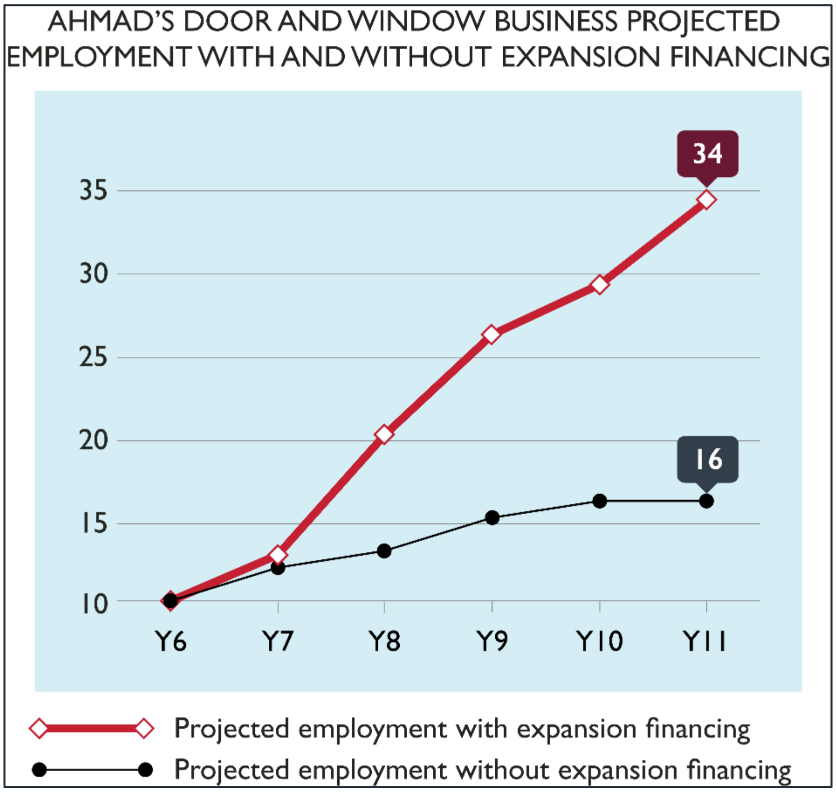
The Opportunity:

Ahmad's business has been presented with a very promising opportunity to make door and window frames for a new apartment development going up next year.

In order for Ahmad's business to fulfill the contract, and take on other big opportunities, he needs US$5,000 for new equipment and working capital. If his business were able to capitalize on this opportunity and finance the expansion, these would be their new sales projections for the next 5 years.



If Ahmad can get the expansion financing he needs, his business will also be able to create more new, skilled jobs for people inhis community.



The Problem:

Ahmad and his team have prepared applications to several banks for the US$500,000 he needs. Unfortunately, he hase been turned down repeatedly because he does not have enough collateral to offer.

As an alternative, Ahmad went to the only private equity fund he could find that makes investments under US$2,000,000.

Ahamd was told that his business (1) was not big enough, (2) was not a technology company and therefore outside of the scope of the fund, and (3) would have to sold to another business or investors be a good investment.

How will Ahmad be able to take advantage of this growth opportunity without access to bank or private equity financing?

INTRODUCTION

More than 30 years of data collected globally show that 4 to 8 percent of formal businesses create 70 to 100 percent of net new jobs[1]. Known to economists as "gazelles," this small percentage of businesses are those whose revenues grow 20 percent or more for four consecutive years or 30 percent per annum over three consecutive years[2]. It is common for these high-impact, fast-growth businesses to be small and medium-sized enterprises (SMEs) depending on the formal definition of an SME that varies by country. Ahmad's business could be a fast-growth gazelle — if he could access the investment he needs to seize his opportunity.

The Middle East/North Africa (MENA) region has an urgent need to focus attention and resources on those SMEs with the potential to produce sustained high-revenue growth. These are SMEs with identified opportunities to expand — SMEs, for example, that are poised to:

- Move from a domestic market to an export market, regional, or beyond
- Take market share away from imports by offering equal quality at a lower price
- Grow from a single store to a group of stores
- Take advantage of new technologies to create a new market
- Close a contract to provide goods or services to a large multinational corporation
- Close a contract with large local firms in growing markets

But potential fast-growth SMEs, and SMEs in general, are not well served by MENA's financial sector. As seen in the table below with data from the latest World Bank Enterprise Survey[3] of businesses having 20 – 99 employees, only 25.6 percent of firms in the MENA region have a bank loan and collateral requirements average to over 200 percent. Additionally, 35 percent of businesses in the MENA region identify lack of access to finance as a constraint. The need for increased access to credit is glaring for firms of all-sizes, particularly those who have the potential to drive significant economic growth.

Economy	% of firms with bank loan/line of credit	% of loans requiring collateral	Value of collateral (% of loan amount)
Egypt	6	92.4	272.5
Iraq	3.8	49.5	158.8
Jordan	16.7	89.6	127
Lebanon	57.3	68.7	207.7
Morocco	51.9	84	165.7
Tunisia	53.6	87	251.5
West Bank and Gaza	6	67.5	130.8
MENA Average	25.6	79	202.6

[1] https://www.infodev.org/infodev-files/growth_entrepreneurship_in_developing_countries_-_a_preliminary_literature_review_-_february_2016_-_infodev.pdf
[2] https://www.oecd.org/std/business-stats/39639605.pdf
[3] http://www.enterprisesurveys.org/

The problem is not simply an "SME finance gap" but rather a "financial instrument gap." The average bank loan for an SME in the region requires collateral equal to more than 200 percent of the amount of the loan. Venture capital (VC) and private equity (PE) are so rare at smaller levels that they have no appreciable systemic value for the SME sector. For expansion-ready SMEs in MENA, there is virtually no widely available type of growth financing offered within the broad gap between bank financing and conventional PE.

Revenue capital (RC) has the potential to fill this instrument gap for many fast-growth businesses. It is a hybrid of banking and private equity, taking more risk than the former and less risk than the latter. It is not the answer to the lack of access to finance in the SME sector in general, but it can be the answer to the investment needs of many of the most valuable businesses in the SME sector — among them, those that create more and better jobs more quickly, those most likely to export or substitute for imports, and those that most rapidly generate new economic activity.

RC is a form of "risk capital" that dispenses with the 100 percent collateral requirement imposed by banks and the "exit" dilemma intrinsic to PE while participating in the growth of the SME investee. RC *reduces* the risk of the investor, *rewards* the entrepreneur whose hard work creates an expansion opportunity, and *realigns* the interests of both the investor and the investee by focusing both parties intensely on increasing revenues as opposed to share value.

With the goal of increasing the use of RC in the MENA region and beyond, this Guide attempts to pose the principal questions raised by RC and answer them for a broad audience, including development professionals who work outside the financial sector as well as financial professionals unfamiliar with this innovative form of finance.

1 - WHY SMES?

THE SIMPLE REASONS FOR SME INTERVENTIONS

Three questions lead us to understand that special attention to SMEs as a segment of the private sector should be a high priority in efforts to grow free-market economies:

1. **Where do the large firms that drive economies come from?**
2. **How does a country diversify its economy?**
3. **Which group of businesses, by size and degree of development, have the greatest incentive to insist on policy reforms and accountable, transparent government?**

When we pose these questions in the context of the MENA region, particularly within the context of interventions related to access to finance, the need for innovative and demand-driven, SME-specific programs appears all-the-more urgent.

2 - WHAT CONSTRAINTS DO SMES FACE IN MENA?

SMES IN MENA RESPOND IN THE WORLD BANK ENTERPRISE SURVEYS

The data below, selected from the most recent of the World Bank's Enterprise Surveys, show how businesses in MENA countries where USAID operates, specifically SMEs with 20 to 99 employees, view an array of issues in the business environment.

Table 1: Selected Indicators of the Business Environment for SMEs[4]

Selected Indicators	MENA Region	Egypt (2013)	Iraq (2011)	Jordan	Lebanon (2013)	Morocco (2013)	Syria (2009)	Tunisia (2013)	West Bank Gaza (2013)	Yemen (2013)	Avg. of MENA Countries
Corruption (public sector transactions)											
Experienced at least 1 bribery payment request	25	17	37	13	19	37	70	10	7	64	29
Expected to give gifts to officials "to get things done"	22	29	32	8	21	16	84	6	7	55	25
Identify corruption as a major constraint	55	60	62	21	61	53	67	36	50	97	50
Identify court system as a major constraint	15	6	14	8	9	28	61	3	17	41	20
Infrastructure											
Identify transportation as a major constraint	23	17	40	6	15	27	56	8	34	34	24
Identify electricity as a major constraint	43	40	54	8	55	24	58	9	54	77	38
Losses due to electrical outages (% annual sales)	7	6	6	0	7	0	n.a.	0	6	16	4
Regulations and Taxes											
Senior management time dealing with regulations (%)	9	3	7	5	4	5	12	46	4	2	9
Identify tax rates as a major constraint	32	21	40	28	27	32	43	16	35	39	29
Identify tax administration as a major constraint	21	16	30	13	14	25	51	14	24	33	23
Identify licensing and permits as a major constraint	16	18	40	11	7	14	42	3	27	26	19

The above issues are typical of the kinds of constraints to growth addressed by multilateral and bilateral development institutions working with national governments in the MENA region. Progress on these issues is crucial to the performance of the SME sector. They affect almost all SMEs.

Table 2 below shows what the same businesses report as issues within the financial sector specifically.

[4] http://www.enterprisesurveys.org

Table 2: Selected Indicators in the MENA Financial Sector[5]

Selected Indicators	MENA Region	Egypt (2013)	Iraq (2011)	Jordan (2013)	Lebanon (2013)	Morocco (2013)	Syria (2009)	Tunisia (2013)	West Bank Gaza (2013)	Yemen (2013)	Avg. of MENA Countries
Firms identifying access to finance as a major constraint	36	31	56	33	40	25	38	27	38	31	35
Firms having no checking or savings account	24	27	30	8	1	4	6	3	13	3	11
Firms having no bank loan/line of credit	74	95	88	75	30	43	63	41	81	75	66
Proportion of loans requiring collateral	79	100	84	91	61	84	90	91	67	88	84
Value of required collateral as % of loan amount	202	316	220	144	250	138	138	245	91	284	203
Firms using banks to finance working capital	24	7	22	33	53	47	16	51	18	25	30
Firms using banks to finance investments in their firm	23	3	21	62	63	31	20	24	9	0	26
Firms using equity or stock sales to finance investments	3	0	0	5	2	6	n.a.	7	3	1	3

Given that the above figures are derived from surveys of businesses with 20 or more employees, it is significant that only 30 percent have financed working capital through banks and that only 26 percent have financed capital expenditures through banks.

[5] http://www.enterprisesurveys.org

3 - WHAT'S AVAILABLE FOR SMES IN THE FINANCIAL MARKET NOW?

ENTERPRISE SURVEY RESPONSES AND DATA ON LENDING AND PRIVATE EQUITY IN MENA

Most commercial banks in MENA are conservative lenders, and, despite claims to the contrary, cash flow–based financing (lending against less than 100 percent collateral coverage) is extremely rare.

While banks may provide non-asset–based financing (loans without collateral) to a small number of businesses in the SME range, these businesses are generally well-connected affiliates or subsidiaries of larger businesses, holding companies, or "family conglomerates" whose significant underlying assets are familiar to, or within, the bank. Independent entrepreneurs without such affiliations and contacts will generally be required to provide well in excess of 100 percent collateral coverage within the context of conservative valuations of collateral.

At the other end of the financing spectrum from banking are VC and PE funds.[6] "Venture capital" in MENA generally refers to small investments in "ideas," that is to say in start-up companies, often operating within a business accelerator or as part of what might be called an "angel portfolio." VC in the MENA region is largely focused on technology, particularly Internet-based technology, and on businesses that have not yet begun to generate significant revenues.

"Private equity" in the region refers most typically to investors in the equity of early-stage and expansion-stage businesses, particularly those showing promise for developing into targets for mergers or acquisitions (M&A) or, in rare cases, initial public offerings on exchanges (IPOs). Private equity in MENA rarely reaches down to businesses looking for less than USD $2 million in financing. (Henceforth, all monetary figures should be considered as the U.S. dollar equivalent in the local currency of the country of investment.) Entry valuations are generally low and PE firms tend to seek degrees of control that entrepreneurs consider excessive. PE[7] investment at the SME level is very rare in the region.

PE is primarily about investing in the equity of a company and then selling the whole company after the company has grown with the help of the PE fund. To be successful, PE fundsmust sell a small percentage of portfolio investees at high multiples of the original investment, almost exclusively via M&A or IPOs. PE is similar to betting on horses: if I bet on 10 horses in each of 10 races and one is a winner at 30:1 odds, then I can lose the other 9 races and still come out

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[6] This Guide will use the term "fund" to refer to any form of nonbank intermediary that pools money from investors to be invested in a managed portfolio of businesses.

[7] In this Guide, the terms "private equity" and "PE" will refer to both PE and VC, the latter being a subset of the former.

ahead. This is a logical financial sector strategy in mature markets. It is not a good development strategy for building the SME sector in developing and emerging markets.

Funds that are viable principally on the basis of selling their equity back to the investee company or its management are rare. When it comes time for thefund to get its money back, there simply isn't enough money in the investee business, or held personally by its managers, to buy back the investor's shares at a significant multiple of the original investment.

The data below come from the National Venture Capital Association in the United States, the European Venture Capital Association, and the MENA Private Equity Association. They show that despite the importance of the VC/PE industry to economies, the percentage of businesses that receive VC or PE funding is miniscule compared with the number of small businesses in an economy, even in the United States.

Table 3: Venture Capital Investments and Exits (CY 2015)

	U.S.[8]	Europe[9]	MENA[10]
Number of VC investments	3,916	1,598	175
Approximate number of active VC funds	500	200	60
Approximate number of investments per fund	8	8	3
Average/median value of VC investments (US$)	6 million (median)	2.5 million (median)	12 million (average)
Number of VC-backed exits by M&A	473	183	15
Number of VC-backed exits by IPO	66	48	6

There are 20 countries in MENA where PE (in the regional sense as defined above) is practiced. With an average of approximately nine investments per MENA country, only one exit per country, and an average investment size of US$12 million per investment, PE scarcely provides a systemic solution to the lack of non-asset–based investment for MENA's many thousands of promising expansion-ready SMEs.

It is pointless to place blame MENA's banks and PE funds for this; rather it is imperative to introduce new financial products that better suit the needs of SMEs, particularly those with immediate opportunities to expand.

[8] http://www.spurcap.com/nvca-yearbook-2016.pdf,
[9] http://www.ey.com/Publication/vwLUAssets/ey-global-venture-capital-trends-2015/$FILE/ey-global-venture-capital-trends-2015.pdf,
[10] http://menapea.com/2015AnnualReport/10th_MENAPEA_AnnualReport_2015_Rev15.pdf

4 - WHAT DO FAST-GROWTH SMES NEED?

WHAT "RISK CAPITAL" IS AND WHY FAST-GROWTH SMES NEED IT

Given the inaccessibility or unsuitability of commercial bank loans and the rarity or inappropriateness of conventional PE, there is an urgent need in MENA for an alternative form of commercially viable business financing for fast-growth SMEs.

What SMEs with expansion opportunities need is *risk capital*. Risk capital has two fundamental characteristics:

1. It does not require 100% collateral coverage (and certainly not 200%).
2. It is risk-sharing, meaning that the investor shares in both the downward and upward performance of the investee.

All PE investing is risk capital, but not all risk capital needs to be PE in the conventional sense of the term. Risk capital includes various instruments such as participations in free cash flows, revenue participations, royalties on units sold or other mechanisms where the risk of the investor is to some degree commensurate with that of the investee.

MENA's SME sector needs a risk capital financial instrument that is a hybrid of bank lending and VC, one that takes more risk than a bank but less risk than a VC fund. Most importantly, the SME sector needs a type of financial fund that can make risk capital investments in sufficient volume to make a systemic impact in the region.

What risk capital investors need is a relatively low-risk instrument with "upside" potential in order to compensate for the risk of an unsecured investment and the labor involved in assisting entrepreneurs to realize their business plans.

If I am a banker and I make a loan at 8 percent interest, then 8 percent is the highest return I can receive on my investment. Any time that I or my colleagues spend trying to help a borrower will eat into my 8 percent% return. That is one of several reasons why, as a banker, I have to be conservative in my lending.

By contrast, if I am a risk capital investor, I have the opportunity, though not the certainty, of helping my investee grow its share value, earnings, free cash flow, revenues, units sold or whatever my investment calls for me to participate in. If I have made a good investment and added other value that improved my investee's performance, in theory I will be rewarded for my efforts through my participation in the business's growth.

This "theory", however, has a significant flaw when applied to investment based on capital gains from the exit of equity investments. That flaw is dispositivey demonstrated by Table 3 above.

5 - WHAT IS REVENUE CAPITAL?

REVENUE-BASED VS CAPITAL GAINS–BASED RISK CAPITAL

Revenue Capital is a form of risk capital that is both unsecured and participating, which is to say, risk-sharing. More specifically and most importantly, an RCinvestor has the right to participation in the sales revenues of the investee business, whether sales go up or down. (Henceforth, the RC investor will be referred to as the "RC fund.")

RC is primarily invested in the form of a loan. Some RC structures call for an equity investment to accompany the loan, but the loan generally constitutes 85 to 95 percent of the entire investment. The small equity portion of the investment has several purposes, the least of which, generally, is the pursuit of substantial capital gains (as explained below in Question 8, "Why Equity").

Typically the interest on the loan portion of an RC investment is well below market interest rates or, at most, well below what an SME would expect to pay on a bank loan, particularly on aloan that is not fully secured. Also typically, the RC investor's percentage of revenues will be set within a range of 0.5 to 2.5 percent of gross sales, depending on the terms of the loan and any accompanying equity investment. Rarely would the participation exceed 5 percent of sales.

The RC investor has a right to this small percentage of sales in exchange for the two things every promising SME would wish for but can rarely find: 1) the absence of the requirement to provide 100 percent (or more) collateral and 2) an interest rate well below what the business would expect to pay to a bank.

WHAT RC ISN'T

RC is often known as "royalty-based finance." There are a number of standard investment instruments that involve royalties on sales or units of sales. It is crucial to the understanding of RC that these other investment situations be recognized as significantly different from, and unrelated to, what we are calling RC.

Other forms of royalty-based (or revenue-based) finance include investment in the following:

- *Natural resources:* Royalties are often paid to the owners of wells, mines, and land by parties extracting, treating, and selling resources such as oil, minerals, and forestry products.
- *Patents and intellectual property*: Patents and other intellectual property are often licensed in exchange for royalties on sales of products based on them.
- *Revenue bonds:* Municipalities frequently borrow money for public works such as sewer, water, and transportation projects by issuing bonds that are repaid through royalties on revenues from consumers.

This Guide uses "revenue capital" and "RC" exclusively within the context of risk capital financing for SMEs.

6 - IS REVENUE CAPITAL COMPLICATED?

WHY RC IS HARDER TO DESCRIBE BUT PRIVATE EQUITY IS HARDER TO DO

The answer to this question is complicated. Any financial instrument that is too complex for an SME entrepreneur to easily understand is too complex for an SME investor to be using.

Compared with the *idea* of a loan or the *idea* of any equity investment, RC structures can at first seem complicated and forbidding. In comparison with a loan, an RC investment is more complex, but it is important to remember that RC is for SMEs who cannot access bank loans, particularly for SMEs realizing an expansion opportunity. The complexity of bank loans lies in 1) getting the loan, 2) valuing and registering the required collateral, and 3) maintaining sufficient working capital in the early period of an expansion while paying fees, interest, and principal. Overindebtedness is one of the leading causes of business failure at the SME level. Accessing and managing debt is complex.

In comparison with equity, RC would again seem to be a more complex proposition. An equity investor simply puts money into a company in exchange for a certain number of new shares. This sounds simple but is far more complicated than investing in public equities whose detailed information is published in annual reports and whose share values are posted by daily newspapers and online brokerages.

Indeed, the two most prominent complications in PE involve placing a value on the shares of the investor:

- *Valuation of the investor's equity going into the investee business*

  Investors want to receive as many shares for their investment as possible while entrepreneurs/businesses owners (collectively the "principals") would like to give investors the fewest number of shares for that same amount. The most common method for establishing entry valuation is to use a multiple of earnings (also known as "profits").

  But then there is the question: What "profits"? This year's, last quarter's (annualized), an average of the last 3 years' profits? And the questions: pretax, posttax, predepreciation, postdepreciation? And with small businesses, particularly in developing markets, there is also the question of which set of books is being used to determine earnings in that most SMEs "manage" their earnings downward to reduce their taxes but would like their earnings to be "managed" upward when it becomes time to determine what the investor should pay for shares.

  Once the above questions are settled, there is then the crucial question: what multiple of earnings? Smaller businesses are typically valued by investors at anywhere between two and 10 times earnings. The multiple offered by the investor depends on factors such as the quality and replaceability of the management team; the strength and stability of the market; the degree of competition and competitive advantage; the value of the business's hard assets; and the consistency of past earnings from year to year.

There can be some science in these determinations, but each is arguable, making the valuation multiple highly arguable and the negotiation of price per share highly complex.

- *Valuation of the investor's equity at exit*

  Entry valuation is often complex. Valuation of equity when it is time for the investor to exit is even more complex. In the case that one or more offers have been made to buy the investee business (in what is generally called an acquisition or "trade sale"), assuming that the investee's principals want to sell the business, the interests of the investor and the principals are perfectly aligned. Both parties would like to sell the business at the highest price possible. The acquiring company, however, would like to pay the lowest price possible for the business. We are now back to the complexities of the entry valuation, except that now the stakes are higher and the investee business itself is larger and more complex.

  The above complications do not arise often in risk capital targeting SMEs. Acquisitions of SMEs are very rare. Please see again Table 3 under Question 3 earlier, "What's in the financial market now?"

  An entrepreneur who is not familiar with terms such as discounted cash flow, full ratchet, antidilution, protective provisions, and tag along, drag along and their significance may find the term "equity" capable of generating significant complexity, particularly when negotiating with a professional PE investor.

  Similarly, anyone putting together an investment fund to make equity-led investments in SMEs should be aware of the personnel issues involved. Finding financial professionals who are familiar not only with these terms but with the process of valuing and selling companies and want to apply these skills at the SME level in an emerging or developing market will be difficult and, at best, very expensive.

WHY IS RC SIMPLER?

The simplest answer to this question is that in RC, transactions are based on the least problematic line of numbers in a financial statement: sales revenues. This will become clearer from the answer to Question 7 immediately below.

7 - ARE THERE DIFFERENT TYPES OF REVENUE CAPITAL?

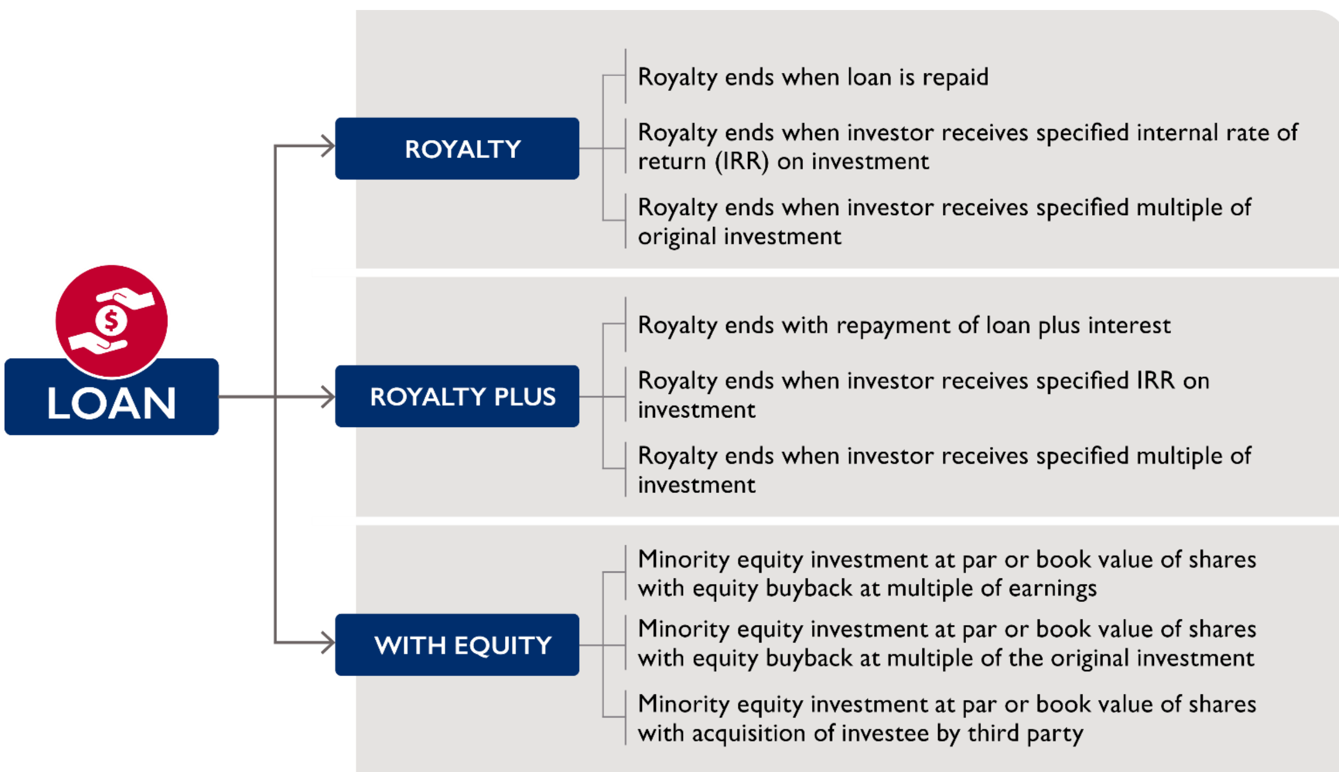
VARIATIONS OF RC FINANCIAL INSTRUMENTS

In its simplest form, RC is a loan for which the borrower pays the lender a small percentage of the borrower's gross sales in lieu of a market interest rate. We can call this payment a "revenue participation" or, even more simply, a "royalty." The variants on this are few and, again, relatively simple. The four basic variants include the following:

1. A loan with royalty payments
2. A loan with royalty payments plus a low interest rate
3. A loan with royalty payments plus a small equity participation
4. A loan with royalty payments plus a low interest rate plus a small equity participation

Below is a diagram showing virtually all permutations of these four basic structures as RC is currently practiced in emerging and developing countries as well as in the United States.

Figure 1: Variants of Revenue Capital Structures



The above variants of RC also fall into two primary categories: royalty-based loans without equity and royalty-based loans with equity. All of the variants are based on a loan, and, with few exceptions, the loan portion of the investment constitutes at least 80 percent of the entire investment.

Below are brief pros and cons of each of the variants of the royalty-based loan.

Table 4: Pros and Cons of Revenue Capital Variants

Revenue Capital Variant	Pros	Cons
Royalty only, with royalty ending when loan is repaid.	More acceptable to entrepreneurs and perceived as more fair and risk-sharing.	Higher risk of a low return and limited upside.
Royalty only, with royalty ending when investor receives specified internal rate of return (IRR) on investment.	Investor has the right to receive projected return even if loan has been paid, eliminating risk if enforced.	Entrepreneurs may perceive as unfair, leading to hostile relationship. May be difficult to enforce in some jurisdictions.
Royalty only, with royalty ending when investor receives specified multiple of original investment.	Investor has the right to receive projected return even if loan has been paid, eliminating risk if enforced.	Entrepreneurs may perceive as unfair, leading to hostile relationship. May be difficult to enforce in some jurisdictions.
Royalty combined with low interest rate, with royalty ending with repayment of loan plus interest.	Provides a base return to investor, therefore less risk. Allows for lower percentage royalty payment by investee.	Some potential limitation of upside to investor.
Royalty combined with low interest rate, with royalty ending when investor receives specified IRR on investment.	Provides a base return to investor, therefore less risk. Allows for lower percentage royalty payment by investee.	Entrepreneurs may perceive as unfair, leading to hostile relationship. May be difficult to enforce in some jurisdictions.
Royalty combined with low interest rate, with royalty ending when investor receives specified multiple of investment.	Provides a base return to investor, therefore less risk. Allows for lower percentage royalty payment by investee.	Entrepreneurs may perceive as unfair, leading to hostile relationship. May be difficult to enforce in some jurisdictions.
Royalty-based loan with minority equity investment at par or book value of shares, with equity buyback at multiple of earnings.	Eliminates valuation issues. With purchase of shares at par or book value, investor's exposure in equity will generally be a small fraction of total investment, and capital gains may be significant if earnings are high.	May undermine relationship between investee and investor if multiple is too high. Determination of earnings may be contentious and investee principals may not have sufficient funds for buyback.
Royalty-based loan with minority equity investment at par or book value of shares, with equity buyback at multiple of the original investment.	Eliminates valuation issues. With purchase of shares at par or book value, investor's exposure in equity will generally be a small fraction of total investment, and capital gains may be significant.	Investing at book value may reduce the number of potential investments, given that some companies may have book value too high to allow investor to maintain a small equity exposure.
Royalty-based loan with minority equity investment at par or book value of shares, with acquisition of investee by third party.	Eliminates valuation issues. Investee's principals will normally agree to "tag along" whereby investor receives full value for shares from third party.	Acquisitions at SME level are rare.

8 - WHY EQUITY?

WHILE RC IS DEBT-BASED, A SMALL EQUITY COMPONENT MAY SERVE SEVERAL PURPOSES

If RC is an alternative to PE, then why do some of the variants include equity?

For a conventional PE investor, there is generally only one reason to purchase shares in a company, and that is, of course, to realize capital gains. This happens when the investee business is sold or listed on a stock exchange or when the investor's shares are repurchased by the management of the business. As explained earlier, the last of these three exit mechanisms is generally unexciting for the investor financially, particularly in the case of smaller and early-stage businesses. The first two are rare at the SME level in all countries, but particularly in emerging and developing markets.

From the point of view of an entrepreneur, having an equity investment from a VC or PE fund may result in making considerably less money from the investment and having considerably less control over strategic, and even operational, decisions. However, many entrepreneurs look to PE investors for their expertise and contacts as much as for an infusion of capital. This is particularly true in the case of technology companies.

For an RC fund, structuring an equity component in a royalty-based investment may have several purposes of equal or greater importance than receiving capital gains at exit, including:

Regulatory compliance:: In many emerging and developing markets and in most MENA countries it is simply not legal to operate a financial fund whose primary business is making loans without being regulated under banking laws. RC investing is incompatible with bank regulations for many reasons. RC takes greater risk than banks are generally allowed to incur. Capital requirements for banks are too high and reporting requirements too burdensome for a risk capital intermediary. However, most countries permit any business to lend to a company in which it is a shareholder. This is looked at by regulators as essentially making a loan to oneself and is generally permissible throughout MENA. The annex to this report, "Assessment of Key Legal and Regulatory Issues for Revenue Capital Financing', provides greater details on this issue.

Being a "partner": As a shareholder in the investee, the investor is seen not only as sharing financial risk but also sharing reputational risk with the investee. This makes it more likely that the investee will share information more openly and seek the advice of the investor. "Hand-holding" is an essential element of all forms of risk capital, and it is simply easier for a shareholder than for a lender to have a close partnership with an SME investee.

Endorsement: Risk capital funds generally have more far-reaching recognition than individual SMEs. SME risk capital funds, in particular, tend to be sponsored and capitalized by developed-country governments (bilateral development financial institutions [DFIs]), multilateral development banks, and organizations with well-known directors and broad contacts. As such, the fund's participation in the company is an endorsement of the entrepreneur(s) and the business on the part of internationally known individuals and institutions. This can be particularly helpful when an entrepreneur from a MENA country attempts to enter the European or U.S. market.

Decision-sharings rights: A shareholder in a company generally has the right to participate in strategic decisions of the company. With SME entrepreneurs, this is best characterized as decision-sharing but can also amount to "blocking" rights if the investors' percentage shareholding reaches a certain level, in most countries 26 percent. Please see the annex for more specific information on minority shareholder rights.

9 - HOW DOES EQUITY WORK IN REVENUE CAPITAL?

HOW THE EQUITY COMPONENT IS STRUCTURED INTO AN RC INVESTMENT

Because of the "regulatory compliance" reason alone, RC investments in most emerging and developing markets, particularly in MENA, will include equity. So it is important to understand how equity works in an RC structure.

The RC variants listed above in Figure 1 and described in Table 4 highlight the significant distinction between RC and capital gains–based investment as practiced by PE investors. Again, the essential difference is valuation.

In conventional PE, particularly with smaller and early-stage companies, the shares of the investee are generally valued in one of two ways: "multiple of earnings" and "discounted cash flow." Both of these valuation methods are easy to understand in theory but are more difficult to describe in detail and far more complex to put into practice. For the purposes of this Guide, there is no need to describe how either is derived. What is important is that in PE, if all of the investor's investment is in equity, then valuation of the equity determines how much money the investor makes. Period.

By contrast, in RC, where typically 90 percent or more of the investment is in the form of a revenue-based loan, the value of shares at entry and exit are of lesser consequence than the amount and growth of the investee's revenues. Limiting the percentage of equity in the total investment is made possible by determining the price of the equity purchased according to two numbers generally established by the potential investee prior to having met the investor.

These two numbers are normally only a small faction of what the investee's equity valuation will be if it is determined by the multiple of earnings or discounted cash flow method. Not only are they smaller amounts but they are much less arguable than PE valuations. They are:

1) *Registered capital value:* the amount of share capital (or equity interests) registered by the business at the time of its legal establishment. For simplicity, we will call this "par" value, the value of each share of registered capital times the number of shares. Depending on local law and the number of shareholders in a business, the par value of capital will typically be between the equivalent in local currency of US$1 and US$10,000.

2) *Book value*: the equity value of the SME on the balance sheet portion of its financial statements. Book value for small businesses is generally equivalent to net asset value. Most SMEs rent their premises, use significantly depreciated equipment, do not keep large amounts of cash out of use in their operations, and have small loans and bills to pay. Therefore their net asset is small. Typically, SMEs will have equity with a book value within the range of 10 to 25 percent of their sales (though the sales and book value of equity are not directly related).

Table 5 below shows these four types of valuations of a typical SME in an emerging or developing market. In this case, the example SME has US$1 million in annual sales with a profit margin of 20 percent and is seeking an investment of US$500,000 in exchange for 33 percent of its postinvestment equity.

Table 5: Comparison of Equity Values (Example in US$)

Valuation Determinant	Preinvestment Value of the Company's Equity (US$)	Amount Paid by Investor for 33% of Postinvestment Equity (US$)
Par value	100	50
Book/balance sheet equity	100,000	50,000
Multiple of earnings value	1,000,000	500,000
Discounted cash flow value	1,000,000	500,000

The numbers in Table 5 are intended to show the magnitude of differences among the ways of determining the value of a business. It should be noted again that multiple of earnings valuations and discounted cash flow valuations do not typically produce the same number. They are the same in Table 5 only so that in each case US$500,000 is equal to 33 percent of equity postinvestment equity.

The point being made by Table 5 is a simple one: In this example, investing at par would allow the RC fund to invest 99 percent of the investee's total required financing in the form of a royalty-based loan and investing at book value would provide for 90 percent of the investment to be in the form of a royalty-based loan. The effect is the same in each: to shift the investor's focus from the capital, now related to only 1 percent or 10 percent of the total investment, to the royalties on sales related to 90 to 99 percent of the investment.

The multiple of earnings and discounted cash flow valuations in Table 5 would normally be arrived at through a combination of science and art: each party performs various mathematical calculations to arrive at the valuation each is seeking and then the two parties negotiate. Though many PE investors and their investees have friendly relationships, many don't. This initial negotiation process can be a source of tension between the investor and investee throughout the period of the investment. In the late 1990s, it led to the coining of the term "vulture capital."

A common complaint among SME entrepreneurs in MENA who have been approached by PE investors is that many PE investors in the region have a policy of not offering more than three times earnings, regardless of the potential of the SME. This is a low valuation by VC/PE standards in more active markets, particularly when most PE investors in the region target exits of their investments at a valuation of at least six times earnings.

The above discussion of equity is largely presented from the point of view of an investor. An entrepreneur reading the foregoing, particularly an entrepreneur needing expansion capital but not contemplating selling his/her company in four to six years, might be troubled by a very good question: What will be the value of the equity at the point of exit when the entrepreneur must repurchase the RC fund's shares?

"If the RC fund buys 33 percent of my company for US$50,000 at book value and my company has a market value of US$3 million five years from now, will I owe my RC fund US$1 million at the end of five years?"

Few entrepreneurs will accept that the investor should receive US$1 million for something for which the investor paid US$50,000, particularly when the entrepreneur has been making royalty payment to the investor for five years.

The answer to the entrepreneur's question is, once again, simple: the exit price will be related to what the RC fund initially paid for the shares rather than to the market value of the shares at the time when the RC fund's shares must be repurchased. The US$3 million market value above might be determined by a multiple of earnings, discounted cash flow, the market value of comparable businesses recently sold, or a blend of these.

In an RC investment, the price for the entrepreneur's repurchase of the RC fund's equity will be set according to one of three formulas:

1. A small multiple of the original price paid for the RC fund's equity (e.g., two times)
2. A pro rata share of a small fraction of the investee's sales in the final year of the investment (e.g., 10 percent)
3. Another formula similarly limiting the cost of repurchase of the RC fund's equity, such as a multiple of net asset value

Table 6 below shows what the entrepreneur's buyback price would be according to various formulae. Table 6 uses the example investment portrayed in Table 5 above but adds the assumptions that the investee's sales in the final year of the investment will be US$3 million and its net asset value will be US$300,000.

Table 6: Comparisons of Equity Repurchase Formulas (in US$)

Valuation Formula	Calculation	Amount Paid to Repurchase 33% of Equity (US$)
Multiple of original purchase price	2 x 50,000	100,000
Fraction of final year sales	33% x 10% x 3 M	100,000
Multiple of net asset value	33% x 300,000	100,000
Multiple of earnings value	33% x 3,000,000	1,000,000
Discounted cash flow value	33% x 3,000,000	1,000,000

10 - HOW DOES THE WHOLE REVENUE CAPITAL STRUCTURE WORK?

BASIC TERMS AND QUANTITATIVE BEHAVIOR OF AN EXAMPLE RC INVESTMENT: SUMMARY

At this point, we have established the following:

1. Many high-potential SMEs cannot realize their expansion opportunities because they lack access to bank loans or PE, so some other expansion-oriented form of financing needs to be available in the market.
2. An RC investment, something between a bank loan and a PE investment, is fundamentally an unsecured (or partially secured) loan on which the borrower pays a low interest rate in addition to a small percentage of sales of the lender.
3. In most MENA countries, to make RC loans without becoming a bank, an RC is required by law to have an equity stake in each business to which it makes an RC loan.
4. To allow for the large majority of an RC investment to be made in the form of a loan, the RC fund's equity must be bought at a low valuation, generally at par or book value.

Of all the RC variants listed in Figure 1 above, the most common is likely to have the following fundamental structure:

1. A 4- to 6-year unsecured loan with a 12- to 18-month grace period and a low interest rate, typically half the rate an SME would expect to pay to a bank (if it could obtain a loan).
2. The fund's right to receive, in exchange for the below-market interest rate and lack of collateral, a small participation in the investee's gross revenues during the period of the loan, typically between 0.5 and 2.5 percent of gross sales.
3. A minority participation in the investee's equity, purchased at a low, easily determined "book equity," with an agreement that once the loan and revenue participation are paid, the investee's principal(s) can repurchase the fund's equity at a small multiple of the original purchase price.

The RC structure described above is often called a "shareholder loan investment" or "SLI" because it is principally a loan, the lender is an equity holder in the investee, and it is an investment made by a professional fund.

FULL EXAMPLE OF A REVENUE CAPITAL INVESTMENT USING THE SLI STRUCTURE

We now return to Ahmad, whose numbers below we have been using for the preceding three sections:

First year sales:	US$1,000,000
Earnings:	20% of sales
Book equity:	US$100,000
Required financing:	US$500,000

Below we will break down the investment in Ahmad's business, its terms, its constituent parts, and the cash flows to each party. Table 7 provides the basic terms of the investment. The last line of Table 7 refers to a "tag along" right. This term will be discussed later in this section.

Table 7: Example Terms of a Shareholder Loan Investment

Revenue Capital Investment – SLI Structure	
Terms of Loan Component	
Amount	US$450,000
Term and grace period	5 years with 12-month grace period
Interest rate	5%, paid monthly
Terms of Revenue Participation (Royalty)	
Royalty as % of gross sales	2% of gross sales revenues, paid monthly
Terms of Equity Component	
Amount	US$50,000 for 33% of postinvestment equity
Preagreed buyback ("put") price	2 x original purchase price (2 x US$50,000 = US$100,000)
Dividends	none paid
Other rights	"tag along" right to sell shares at full value in an acquisition

Below are three "snapshots" from an Excel modeling of an RC investment in Ahmad's business, based on the assumptions and terms given above. Note that in the first snapshot, Table 8, the blue cells are "negotiated terms." Although an investment fund might repeatedly invest through a single RC instrument such as this, the structure still has significant flexibility by varying the quantitative terms to best suit Ahmad's projected cash flows and the fund's return objectives of the fund.

Table 8: Negotiated Terms of a Revenue Capital (SLI Structure)

Negotiated Terms	Investment Amount	Pre-Investment Book Equity	Post-Investment Book Equity	RC Fund's % Shares Post-Investment	Buy-Back Multiple
Equity Investment (book value)	**50,000**	100,000	150,000	33%	**2.0**
	Loan Amount	Term in Years	Interest Rate	Revenue %	Grace Period Yrs
Shareholder Loan	**450,000**	**5**	**4.0%**	**2.0%**	**1**

Using Ahmad's example as a typical SME expansion scenario, the set of figures in Table 9 below, Revenue Growth of the Investee, shows a typical growth trajectory if such a business can access sufficient financing, combined with targeted business assistance, in order to realize the expansion.

Table 9: Revenue Growth of the Investee

Investee Flows		Year 2	Year 3	Year 4	Year 5
Percentage Growth in Sales		75%	25%	20%	15%
Sales	**1,000,000**	**1,750,000**	**2,187,500**	**2,625,000**	**3,018,750**

In such expansion situations, there is normally some incremental growth in Year 1 due to increased capacity, but it occurs within the context of ongoing activities of the business. High growth generally comes in Year 2, when new capital purchases, additional employees, and other requisites of the expansion are in place and the opportunity is realized. Growth slows in Years 3 through 5, but with the reinvestment of earnings made possible by the SLI investment structure, Ahmad's business is able to continue to grow at relatively strong pace.

The third snapshot, Table 10 below, Flow of Funds, shows revenues to the RC fund based on the above assumptions. Note again that, as exemplified in Table 6, Comparisons of Equity Repurchase Formulas, if Ahmad's business had a multiple of earnings or discounted cash flow valuation of US$3 million, then normally an equity investor should have the right to be paid 1 million for the investor's 33 percent equity holding. However, in the case of this RC investment in Ahmad, Ahmad will pay only US$100,000 to repurchase a third of his company – two times the RC fund's original investment but only a tenth of the market value of his company.

Table 10: Flow of Funds (US$)

Flows to RC Fund					
Fee Payments	0	0	0	0	0
Principal Payments on Shareholder Loan	0	112,500	112,500	112,500	112,500
Interest Payments on Shareholder Loan	18,000	18,000	13,500	9,000	4,500
Revenue Participation Payments	20,000	35,000	43,750	52,500	60,375
Dividends	0	0	0	0	0
Equity Buy-Back					100,000
Total Flows to th RC Fund	**38,000**	**165,500**	**169,750**	**174,000**	**277,375**

PRESERVING WORKING CAPITAL

The essence of the above structure is that it better fits the cash flow pattern of a business expansion. It is designed to allow for adequate working capital during the early phase of the expansion, not only by providing a significant grace period on principal payments, but also through "back-ending" much of the cost of the financing by combining a significantly below-market interest rate and a low revenue participation before sales have begun to expand. This preserves working capital of the Investee at the expense of a market-rate income to the Fund during first one or two years of the investment. However, the Fund is then compensated in the later years of the investment when the majority of the loan has been amortized and the Fund's income from the revenue participation is significantly increased due to the significantly higher level of post-expansion sales.

RETURN ON INVESTMENT

For the RC fund, the gross return (or IRR) on its investment in Ahmad's business, again based on the assumptions and terms we see above, is 15.5 percent. For Ahmad, this means that his business has paid the RC fund almost twice the corporate lending rate of local banks offered to fully secured or well-established corporate clients of the bank.

But Ahmad is well aware that when he was first offered the opportunity to produce all of the door and window frames for the apartment complex, banks would not take the risk of financing his business without more than 100 percent collateral and the PE funds would not take the risk of never being able to sell Ahmad's business at the high multiple they would have required.

Ahmad knows that without the RC fund's investment, he might have never been able to grow his business so rapidly and establish himself as a significant player in his market. In other words, Ahmad recognizes the risk the RC fund has taken and agrees that the RC fund should be compensated for this risk. He also recognizes that the way in which he has paid the RC fund for its investment has been tailored to his cash flows.

We should recall that even before meeting the RC fund, Ahmad had already established a strong reputation for the quality of his products and the high standards of his business practices. But these virtues were insufficient to provide his access to the financing he needed. The tangible assets he brought to the table when he first met with the RC fund were worth about US$100,000.

In calculating the RC fund's return on its investment in Ahmad's business, we started with the USS500,000 the RC fund put into his business and then used the stream of payments he made to the RC fund to calculate the RC fund's 15.5 percent IRR. If we were to start with the US$100,000 that Ahmad brought to the investment and then use the stream of annual earnings generated by the business during the five years of the investment, Ahmad's return on his US$100,000 would be 180 percent.

WHEN IS AN RC INVESTMENT ALSO A PE INVESTMENT?

This question brings us back to "tag along" rights. As exotic as this sounds, it simply means that if another company or investor wants to buy Ahmad's business, then the RC fund tags along with Ahmad's shares and the RC fund receives the same price per share as Ahmad. If Ahmad sells his business for US$3 million, then the RC fund receives US$1 million for its 33 percent of equity. The acquisition of Ahmad's business has turned the RC into a fairly classic PE investment.

But this question also brings us back to Table 3 that showed us that the MENA Private Equity Association reported in 2015 that in all of MENA there were 175 PE investments but only 15 acquisitions and 6 IPOs. And the average PE investment in 2015 was US$12 million.

The RC strategy is based on the assumption that acquisitions at the SME level are extremely rare and IPOs far more rare. It assumes that if an investor invested US$500,000 in Ahmad's business for a third of his company's equity, that even after five years of high-growth performance, Ahmad would be unlikely to have US$1 million to buy out the investor's shares. There are abundant data to show this is a valid assumption, but around the globe it is still learned the hard way.

11 - WHAT HAPPENS BETWEEN THE REVENUE CAPITAL INVESTOR AND INVESTEE BETWEEN ENTRY AND EXIT?

POSTINVESTMENT SUPPORT: HANDS-ON BUSINESS AND TECHNICAL ASSISTANCE FOCUSED ON SALES GROWTH

All risk capital investors provide some degree of nonfinancial help to their investees over the life of the investment. This is often as an active board member who makes key contacts for the investee. But post-investment support, often referred to as “added value,” can be much more involved. Again, the principal difference between banking and risk capital is that there is the potential for “upside,” that is to say, for improving return on investment by successfully helping the investee improve its performance. Again by contrast, if a banker makes a loan at 8 percent, then 8 percent is the maximum return and any effort to assist the borrower will eat into the 8 percent.

An essential feature of RC’s revenue-based investment model is that it motivates investment staff of the RC fund to take a labor-intensive “hands on” approach to investment in order to assist investees to sustain high revenue growth. This means not only making the best use of RC fund staff to provide direct business assistance but also identifying other affordable and effective sources of outside assistance.

Typical ways in which investment staff assist portfolio investees include:

- Advice in business and financial planning
- Design and implementation of financial controls
- Design and implementation of marketing strategies
- Improvement of terms and conditions of sales and purchasing agreements
- Raising and maintaining operational processes and quality control to international standards
- Cost accounting and pricing
- Preparation of product catalogues and trade fair presentations
- Preparation of permit and licensing applications and agreements
- Growth management
- Human resources management
- Restructuring and/or negotiation of bank debt

Given the developmental objectives of most SME risk capital funds and their investors, many have been able to raise grant funding from official development agencies, governments, and private sources. Such grant funding is generally held outside the accounts of the fund to pay for additional technical assistance required by, or improving the performance of, portfolio investees. Funding is often pooled into what is known as a "technical assistance facility." Typical uses of a technical assistance facility include:

- Creation of customized accounting or management information systems
- Creation of Internet capabilities and other information and communication technology capacities
- Procurement of engineering or other technical services to create or enhance production or distribution of products or services
- Qualification for a specific certification or license, including ISO certification
- Funding and organization of training for managers in areas such as:
  - Use of available information and telecommunications technology
  - Human resource management and employee relations
  - Local and international legal issues and interpreting legal documents
  - Customer relations and standards of business practice

Normally the investment officer of a fund will be in close consultation with investees to jointly identify the nature of third-party assistance interventions needed by the investee. The third-party service supplier is then paid by the facility and either partially or fully reimbursed by the investee on a cost-sharing or interest-free loan basis as negotiated between investee and the fund.

Mentoring of entrepreneurs by experienced business people has also proved to be an effective way of assisting portfolio SMEs, particularly when an investment officer has helped the investee identify a particular problem or opportunity so that the right mentor can be matched to the right task. In addition to NGOs that identify, vet, and arrange assignments for mentors and entrepreneurs, some funds build their own stables of volunteer mentors, who may be retired business executives or volunteers taking time off from their professional or personal activities. With RC investments, mentoring can be particularly useful when revenue growth can be directly tied to the mentor's intervention.

This Guide assumes that most readers will be familiar with company-level business and technical assistance, and the brevity of this section does not mean to undermine postinvestment support as imperative to successful RC investing.

12 - IN SUMMARY, WHY IS REVENUE CAPITAL A GOOD IDEA?

THE ADVANTAGES OF RC FOR SMES, PARTICULARLY AS COMPARED WITH PRIVATE EQUITY

Before summarizing the principal virtues of the RC model, there are two important points that the reader should have in mind:

1. Almost every risk capital investor, including VC and PE professionals, will tell you that the most important word in the risk capital lexicon is *alignment*, referring to the alignment of interests among the investee business, the fund manager, and the investors in the fund (the fund). When this alignment is broken, investments do not generally work out well.

2. In most developing and emerging jurisdictions, courts have a weak understanding of risk capital, and enforcement of an investor's rights through the courts is a long and expensive process in which there are often no winners. Experienced professionals in SME risk capital know that the best security in a risk capital investment is the relationship between the investor and the investee.

For national and local economies, RC can offer a new SME-friendly financial product in the market designed to fit the needs of high-impact, fast-growth SMEs who don't fit the investment policies of banks and PE funds. It offers a financial instrument that attempts to fill the gap between commercial banking and PE. The ultimate benefit of RC is to help realize the potential of the SME sector by diminishing the number of expansion opportunities that go unrealized.

SUMMARY…

the virtues of RC for the investee and RC investor include the following:

- The interests of the fund and the investee are aligned by a shared focus on sales.
- Investees are able to preserve additional working capital needed in the early years of the investment.
- The cost of financing "floats" with the performance of the investee rather than with interbank or market rates.
- Sales revenues are more easily agreed upon and tracked than would be the case with attempts to agree on earnings.
- In most RC models, all financing costs of financing are agreed in fixed nominal terms at the outset and are therefore better understood and more enforceable.
- Elimination of dividends combined with a fixed equity buyback price reduce information asymmetry and disputes over earnings, facilitating postinvestment assistance from the fund.
- Freedom from reliance on an acquisition of the investee eliminates the requirement of hiring high-salary investment staff with PE and/or investment banking experience.
- The tag-along right provides that in the rare case of an acquisition of the investee, the investor receives full per-share value and therefore is not precluded from receiving a conventional PE return.

13 - WHO IS, OR SHOULD BE, INVESTING REVENUE CAPITAL?

A LIST OF THE MOST PROMINENT SME INVESTORS USING FORMS OF RC FUNDS

The first answer to this question is "funds". Although revenue-based financing can be used by individual "angel" investors or any type of financial organization, as local regulations permit, the normal vehicle for financing SMEs through RC will be a fund. By "fund," we mean a pool of money managed by a "fund manager." Fund managers may be organizations established to manage several different funds under a separate contract with each fund or may be a team hired by the fund as its own employees.

In either case, the essence of a fund is that the parties whose capital is being invested entrust their money to a team of professional investors, typically to do the following:

- Identify potential investments, generally through networks and events
- Perform financial analysis and due diligence review of potential investees
- Engage in preinvestment business planning assistance to potential investees
- Negotiate, structure, and close investments
- Arrange for ongoing technical assistance and business support to investees in areas such as the following:
  - Provision of advice in business and financial planning
  - Design and implementation of financial controls
  - Design and implementation of marketing strategies
  - Preparation of product catalogues and trade fair presentations
  - Preparation of permit and licensing applications and agreements
  - Growth management
  - Human resources management
  - Restructuring and/or negotiation of bank debt
- Monitor investments, often as a function of providing business assistance
- Assist investees in working with commercial banks and other sources of finance for cofinancing and later-stage financing
- Determine and implement exits
- Provide financial and operational reporting to the fund's investors and governing bodies

The convention in VC/PE has been to form funds as limited-life entities that make investments for a period of years, typically three to five years and then exit those investments during the remainder of the life of the fund. Most funds are 10-year funds, obligating the fund manager to return to the investors their original capital plus whatever profits have been made on the investments by the end of 10 years. Also typically, the fund manager is entitled to a percentage of the profits of the fund (a "carried interest") once initial capital is returned and investors have received an agreed upon rate of return.

EVERGREEN FUNDS

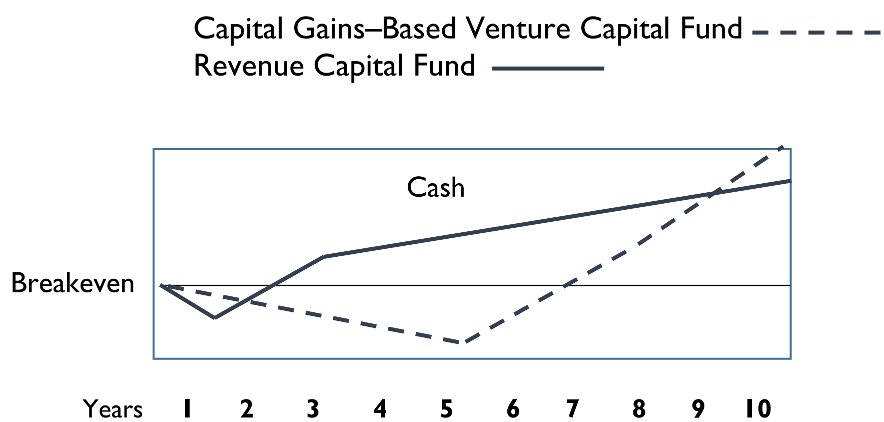
In recent years, the limited-life model has been challenged by increasing numbers of fund investors and fund managers, resulting in the greater presence of what are known as "evergreen" funds. An evergreen fund is an unlimited-life investment intermediary that continues to make investments much in the way a commercial bank does. Although there are various types of provisions for withdrawal by investors, the intention of the evergreen structure is that investors remain long-term equity participants in the fund, receiving a return on their equity through dividends once the fund is profitable.

The evergreen structure appears to be particularly well suited to RC investing. Limited-life VC/PE funds rarely take dividends from their investees, preferring that they reinvest profits in order to grow the size and value of the investee. Typically, such funds do not reach financial breakeven until their sixth year, two to four years after they have ceased to make investments. Having little revenue to cover operating costs (the fund management fee) during the first half of the fund's 10-year life, VC/PE funds typically invest only around 90 percent of the capital invested in the fund.

By contrast, an RC fund will begin to receive revenues in the form of interest and royalty payments from each investment within the first month or quarter after the investment is made. With 80 percent or more of the RC investment in the form of a loan, the RC fund will begin to receive a significant portion of its entire investment through principal payments after a grace period of typically 12 to 18 months. With this pattern of current revenues and "self-liquidation" of the investment during the period of the loan, an RC fund should be able to begin covering its operating costs early in its third year of operations and begin reinvesting revenues shortly thereafter.

The illustrative figure below roughly portrays and compares what is often called the "cash flow J-curve" of a modestly successful conventional VC/PE fund achieving its first exits in Year 5 with the J-curve of an RC fund.

Figure 2: Comparative J-Curve Cash Flow Scenarios



CURRENT INVESTORS IN RC FUNDS

As is the case with nearly all SME risk capital funds in developing and emerging markets, those practicing RC are almost entirely capitalized by investments from bilateral and multilateral DFIs and a small number of private nonprofit organizations. This is as it should be. This is the role of these institutions. There appear to be no investors in funds practicing RC in developing and emerging and markets who have invested for purely return-based reasons. Our hope, however, is that as the number of funds using RC instruments increases and have begun to return capital to their investors along with anticipated rates of return, private investors will take RC into the mainstream.

In the few places where RC is being practiced in emerging and developing markets, it appears to be succeeding, but it is still a relatively recent phenomenon. The one SME investor who has been practicing RC the longest, Business Partners Limited (BPL) in South Africa, and its subsidiary Business Partners International (BPI) is a proven success. In addition to BPL and BPI, other funds practicing versions of RC and targeting SMEs in developing and emerging markets are shown in Table 11. Most of these funds began RC investing after some years of investing through other quasi-equity and equity instruments. Of these funds, only BPI and Gazelle Finance launched with the intention of investing primarily through revenue-based instruments. None practices RC exclusively, although some 90 percent of BPI's investments are royalty-based.

Among the institutions that have invested in the above funds are:

- IFC - International Finance Corporation
- EIB - European Investment Bank
- AfDB - African Development Bank
- MEDA - Mennonite Economic Development Associates (Sarona Risk Capital Fund)
- EADB - East African Development Bank
- FMO - Netherlands Development Finance Company
- PROPARCO – Société de Promotion et de Participation pour la Coopération Economique
- Stichting DOEN (Dutch Government)
- DGGF - Dutch Good Growth Fund (Dutch Government)
- SIFEM - Swiss Investment Fund for Emerging Markets

The above list does not include the several large multinational South African firms who are the principal shareholders in BPL.

For additional information on the organizations listed above and SME risk capital in general, we highly recommend reading New Perspectives on Financing Small Cap SMEs in Emerging Markets: The Case for Mezzanine Finance, commissioned by the Dutch Good Growth Fund and authored by: Eelco Benink and Rob Winters: file:///C:/Users/tgibs/OneDrive/Documents/.i%20-%20Holding/mezzanine-finance-final%20(1)%20(1).pdf

Table 11: Funds Practicing RC Targeting SMEs in Developing/Emerging Markets

Fund	Approx. Capital (US$ millions)	Geographical Focus
Business Partners Ltd.	350	South Africa
www.businesspartners.co.za/		
Business Partners International (BPI)	60	Kenya, Rwanda, Uganda, Namibia, Malawi, Zambia
www.businesspartners.co.za/about-bpi/		
Tunisian American Enterprise Fund (TAEF)	80	Tunisia
http://www.taefund.org/en/		
Tunisian American SME Company (TASME)	30	Tunisia
http://www.taefund.org/en/tasme/		
Gazelle Finance Fund	30	Moldova, Georgia, Kyrgyzstan, Armenia
http://gazellefinance.com/		
Investisseurs & Partenaires	80 – 100	Sub-Saharan Africa and Indian Ocean
http://www.ietp.com/en		
Pyme Capital	8 – 12	Bolivia, Colombia, Nicaragua, Guatemala
http://www.pymecapital.org/web/		
Grassroots Business Investors Fund I	60	10 countries on 4 continents
www.gbfund.org/		
Small Enterprise Assistance Funds (SEAF)	500	global, 28 countries
http://seaf.com/		
extra Small Medium Large (xSML)	65	Central and West Africa
https://xsmlcapital.com/		

14 - HOW DO WE MAKE BEST USE OF THIS GUIDE?

WHO CAN MAKE USE OF THIS GUIDE AND SUGGESTIONS ON HOW TO USE IT

This Guide has been prepared in response to a growing interest in RC and a growing frustration with the financial "instrument gap" felt within the SME sector and among development professionals. Its use will vary, of course, according to the professional interests of the user. We suggest that among its uses may be the following:

ECONOMIC GROWTH AND DEVELOPMENT PROFESSIONALS IN DEVELOPMENT AGENCIES

Development agencies have spent considerable human and financial resources during recent decades in efforts to persuade or enable commercial banks to either provide more cash flow–based lending to SMEs or lower their collateral requirements. Other efforts have been focused on support of financial intermediaries with the capacity to provide equity financing to SMEs. These efforts have not succeeded as intended, as banks have little incentive to increase their risk in SME lending and so-called "SME funds" have steadily increased the size of their investments to above the SME level. We hope that this Guide will encourage development agencies to consider, recommend, and support RC investment as a "third way" to finance high-potential businesses within the SME sector.

FUND SPONSORS

An increasing number of NGOs have begun to raise or, at least to contemplate raising, risk capital funds to extend their development reach into economic growth at the SME level. Their research has often led to them to doubts about the viability of conventional capital gains–based VC/PE in developing countries, particularly at the SME level. This Guide is intended to help organizations develop their concept of a fund and, for some, demystify the often not-well-understood limitations and potential of risk capital.

FUND MANAGERS

In the case of purely profit-oriented VC/PE, funds are generally conceived and raised by fund managers. By contrast, in the case of development-oriented finance, funds are often conceived by development agencies, governments, or NGOs who design their funds in advance of identifying a fund management organization to operate the fund or hiring personnel to build a fund management team. We hope this Guide may be useful to individuals and fund management companies who may be approached by sponsoring organizations or invited to bid in tenders for fund managers. If the potential fund manager in such cases favors RC, then the Guide should be useful in developing proposals and otherwise communicating with fund sponsors.

INVESTORS IN SME RISK CAPITAL FUNDS

A majority, but not all, of the most prominent bilateral and multilateral DFIs have invested in intermediaries using some form of RC. For these organizations, the Guide may provide additional perspective in assessing the performance of these investments and in communicating to other parties within or outside their organizations why they have chosen to invest in RC. This should hold true for other categories of investors who have invested in funds using variations of RC.

POTENTIAL INVESTORS IN SME RISK CAPITAL FUNDS

Although the majority of investors in funds practicing RC are DFIs, there is potential to attract other types of investor to join the DFIs. Such investors would include non-DFI development agencies, national development agencies and development funds of developing countries, NGOs, foundations, and multinational corporations seeking to contribute to economic development in countries where they export their goods and services, manufacture products, or extract natural resources such as minerals and oil. We would hope that the Guide will find its way into the hands of individuals in such potential investors.

We invite you to forward this document to persons within any of the above groups of potentially interested parties.

ANNEX: ASSESSMENT OF KEY LEGAL ISSUES FOR REVENUE CAPITAL FINANCING

I. Introduction

This annex discusses the results of an assessment conducted on the legal issues related to revenue capital (RC) investments in Jordan, Morocco, and Egypt. In each of these countries, RC investments are a new type of investment that solicit a unique financial and legal structure. The object of this assessment was to briefly analyze the existing financial regulatory environments of a select variety of Middle East/North Africa region countries, determine the extent to which there are existing legal or regulatory barriers that specifically prohibit the utilization of the RC investment structure in these countries, and outline potential work-arounds or solutions that can be considered to possibly ameliorate problems encountered. The assessment also provides a series of recommended next steps that could be taken to promote RC investment transactions and reduce or navigate existing legal barriers.

The annex is organized by first providing a description of the methodology of the assessment; then outlining the general regulatory profiles for Jordan, Morocco and Egypt, outlining specific legal issues related to the RC financing structure; defining key legal barriers noted in each country related to RC finance; and proposing potential solutions or work-arounds when applicable. Lastly, this annex provides a summary of findings and proposed next steps to address regulatory barriers when considering the RC approach.

II. Methodology for Assessment

Legal counsel in Jordan, Morocco, and Egypt were consulted to gather information for this assessment. The local legal counsel consulted were reputable experts in local commercial and corporate law. When available, local offices for an international accounting firm were also consulted. Meetings with local legal counsel lasted from one and one-half to three hours at each organization. The approach to meetings began with describing the nature and purpose of the RC investment transactions, then asking whether local counterparts saw any specific problems from the point of view of the legality of such a transaction in their country, and then following up with a more detailed discussion of the elements of the transaction and specific legal issues.

In meetings conducted, advice received was given with the understanding that it was based on local legal counsel's initial reaction to the summary description of what was, in the context of that country, a new transaction structure. Local legal counsel in each country stated that they were not aware of any example of a transaction similar to the RC structure in their country. As discussed below, counsel advised in all cases that tax issues were a separate legal specialty and generally outside the expertise of the local legal counsel met with and are therefore not included in this assessment.

A. Tax Issues

In several cases, local counsels were aware of specific local tax issues that they viewed as both unexpected and particularly relevant to international investors or to the structure of RC financing. The specific tax issues mentioned do not reflect a comprehensive review of relevant local tax law. They are individual issues that were outlined on an exception basis. Review of local tax law, such as the design of specific legal structures suitable for each country, is work that will be necessary for the successful operations of a RC investment.

III. Regulatory Profiles: Jordan, Morocco, and Egypt—General Regulatory and Legal Issues

Topic	Jordan	Morocco	Egypt
Nature of Regulatory Regime for Private Equity Investments	Investment in unlisted securities is not regulated.	Investment in unlisted securities is not regulated.	Investment in unlisted securities is not regulated.
Nature of General Regulatory Regime for Lending	• Lending is generally regulated by the Central Bank. • Loans to microenterprises and small enterprises are regulated in the same way. • Loans to medium-sized enterprises are not subject to regulation.	• There are no legal limits on interest rates for business loans. Note: Counsel advised that interest in excess of 3.65 percent/year is not deductible for tax purposes.	• Generally, only licensed banks can provide loans domestically. • Civil law limits interest on a loan from any entity other than a bank to 7%. • Interest rates on loans to microenterprises are separately regulated. • Loans to domestic borrowers from foreign lenders are not regulated if execution and delivery of the transaction takes place offshore.

Regulation of Investment for Foreign Investors	• Investments by foreign investors are generally not restricted. • There are some restrictions on foreign ownership in a limited number of industries.	• Investments by foreign investors are generally not restricted. • There are some restrictions on foreign ownership in a limited number of industries.	• Investments by foreign investors are generally not restricted. • There are some restrictions on foreign ownership in a limited number of other industries, including real estate and import/export businesses.
Foreign Exchange Issues	There are no restrictions on foreign exchange or transfers of funds out of the country.	• Transfer of foreign exchange is regulated. • Interest on foreign shareholder loans to a Moroccan company and profits on sale of Moroccan securities can generally be remitted. • If an investment in foreign currency is registered within six months, the proceeds and profits from the investment can be freely remitted in foreign currency. Note: Counsel advised that foreign exchange regulations require interest paid by Moroccan companies to be in line with interest paid by similar companies in the international market. Government regulators take the position that interest over the international market rate as determined by	• Foreign exchange is subject to regulation but generally not restricted. Note: Counsel advised that the primary issue with remitting funds is not regulatory limitations but the general scarcity of foreign exchange and delays in executing transactions.

		government regulators cannot be remitted.	
Common Formal Business Organizational Forms for Small and Medium-Sized Enterprises (SMEs)	The two most common legal organizational forms used by SMEs are the private shareholding company and the limited liability company.	• The two common legal forms used are the *Societe a responsibilite limitee* (SARL) and *Societe Anonyme* (SA). • The majority of SMEs are organized in SARL form. • The SA form is used primarily by larger enterprises. • Special rights and protective provisions can be added to the organizational documents of an SA but not to those of an SARL.	• The two common legal forms used are the limited liability company and the joint stock company. • Counsel advised that joint stock companies are viewed as "more prestigious" and often used by SMEs. • The government has prescribed model forms of organizational documents for both limited liability companies and joint stock companies. • Counsel advised that special protective provisions can be added to organizational documents but require specific governmental approval.
Legal Enforcement	• Court system is relatively slow and expensive. • Arbitration is permitted, common, and enforceable.	Counsel advised that arbitration is permitted, common, and enforceable by courts.	• Court system is relatively slow and inefficient. • Arbitration is permitted, common, and enforceable.

IV. Regulatory Profiles: Jordan, Morocco, and Egypt—Regulatory Considerations With Respect to the RC Financing Structure

Topic	Jordan	Morocco	Egypt
Usury/Legal Limit on Interest	Central Bank establishes maximum interest rate for loans. Note: Loans to medium-sized enterprises are not currently subject to Central Bank regulation.	Counsel advised that there is no legal limit on interest, but see Foreign Exchange Issues.	• Generally only licensed banks may lend domestically. • Civil law generally limits interest on any loan by a nonbank lender to 7%. • Legal limits on interest do not apply to loans by offshore lenders to domestic entities that take place offshore.
Treatment of Loans by Shareholders	Loans by shareholders are not subject to interest rate limitations.	Loans from shareholders holding 5% or more of a company's equity are not subject to regulation.	Loans from shareholders are not subject to interest rate limitations.
Participation in Revenue	Counsel advised that a participation in revenue was unlikely to be treated as interest on a loan and likely to be treated as a separate financial interest.	• Counsel advised that the treatment of a share of revenue in this case is unclear but thought it was unlikely to be treated as a separate financial interest. • Counsel advised that the most likely treatment of a participation in revenue will be as interest on a loan.	Counsel advised that a participation in revenue will not be characterized as interest for purposes of laws limiting interest on loans.

Put/Resale Agreement on Shares	• A private shareholding company may generally repurchase issued shares. • A limited liability company may repurchase issued shares if its organizational documents permit it to do so. • Repurchase of shares by a company's owner is permitted.	• An SARL may repurchase shares if its organizational documents permit it to do so. • An SA may repurchase its shares for purposes of reducing its capital. • Repurchase of shares by a company's owner is permitted. Note: Counsel advised that in the case of a sale of shares and a repurchase of shares, the tax authorities' policy is to treat any difference between purchase price and fair market value as taxable income.	• Counsel advised that a company can repurchase its shares with approval of the majority of shareholders. Note: Counsel advised that a recent arbitral decision held that a purchase and put agreement was in effect a loan with the difference between purchase price and put price treated as interest. Counsel advised that share purchase and put transactions should be with different parties to avoid risk of this characterization (e.g., buy from the company and sell to the owner).
Covenants/Protective Provisions	• Courts are limited to awarding monetary damages for breach of contract. • Courts do not have power to order covenants in contracts specifically enforced. • Counsel advised that it is possible to create protective provisions as part of a private shareholding company's or a limited liability company's organizational documents.	• Courts are limited to awarding monetary damages for breach of contract. • Courts do not have power to order covenants in contracts specifically enforced. • Special rights and protective provisions can be added to the organizational documents of an SA but not to those of an SARL.	• Counsel advised that courts can specifically enforce covenants and other contractual provisions. • Counsel advised that the primary issue with enforcement is the inefficiency of the court system. • Counsel advised that it is possible to create protective provisions in a company's organizational documents.

V. Regulatory Profiles: Jordan, Morocco, and Egypt—Key Barriers and Solutions Related to RC

Barrier	Suggested Solution by Country (when applicable)		
	Jordan	**Morocco**	**Egypt**
Regulatory regime for loans to small businesses on the same regulatory basis as loans to microenterprises, creating a regulatory burden for an investment fund	Consultation with the regulatory authorities to find a workable solution and reduce regulatory uncertainty	Not applicable	Not applicable
Legal system not allowing for the specific enforcement of contractual provisions as a judicial remedy for breach of contract; judicial remedies for breach of contract limited to monetary damages	Develop organizational documents for an SME, such as by-laws and statutes that contain protective provisions, that will provide minority equity holders with additional rights with respect to decisions that are material for the RC investor	Develop organizational documents for an SME that contain protective provisions that will provide minority equity holders with additional rights with respect to decisions that are material for the RC investor	This issue is not present in Egypt; however, the inefficiency of the court system makes it worthwhile to develop organizational documents for an SME that contain protective provisions as an alternative to relying on enforcement of contractual provisions.
Regulatory requirement that interest charged to domestic companies should be consistent with international market interest rates for a similar transaction; where the regulatory authority concludes that the interest rate charged a domestic company on an international loan is above the international market rate, remission of the amount of interest determined excessive not permitted	Not applicable	Increase understanding of RC transaction structure on the part of regulatory authorities sufficient to avoid potential misunderstanding of interest rates	Not applicable
Where tax authorities determine that purchase price for a company's	Not applicable	Increase understanding of RC transaction structure by	Not applicable

shares was significantly lower than the fair market value of the shares, difference between purchase price and fair market value potentially viewed by tax authorities as income to the buyer		regulatory authorities sufficient to avoid potential misunderstanding of the pricing of the purchase and resale of shares in the transaction	
Uncertainty regarding treatment of a purchase and resale of shares (a recent arbitral decision treating the difference between the purchase price for shares and the put price for the same shares as interest)	Not applicable	Not applicable	No specific solution for this potential problem is proposed; however, increasing awareness of the structure of RC transactions in the business community may reduce risks of mischaracterization.
Lack of local familiarity and legal precedents for RC transactions	• Increase awareness of RC transactions in the local legal community • Prepare localized model terms and legal documents for an RC transaction	• Increase awareness of RC transactions in the local legal community • Prepare localized model terms and legal documents for an RC transaction	• Increase awareness of RC transactions in the local legal community • Prepare localized model terms and legal documents for an RC transaction

VI. Summary of Findings and Key Conclusions

The overall conclusion is that while each country reviewed presents unique legal and regulatory issues that will affect how RC transactions can be effectively structured and managed in that country, there do not appear to be any legal or regulatory obstacles that will make RC transactions impossible in any country reviewed.

Nonetheless, each country presents issues that need to be addressed, and in all countries the transaction documentation will need to be localized. In some cases it appears that effective consultation with local regulators to achieve a mutual understanding of the RC structure will be very important in order for an investment fund to operate. In other countries, the transaction structure may need to be adjusted to comply with local law.

The more significant issues and suggested approaches noted in the table above are discussed in more detail on a country-by-country basis below.

A. Jordan: Jordan presents both regulatory and legal issues.

- Jordan has recently changed the regulatory regime for loans to small businesses to put such loans on the same regulatory basis as loans to microenterprises. (For this purpose, "small businesses" are defined as businesses that have annual revenue of between JD100,000 and JD1,000,000 and between five and 20 employees.) Counsel advised that this regulatory change has required most lenders to create a separate business entity to make their loans to small businesses. By contrast, at present, Jordan does not regulate loans to medium-sized businesses. The regulation of loans to small businesses may create a regulatory burden that cannot be effectively managed by a small private investment fund making RC investments in SMEs. The recent regulation of loans to small businesses and absence of current regulation on loans to medium-sized businesses suggests that regulations governing loans to medium-sized businesses are likely to be developed in the future. In the case of both loans to small businesses and loans to medium-sized businesses, the most practical approach to finding a workable solution and reducing regulatory uncertainty is consultation with the regulatory authorities.

- Jordan's legal system does not allow for the specific enforcement of contractual provisions as a judicial remedy for breach of contract. Judicial remedies for breach of contract are limited to monetary damages. This is a significant issue in an RC transaction where monetary damages alone may not provide an effective remedy for some types of problems. Discussions with counsel suggest that it may be possible to develop organizational documents for an SME that contain protective provisions providing minority equity holders with additional rights with respect to decisions that are material for the RC investor. This approach to the basic problem will require further research. There are significant issues that will need to be addressed with respect to the development of provisions that can be easily understood by entrepreneurs and the development of a process for incorporating such provisions in a company's organizational documents or changing the legal form of the company to one where such provisions can be used.

B. Morocco: Morocco presents both regulatory issues and legal issues.

- There are two potential regulatory issues that were brought to our attention by counsel. Both of these issues suggest that developing a relationship with regulatory authorities sufficient to promote an understanding of RC transactions will be necessary to avoid potential problems.

    a. Counsel advised that the policy of the Moroccan foreign exchange authorities is that interest charged to Moroccan companies should be consistent with international market interest rates for a similar transaction. Where the regulatory authority concludes that the interest rate charged a Moroccan company on an international loan is above the international market rate, the foreign exchange authority will not permit the amount of interest it has determined to be excessive to be remitted. This issue with interest rates is significant if there is a risk that the revenue share received in a transaction could be considered as interest on the loan portion of the transaction. The financial structure of RC investments can result in payments that could be much higher than market rate interest, if the revenue share was treated as annual interest on the loan portion of the RC investment.

b. Another regulatory issue was identified in connection with the tax treatment of a purchase of shares. Counsel advised that in a case where the tax authorities determine that the purchase price was significantly lower than the fair market value of the shares, the tax authorities could potentially view the difference between the purchase price and the fair market value as income to the buyer. This will clearly be a problem in the case of an RC transaction, as both the original purchase of equity in the company and its resale of the equity to the company (or the entrepreneur) at the conclusion of the transaction will likely be at prices significantly below the fair market value of such equity, which could result in both the purchase and resale of the shares creating noncash taxable income.

- Morocco's legal system does not allow the specific enforcement of contractual provisions. Judicial remedies for breach of contract are limited to monetary damages. This is a significant issue in an RC transaction where monetary damages may not provide an effective remedy for some types of problems. Discussions with counsel in Morocco suggest that it may be possible to develop organizational documents for an SME that contain protective provisions to provide minority equity holders with additional rights with respect to decisions that are material for the RC investor. This approach to the basic problem will require further research. There are significant issues that will need to be addressed with respect to the development of provisions that are easily understood by entrepreneurs and a process for incorporating such provisions in the company or changing the legal form of the company from an SARL to the more complex form of an SA (discussed below) where such provisions could be used. Although the basic problem and the potential approach is similar to that discussed in the case of Jordan, differences in the actual statutes and legal entities will mean that there may not be significant specific carryover from the legal work on a similar project in Jordan.

C. Egypt: Egypt presents some practical issues and limited legal issues.

- Counsel advised that while there were no significant regulatory issues with respect to remitting investment proceeds, currently there could be practical problems with finding a bank with regular access to sufficient foreign exchange.

- Counsel advised that loans by a shareholder to a company in which the person held shares were not subject to interest rate limitations, and he did not believe that a participation in revenue will be considered to be interest. However, counsel indicated that there was some degree of uncertainty in terms of what could be considered interest. Counsel described a recent arbitral decision treating the difference between the purchase price for shares and the put price for the same shares as interest. Although this was an arbitral decision, counsel thought it raised some concerns about what regulators might view as interest.

- Egyptian law permits courts to specifically enforce contractual provisions. The law also permits organizational documents to incorporate protective provisions. However, counsel advised that slowness and inefficiency of governmental action was a serious problem for effective remedies. This environment is likely to put particular importance on the use of aspects of the RC structure designed to create a working partnership with the SME, since legal remedies are less likely to provide practical protection.

VII. Proposed Next Steps

Overall conclusions reflect findings that although the specific issues related to RC financing vary among the countries reviewed, there are very similar general issues all the countries. It is recommended that the next steps address these common issues, understanding that the work will necessarily be different for each country.

- Review the domestic tax treatment of revenue participation: As noted in discussions of the legal review above, tax matters are a separate legal specialty and an analysis of tax issues was not included in this review. The tax treatment of different elements of an investment transaction is critical to both structuring and evaluating an investment. In the case of RC transactions, the tax treatment of a participation in revenue appears to be a novel issue in each of the countries reviewed. Clarifying the tax treatment of RC investments, both for the company and for the investor, is an important next step in promoting the use of this form of financing.

- Prepare localized investment structures and model legal documents: RC investments are comparatively complex financial transactions. Although the financial and economic elements of RC investments will be similar from country to country, the specific investment structures, legal approaches, and legal documents will be different for each country. Developing new legal documentation for a new type of transaction is always time consuming and expensive. These transaction costs can be a very significant deterrent to the use of a new type of investment. Working with local counsel to develop model legal forms for RC investments will reduce transaction costs for these investments and make it easier for more members of the legal and financial community to understand and use this type of investment.

- Increase understanding of RC investments by relevant regulatory authorities: One of the recurrent concerns stated in meetings with local legal counsel was that local regulatory authorities might treat elements of an RC transaction in a disadvantageous way, in part because it is something they have never seen before. In the recommended solutions for some of these regulatory issues, it is recommended that a specific approach be made to the relevant regulatory authorities for the purpose of increasing their awareness and understanding of the RC investment structure. A discussion of RC investment with regulatory authorities can also be an opportunity to increase awareness of the unique benefits that this type of transaction can bring to local SMEs, which may encourage a more supportive regulatory approach to RC investors and RC transactions.

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