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Revenue Capital: Reducing, Rewarding and Realigning Risk

Speakers: Nazeem Martin, *Business Partners Ltd. and Business Partners International*
Bo Cutter, *Roosevelt Institute and the Tunisian American Enterprise Fund*
Tom Gibson, *SMEThink*

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Nazeem Martin

Nazeem has extensive knowledge of and experience in SME and entrepreneurial business finance, having worked for Business Partners Ltd (BPL) – a leading, on-scale provider of risk capital, business premises and technical assistance to SMEs in South Africa and selected sub-Saharan countries. Nazeem spent more than 18 years at BPL, retiring as Managing Director of the company and as CEO of its subsidiary, Business Partners International (Pty) Ltd ("BPI"), in 2016. Prior to joining Business Partners, Nazeem held executive positions in the private, public and NGO sectors, including stints as Deputy Director-General of Public Works in the Nelson Mandela government and with Old Mutual Properties – the real estate arm of South Africa's largest life assurer which is listed on the London stock exchange. Currently, Nazeem serves as a non-executive director on company boards, such as Business Partners Ltd and E-Squared (an equity investor in high impact businesses). He also provides consulting and advisory services to SME and entrepreneurial financiers and service providers. And he, together with some close friends, founded the Wallflower Group in 2016 seeking to build interests in food and aquaculture, short-stay health facilities, real estate development and investments, and affordable private education.

W. Bowman Cutter

W. Bowman Cutter is Senior Fellow and Director of the Economic Policy Initiative at the Roosevelt Institute. He was a managing director of Warburg Pincus, a major global private equity firm headquartered in New York City, between 1996 and 2009 where he served as the firm's economist; as a leader in its international business; and as one of the firm's principal fund raisers. Mr. Cutter joined Warburg Pincus directly from a senior economic policy role in the Administration of President Bill Clinton. He has served with distinction during two Democratic presidencies: at the National Economic Council, from 1992-1996, during the Clinton Presidency – as director of the National Economic Council and Deputy Assistant to the President; and at the Office of Management and Budget from 1976-1981, during the Carter Presidency, as Executive Director for Budget. Mr. Cutter also served as leader of the OMB transition team after the election of President Obama. Mr. Cutter was Chairman of the Board of CARE for over seven years, the global development organization (where he had been a member of the Board for 20 years); and is a founder and current Chairman of MicroVest, a leading global microfinance fund with assets under management now in excess of $250 million.

Tom Gibson

Tom Gibson has been promoting and providing risk capital finance for small and medium enterprises in developing markets for more than 25 years. He was founding president and later chairman of Small Enterprise Assistance Funds (SEAF), one of the largest global groups of private SME risk capital funds in developing markets, with more than $500 million under management and over 500 investments. Since his departure from SEAF in 2001, Mr. Gibson has been advising primarily on the design, development, and documentation for new SME risk capital funds as well as providing training for fund managers and stakeholders in SME finance. His clients include, inter alia, the World Bank, International Finance Corporation, Asian Development Bank, U.S. Agency for International Development, Inter-American Development Bank, Millennium Challenge Corporation, numerous developing country governments, and private risk capital fund managers. Working in more than 70 countries, he has held in-depth, on-site, one-on-one investment related interviews with more than 600 SMEs. He has been a frequent speaker at international fora on development finance, a guest lecturer at numerous business schools, and adjunct professor in international development at Tulane University..

Reducing, Rewarding and Realigning Risk

Revenue Capital

From Tunisia to South Africa, the revenue capital approach is financing growing numbers of high-performing SMEs who do not fit the bill for traditional bank financing or venture capital. Access to finance has been a chronic issue for SMEs around the world for decades, but the revenue capital approach is drawing increasing attention as a practical alternative for providing SMEs with the capital needed to maintain their promising growth.

The revenue capital approach reduces the risk of unsecured investing; rewards the work of entrepreneurs poised for expansion; and realigns the interests of entrepreneurs and investors from capital gains to revenue growth.

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ASIA AND THE MIDDLE EAST
ECONOMIC GROWTH BEST PRACTICES PROJECT

"Revenue Capital"

Reducing, Rewarding and Realigning Risk

Alternative Financing for Fast-Growth Small and Medium Enterprises in the Middle East and North Africa

Tom Gibson

What is Revenue Capital?

Revenue Capital is risk capital.

Revenue Capital is a way of investing risk capital in a businesses where the investor *shares* a small part of the *revenues* of the business.

Its most basic form is an unsecured loan for which the borrower pays the lender a low interest rate and shares a small percentage of gross sales.

What is Revenue Capital:

For the entrepreneur, RC:

•***reduces*** the risk of losing her/his business,

•***rewards*** the risk taken in starting and growing a business, and

•***realigns*** risk by focusing all parties on sales growth.

For the investor:

•***reduces*** the risk of investing in a good business but having a bad investment

•***rewards*** risk by providing an "upside" participation in sales

•***realigns*** the risk of relying on capital gains to the risk of low sales growth

The Opportunity:

- In most countries studied, 5% - 10% of businesses create 50% to 100% of net new jobs.*
- Known as "gazelles", these are businesses whose revenues have grown by at least 20% per annum for 4 contiguous years.
- The vast majority of gazelles are SMEs.
- Revenue Capital can be appropriate finance for SME gazelles.

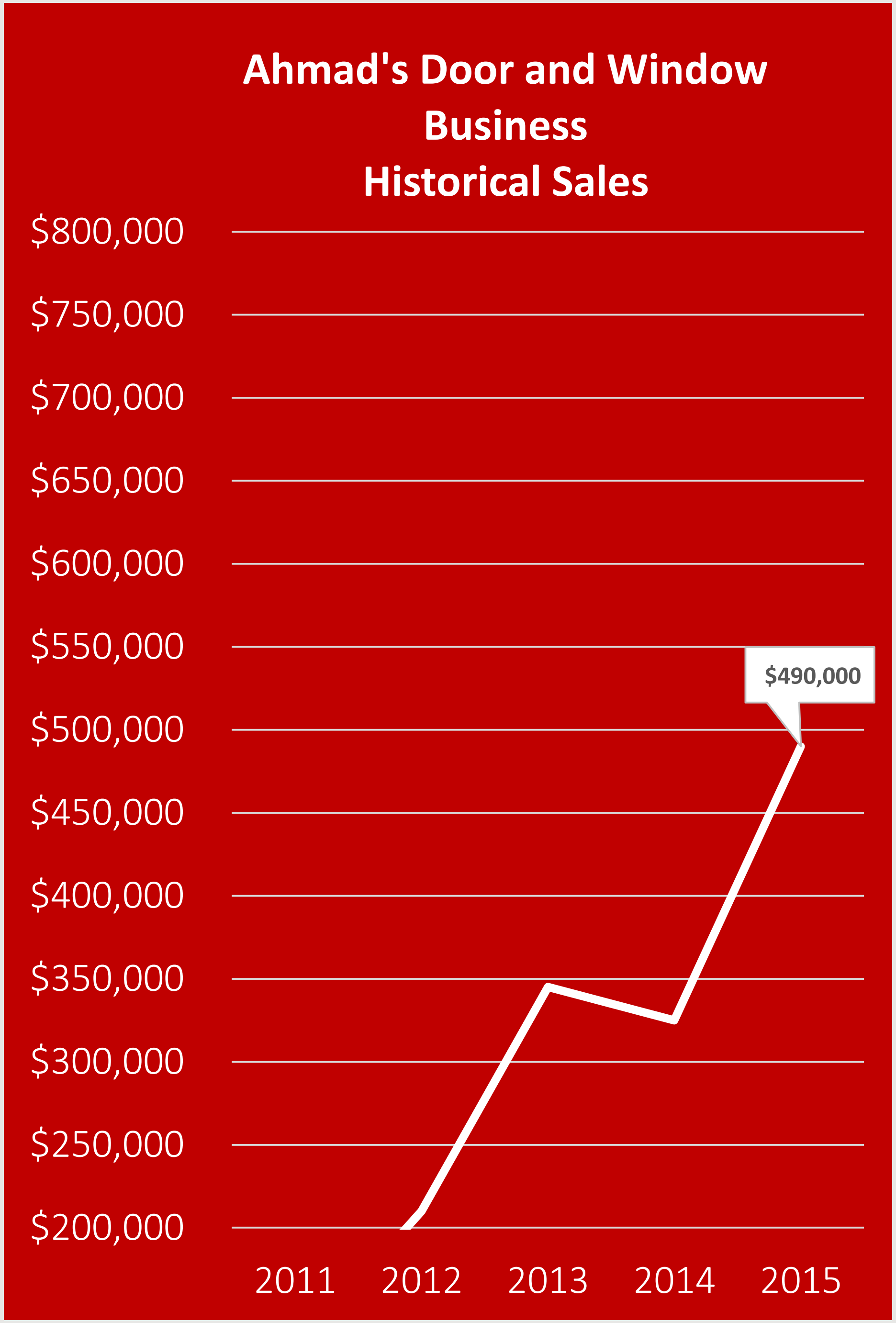
The Opportunity:

My name is Ahmad.
“My business is small…but becoming medium size.

We make door and window frames for houses and small commercial buildings - mostly from aluminum but also from PVC.”

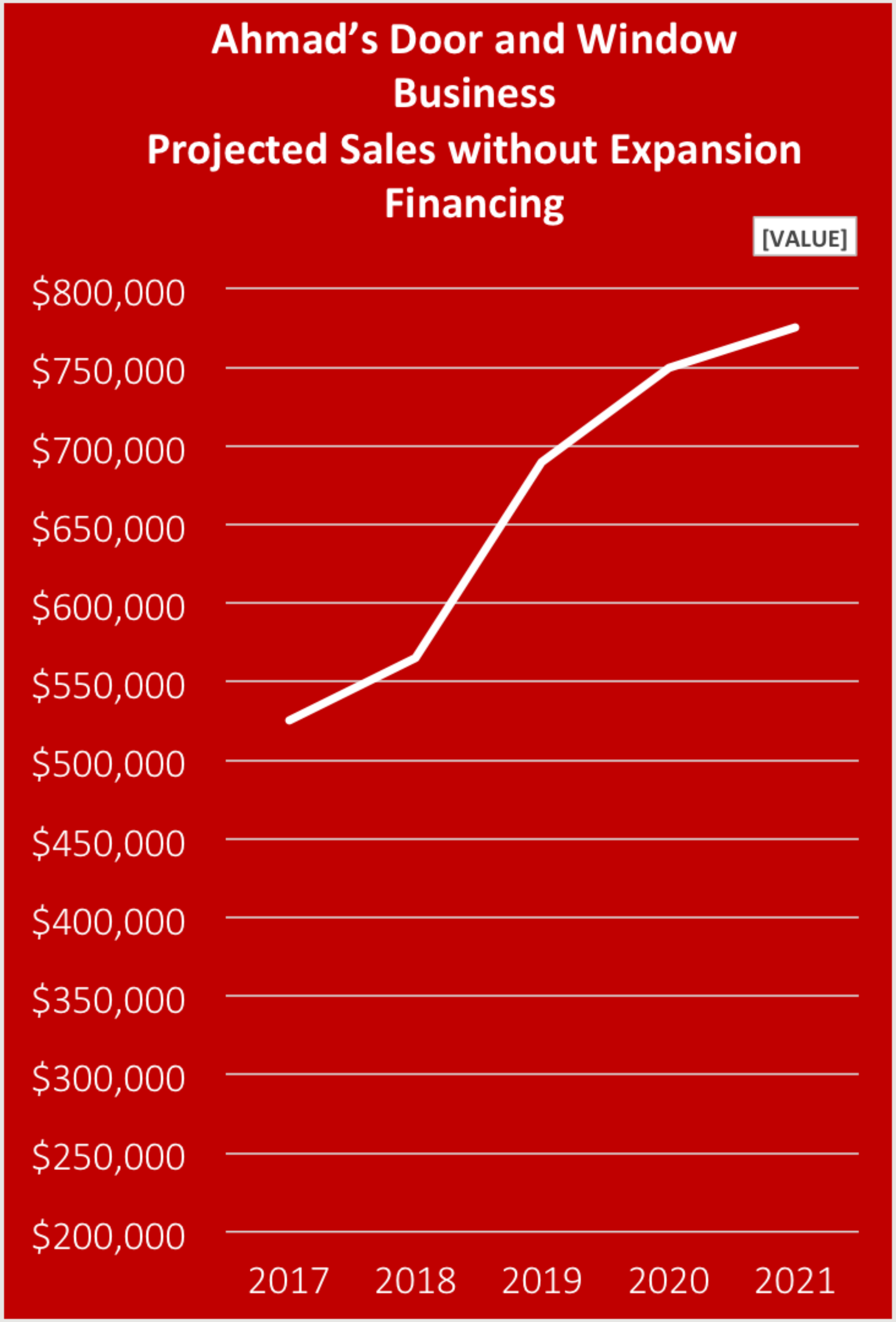
The Opportunity:

“We’ ve been in business for 5 years. These are our sales figures for the past 5 years.”



The Opportunity:

"These are our projections for the next 5 years."



The Opportunity:

“Because of our good reputation we have an opportunity to make door and window frames for a new apartment development going up next year.

This one contract would bring us more business than all of our current work combined.”

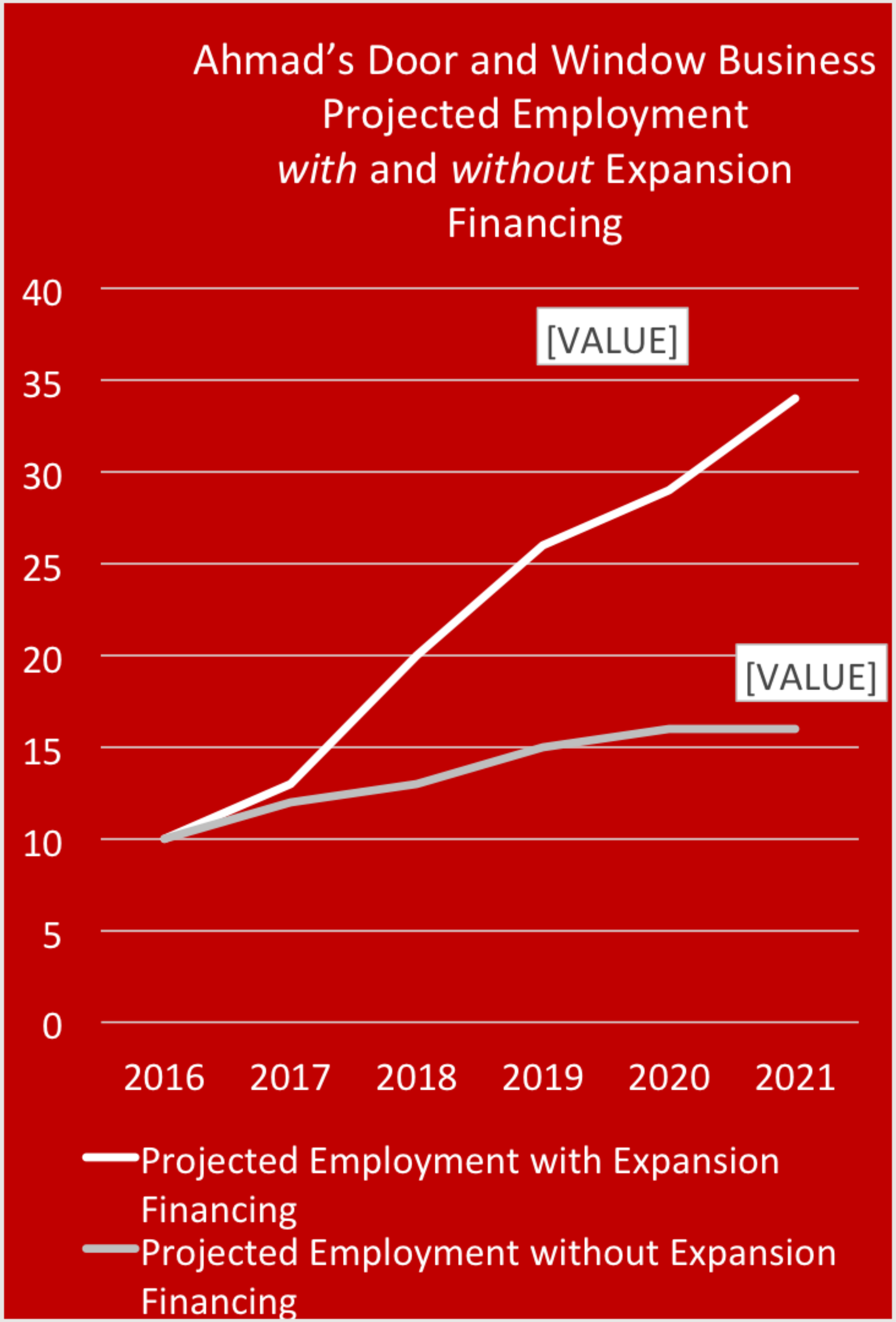
The Opportunity:

"But we need $500,000 for new equipment and working capital to be able to fulfill the contract and do more big jobs.

These are our projections for the next 5 years…if we could finance the expansion."

The Opportunity:

“If we can get the expansion financing we need we could also create more new, skilled jobs for people in our community.”



The Problem:

"My team and I spent a lot of time preparing applications to several banks for the $500,000 we need.

We have been turned down by all of the banks because we don't have enough collateral to offer."

The Problem:

“We also went to the only private equity fund we could find that makes investments under $2,000,000.

They told us that we weren’t big enough, that we weren’t a technology company, and that we would have to sell our business to be a good investment for them.”

The Problem:

Lack of Access to Bank Lending

- According the World Bank's Enterprise Surveys, in MENA, more than 80% of SME loans require collateral and the average collateral requirement is over 200% (!) of the amount of the loan.

- While 82% of SMEs in MENA have retail bank accounts, only 21% finance investments in their businesses through bank loans.

The Problem:

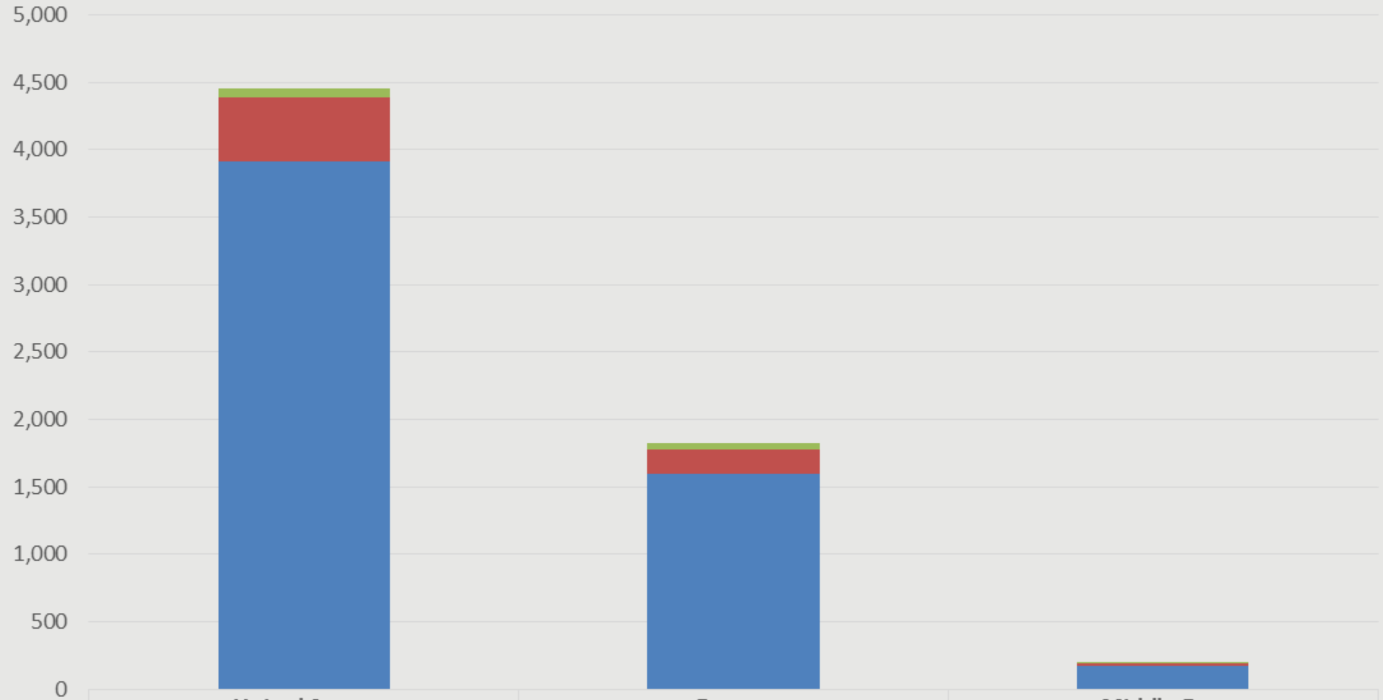
Lack of Access to Venture Capital/Private Equity

- Viable venture capital is predicated upon investors selling a small percentage of portfolio investees at high multiples of the original investment, almost exclusively via mergers or acquisitions (M&A) or through public offerings on stock exchanges (IPOs).
- Venture capital funds are seldom viable based on capital gains from selling their shares back to the management of their investees (MBOs).

The Problem:

Lack of Access to Venture Capital

The data below shows the relative *rarity of VC exits* through M&A or IPOs:



	United States	Europe	Middle East
Number of VC-Backed Exits by IPO	66	48	6
Number of VC-Backed Exits by Mergers and Acquisitions	473	183	15
Number of VC Investments	3,916	1,598	175

Number of VC Investments   Number of VC-Backed Exits by Mergers and Acquisitions   Number of VC-Backed Exits by IPO

Sources: Ernst & Young's Global Venture Capital Trends 2015 and the MENA Private Equity Association's 10th Annual MENA Private Equity and Venture Capital Report 2015

The Problem:

Ahmad's business has the potential to become a high-impact gazelle. However, he is stuck…not in a "finance gap", but in an "instrument gap".

High-Collateral Bank Loans

?

Extremely Rare Venture Capital

"The Instrument Gap"

How Revenue Capital works.

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Basic Structure of a Revenue Capital Loan

Loan Amount	500,000
Interest Rate	5% (half a local bank corporate rate of 10%)
Term	5 years
Grace Period	12 months
Revenue % of sales	2%

	Year 1	Year 2	Year 3	Year 4	Year 5
Ahmad's Sales	500,000	1,250,000	1,500,000	2,100,000	2,400,000
Principal Payments	0	125,500	125,000	125,000	125,000
Interest Payments	25,000	25,000	18,750	12,500	6,250
Revenue Participation	**11,000**	**25,000**	**30,000**	**42,000**	**48,000**
Total Payments to Fund	36,000	175,00	173,750	179,500	179,250

Return on Investment (IRR): 12.8%

Variant of a Revenue Capital with Equity

Loan Amount	450,000
Equity Amount	50,000 (for 25% of equity)- "tag-along"
Interest Rate	5%
Term	5 years
Grace Period	12 months
Revenue % of sales	2%

	Year 1	Year 2	Year 3	Year 4	Year 5
Ahmad's Sales	500,000	1,250,000	1,500,000	2,100,000	2,400,000
Principal Payments	0	125,000	125,000	125,000	125,000
Interest Payments	22,500	22,500	16,875	11,250	5,625
Revenue Participation	**11,000**	**25,000**	**30,000**	**42,000**	**48,000**
Equity Buy-Back					100,000
Total Payments to Fund	33,500	160,000	159,375	165,750	266,125

Return on Investment (IRR): 16.3%

Equity Only Investment

Loan Amount	
Equity Amount	500,000 (for 25% of equity)- “tag-along”
Interest Rate	
Term	
Grace Period	
Revenue % of sales	

	Year 1	Year 2	Year 3	Year 4	Year 5
Ahmad’s Sales	500,000	1,250,000	1,500,000	2,100,000	2,400,000
Principal Payments					
Interest Payments					
Revenue Participation					
Equity Buy-Back					1,065,000
Total Payments to Fund					1,065,000

Return on Investment (IRR): 16.3%

Legal Issues:

For the investing entity/fund:

- regulation of lending
- foreign exchange transfer
- taxation

For the investment:

- treatment of revenue share
- status of loans by shareholders
- shareholder right
- legal remedies

Advantages of Revenue Capital

- The interests of Ahmad and fund are aligned on sales.
- All financing costs will be agreed in nominal terms at the outset.
- Ahmad is able to preserve more working capital for the expansion.
- The cost of financing "floats" with the performance of Ahmad's business.
- Sales are more easily agreed upon than earnings.
- Without earnings disputes information asymmetry is diminished facilitating post-investment support.
- Freedom from having to sell the company means investment staff need no VC or investment banking experience.
- The tag-along right provides for a conventional venture capital return in the rare case of a tag along.

Who is Using Revenue Capital?

Fund	Approx. Capital Under Management	Geographical Focus
Business Partners Ltd.	USD 350 million	South Africa
www.businesspartners.co.za/		
Business Partners International (BPI)	USD 60 million	Kenya, Rwanda, Uganda, Namibia, Malawi, Zambia
www.businesspartners.co.za/about-bpi/		
Tunisian American SME Company (TASME)	USD 30 million	Tunisia
http://www.taefund.org/en/tasme/		
Gazelle Finance Fund	USD 30 million	Moldova, Georgia, Kyrgyzstan, Armenia
http://gazellefinance.com/		
Investisseurs & Partenaires	USD 80 – 100 million	Sub-Saharan Africa and Indian Ocean
http://www.ietp.com/en		
Pyme Capital	USD 8 – 12 million	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/		

Source: New Perspectives on Financing Small Cap SMEDs in Emerging Markets, Dutch Good Growth Fund (DGGF), Eelco Benink and Rob Winters (RebelGroup, The Netherlands)

Revenue Capital:

for the entrepreneur:

•***reduces*** the risk of losing her/his business

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Thank you!
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REVENUE-ROYALTY-BASED FINANCE: THE BUSINESS/PARTNERS APPROACH

Nazeem Martin

Former CEO, now Non-executive Director

Business Partners Ltd and Business Partners International

April 25, 2017

BUSINESS/PARTNERS
Investing in entrepreneurs

THE STORY

1. BUSINESS/PARTNERS:
   A sustainable SME risk financier
2. SME's need much more than just money/finance to thrive
3. Demystifying SME Risk Finance
4. Take-Aways: Revenue-/Royalty-based finance
   - Benefits to SME/entrepreneur and financier
   - Tips to deal with challenges
5. Questions / comments

BUSINESS/PARTNERS
Investing in entrepreneurs

01

BUSINESS/PARTNERS?

Who is BUSINESS/PARTNERS?

- A **specialist risk financier** providing …
  - Funding (customised financial solutions),
  - Business premises, and
  - Technical assistance, sector knowledge, and added-value services

… **on scale** (250 deals in a bad year, up to 700 in a good year)

… **only for SMEs** (formal small and medium enterprises)

… to **"do good" (positive development impact)** and to **"do well" (make profits)**

- Established in 1981 … **sustainable success** in South Africa
- Since 2005 … **expanded** (finance & TA only) **into East Africa** (Kenya, Rwanda and Uganda) **and Southern Africa** (Malawi, Namibia and Zambia)

Milestones

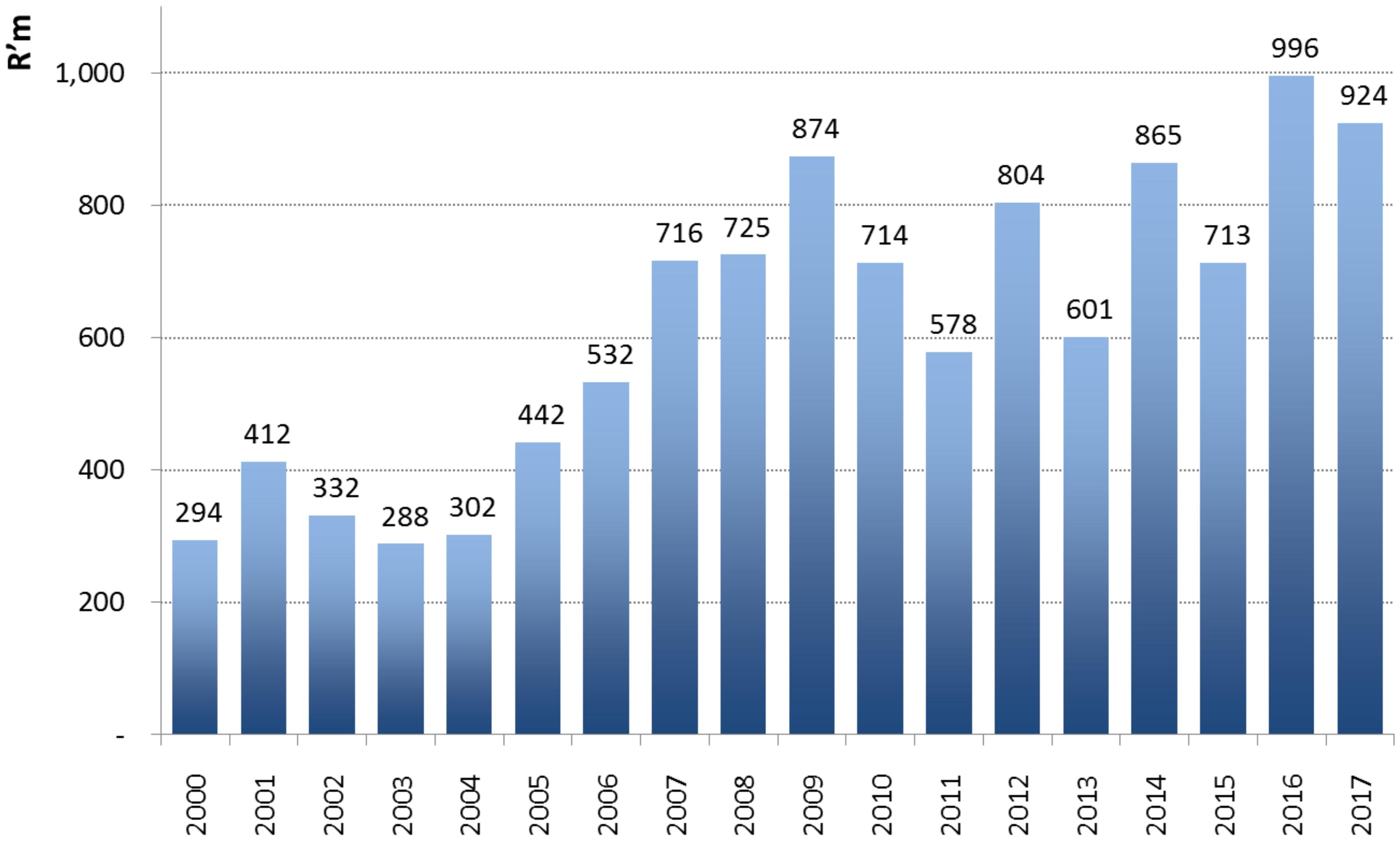
> $1.6 billion
SME finance

> 600 000
Job opportunities facilitated

> 70 000
SME finance transactions

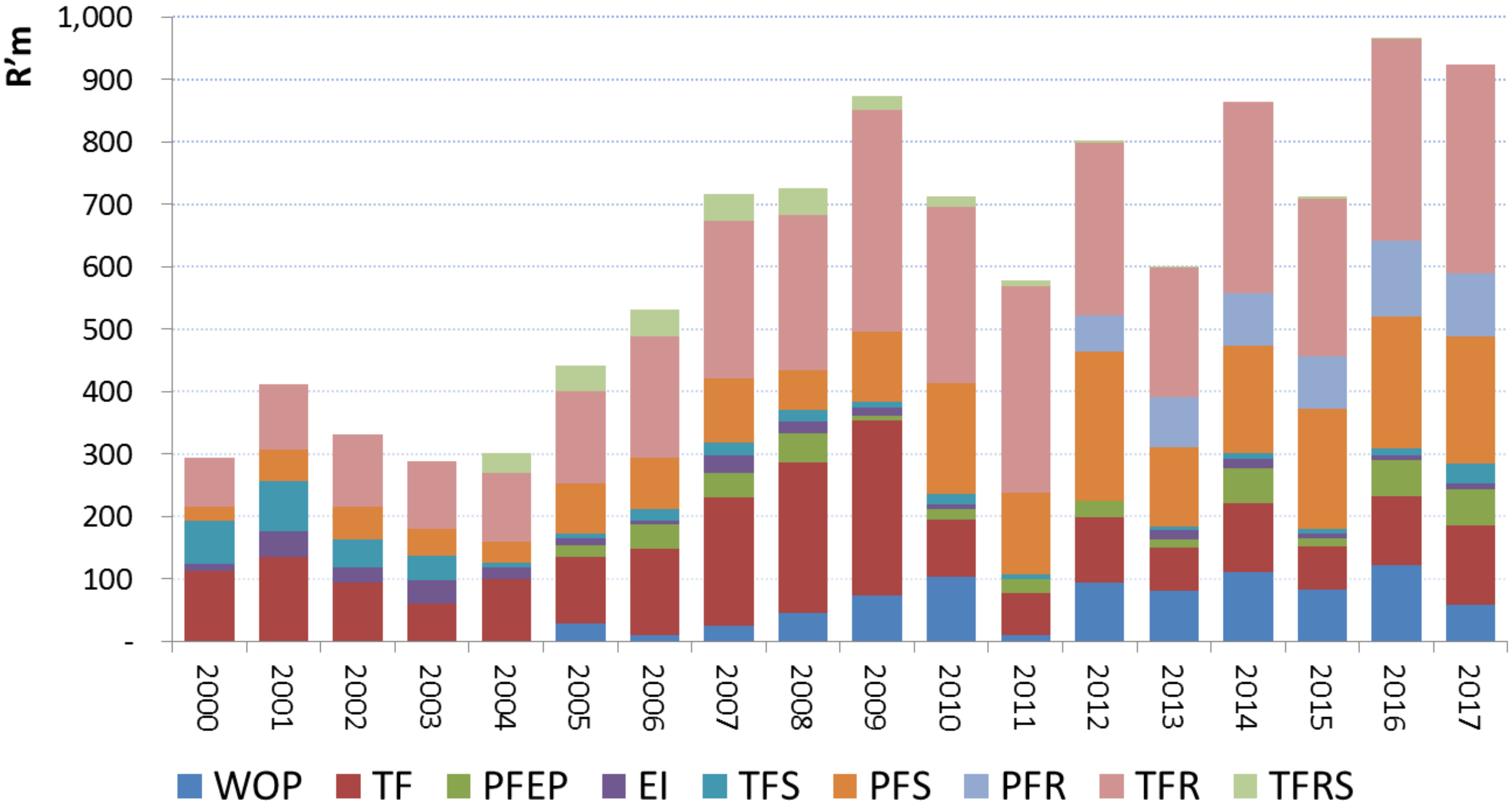
Investments disbursed

(R million: ZAR13.00 = $1)



Disbursements: SME-friendly products/instruments

(R million: ZAR13.00 = $1)



Legend

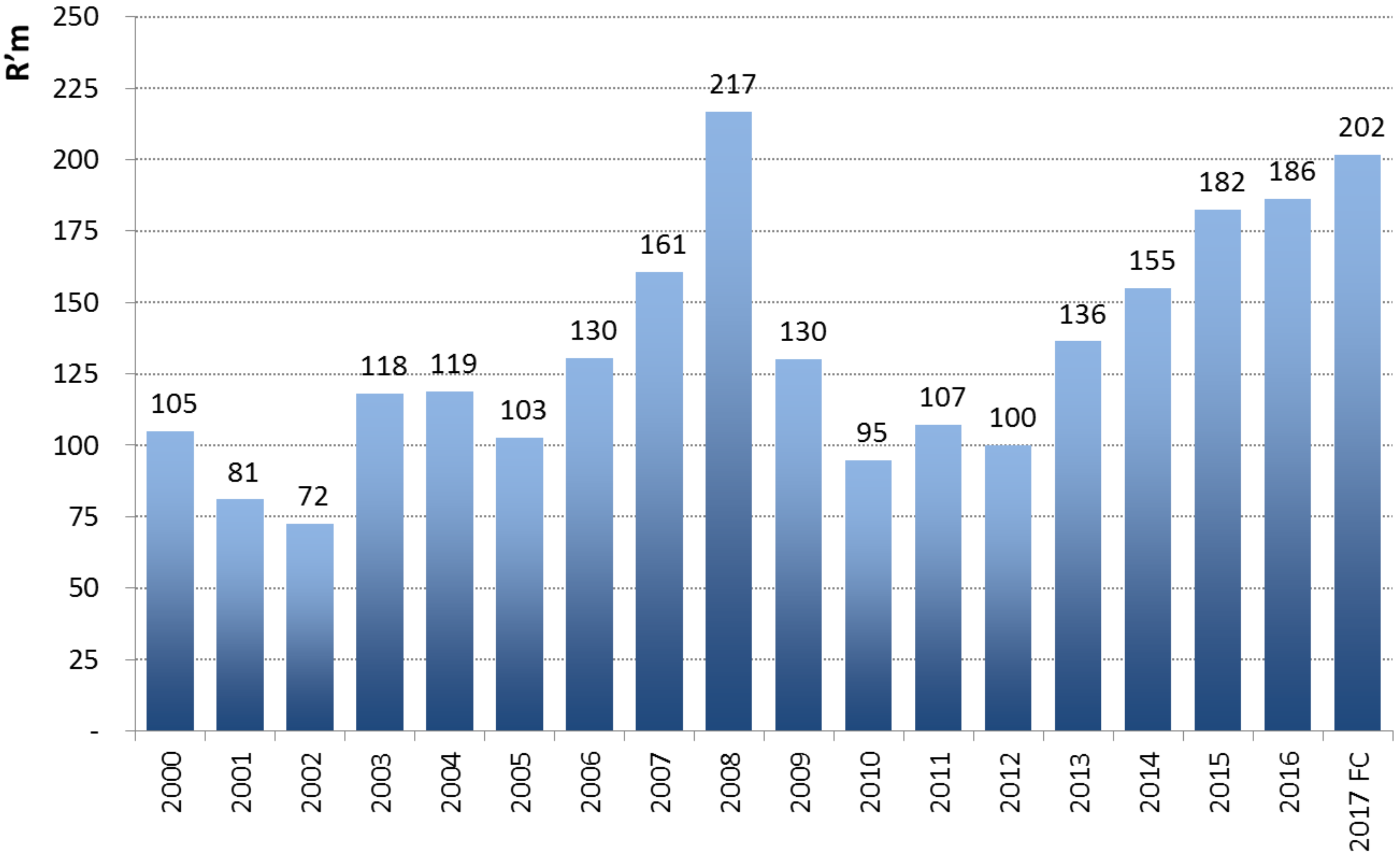
Disbursements by product type

WOP	Wholly-owned Property Investments
TF	Term Finance
PFEP	Property Finance with Equity Participation
EI	Equity Investments
TFS	Term Finance with Shareholding
PFS	Property Finance with Shareholding
PFR	Property Finance with a Royalty
TFR	Term Finance with a Royalty
TFRS	Term Finance with a Royalty and Shareholding

Profits

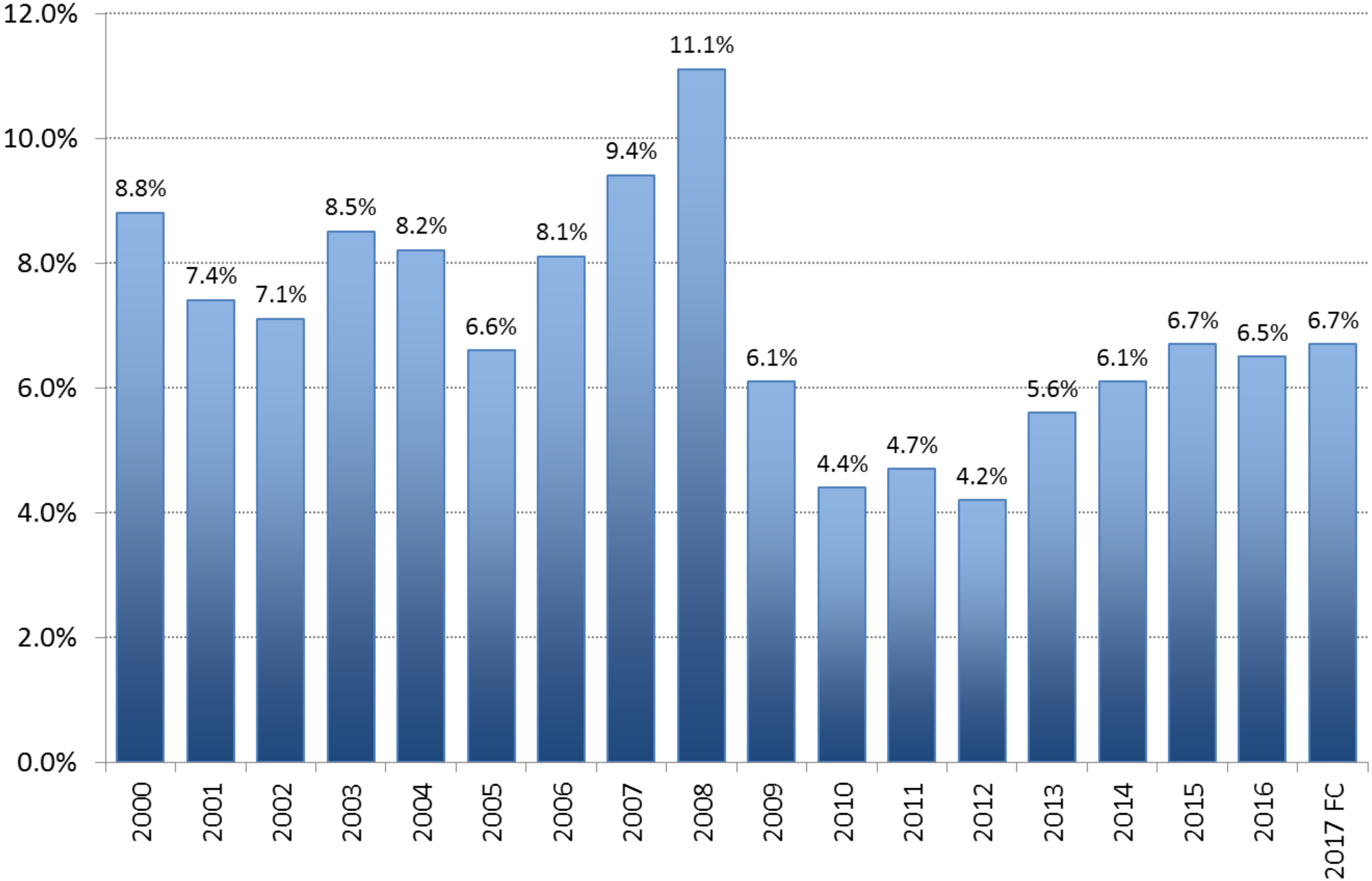
Profitable <u>every year</u> since inception in 1981

(R million: ZAR13.00 = $1)



Return on Equity

A REAL ROE to shareholders since 1981!



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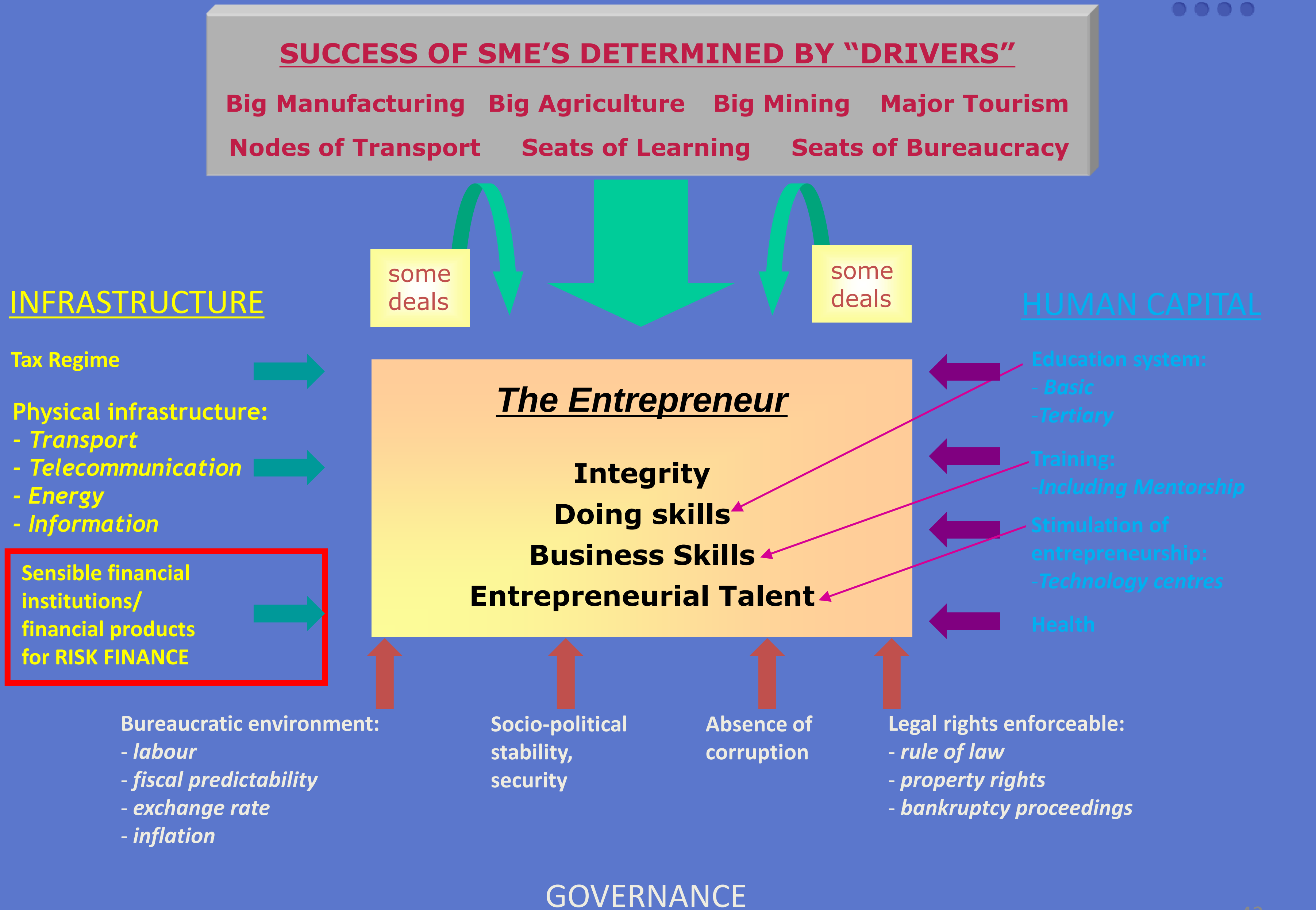
Investing in entrepreneurs

02

FINANCE FOR SMEs:

JUST A “SMALL” COG IN THE ECOSYSTEM

FACTORS THAT PROMOTE OR IMPEDE SME GROWTH



03

DEMYSTIFYING

SME RISK FINANCE

Solving the SME finance conundrum

A competent person with good "doing" skills, business skills and much entrepreneurship approaches a financier with a business plan to set up or buy a viable pizza store

— (requiring $100,000), but with little self contribution (say $10,000) and no assets to pledge as security/collateral.

Deal Structure #1:

Loan finance

- Loan finance @ prime + … like a bank
- But, banks usually require …
  - up to 50% own contribution ($50,000 in example)
  - security/collateral which covers their exposure at least one time.

- **CONCLUSION**: Our entrepreneur's funding requirement will probably not be solved by a traditional bank or lender

Deal Structure #2

Equity finance

- The financier/investor …
  - acknowledges $10,000 equity from entrepreneur
  - invests $90,000 as equity
  - A fair deal? Split shareholding as follows:
    - 10 - 20% for entrepreneur
    - 80 - 90% for investor
- Deal not tenable … entrepreneur will not act as owner

Deal Structure #3

Revenue/royalty-based finance

- The financier/investor …
  - acknowledges $10 000 equity from entrepreneur
  - injects a $90 000 term loan at prime +, with LESS THAN 100% collateral cover
  - obtains no shareholding (100% shareholding for entrepreneur)
  - charges a royalty fee based on % of revenue (or number of widgets sold, etc.)
  - obtains a return (IRR) commensurate with the risk … and shares in the upside like an equity investor

DEMYSTIFYING

SME Risk Finance

Various permutations of loan (interest-bearing debt), equity (shares) and royalty finance are possible.

Doing a fair deal

Cost of Risk Finance

- Secure funds: Good collateral
  - Financier’s expected return (IRR) = prime +
- Less Secure funds: Equipment as collateral
  - Financier’s expected return (IRR) = prime + 200 to 800 basis points
- Funds @ risk: Unsecured
  - Financier’s expected return (IRR) = 25% to 35%

04

TAKE-AWAYS

Benefits of

Revenue/Royalty-based finance

- For the SME/Entrepreneur
  - An opportunity – to start/grow a business
  - Affordable finance (albeit more expensive than loan finance)
  - Retain 100% ownership – especially important for family-owned businesses
  - Access to a risk sharing financier/investor with business acumen and expertise
  - No single, large "exit" required

- For the Financier
  - A financing opportunity with a return commensurate with the risk
  - Regular payments (periodic contractual "exits"), rather than relying on a large, undetermined exit only
  - Lower likelihood of entrepreneur managing the business to reduce the exit of an equity investor
  - Deal structure could "guarantee" a minimum return, plus upside.

Tips'for dealing with Challenges of

revenue/royalty-based finance

- Beware of moral hazard – under-reporting sales/revenue!
  - Monitoring/tracking system – often costly & time consuming
  - Contracting – the less expensive option:
    - "the higher of budgeted or actual revenue"
    - "payable for the period of the loan or until the loan has been repaid in full, whichever period is the longer"
- A royalty, in the wrong hands, is a dangerous instrument!
  - Royalties strip cash out of a business, hence one must be mindful of the "stage in the business' life cycle" and "seasonality".
  - The "rule" - Structure royalties as payable when the cash is there.
- Test Revenue Authorities' perspectives!
  - Is it an expense for the SME?
  - Is it a "deferred interest" revenue for the investor,?
  - Is it equity-like revenue?
- Even with cash royalties – remember to always think and behave like a patient capital investor, not a banker!

THANK YOU

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Tunisian
American
Enterprise
Fund

IMPULSION AU DEVELOPPEMENT

W. Bowman Cutter
Roosevelt Institute and the Tunisian American Enterprise Fund

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