Chapter 7

Revenue-Based Financing

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When considering how to involve community members in financing a small agriculture based business, a revenue-based financing agreement (also known as revenue-participation or royalty financing) may be a good model to explore in conjunction with other options.

What is Revenue-based financing?

Revenue-based financing is debt financing with a twist. It is a loan with a promissory note where repayment of the loan is tied to a percentage of the company's revenue. Instead of repayment being measured in a fixed interest percentage of the loan amount, the return amount is negotiated and that amount is paid through the agreed-upon percentage of revenue.

Profit Margin:
Net proceeds or profit as a percentage of gross revenue.

While revenue-based or royalty financing seems a relatively new financing model, it has historically been used in the oil, gas and mineral industries. Speculators invested in oil, gas or mineral extraction companies in exchange for a percentage of earnings from successful operations. More recently, this financing format has been used in the pharmaceutical and bio-tech industries. Read "Drug Royalty Financing Thrives in a Difficult Market," Reuters (8/20/08); the article notes that the biotech industry was facing a paucity of financing options where venture capital was drying up and banks were reluctant to make traditional loans. Royalty financing filled a need and is a thriving method of financing these companies.

The situation for small businesses, including small agriculture businesses, is similar. There is not a ready source of venture capital available and banks are reluctant to loan money to new or small businesses without financial history or collateral. There are organizations providing loans to small agriculture businesses; however, they tend to provide more traditional financing which include requirements of collateral and personal guarantees. Even if some financing can be obtained by more traditional methods, revenue-based financing is an option that should be considered in an agriculture business plan that includes a community financing component. A revenue-based agreement can provide the kind of flexibility or "patient capital" designed to help the farmer maintain cash flow during seasonal fluctuations or mitigate risk during down periods.[36]

Traditional Financing Options

1. Equity financing is when an investor invests money in a company in exchange for an ownership interest. The investor's return depends on dividends and more likely a percentage of the sale price of the business based on the investor's percentage of ownership. Equity financing is a significant component of capital for fast-growth companies that are likely to be sold.

Equity financing presents challenges to a small farm operation. The owners may not want to dilute their ownership interest by selling equity in the business. Further, the agricultural company may be difficult to value and investors may be less interested in equity positions in situations where a sale of the company is not in the business plan.

2. Debt financing is the commonly used bank or institutional loan. It will often require putting up collateral and giving a personal guarantee among other requirements of any particular lender. Debt financing can also involve secured or unsecured loans with promissory notes to individuals.

While ordinary debt from financial institutions or community loan funds should be considered as part of an overall financing plan, such loans might be hard to secure because of a farm's lack of financial history or collateral. In these situations, considering a royalty financing arrangement with members of the community may be an appropriate option for both the company and the investor.

CAUTION!

It is very important when assessing whether to explore revenue-based financing to understand your company's profit margins. Gross margin can be expressed as a percentage: The revenue minus cost to produce the goods sold as a percentage of total revenue. Finance experts generally suggest that company should have gross profit margins of at least 15 - 25%. The higher the profit margin, the more appropriate it may be to enter into a revenue-based financing deal. A detailed financial analysis of the business should be in place to project cash flow for any revenue-based financing scenario.

There is no one royalty or revenue-based financing agreement. As with most loans, these agreements can be tailored to the needs of the business and the investors. Instead of a fixed interest rate of return and fixed monthly payment, the parties agree to a total repayment amount above the original loan to be paid over time pursuant to the agreed-upon percentage of revenues. An example could look as follows: $10,000 loan to be repaid with 3% of gross annual revenue[37] until lender is repaid $15,000.

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36 If structured carefully, the arrangement can include provisions to mitigate the farmer's risk to the downside. However, the nature of the obligation can be such that it might only be appropriate for farmers who have high profit margins or value-added product lines with predictable sales revenue. Other ways to acquire capital might be more appropriate for farmers with low profit margins or unpredictable sales of products year-to-year.

37 Revenue-based financing agreements typically set payback terms based on gross revenue. However, there is nothing that would preclude parties from agreeing to use net income as the index upon which to base the payment. Gross sales revenue is usually much easier to define than net income, and that is one reason gross is more commonly used. If net income is to be used, the financing agreement should clearly specify the definition of net income and the process by which the parties to the agreement will derive the payment amount. For example, parties could use the farmer's income and expense accounting as documented with the annually-filed IRS tax form Schedule F: Profit or Loss from Farming, and calculate the revenue-based payment at the time this form is officially filed with the IRS each year. Or the parties could specify which expenses can be deducted from gross income for purposes of determining net income and then calculate the revenue based payment amount based on that figure.

The most obvious advantage to this kind of financing is that the repayment of the loan is tied to revenues, which gives the business a reprieve in the event it experiences a sales slow-down or period of no revenue. This may benefit a seasonal operation, such as a farm. There is an upside potential for the lender as well when there is a revenue-based payment involved. The lender will be repaid faster and thus have a higher annual return on the loan when the business does better. Use the example above with the $10,000 loan to be repaid 3% of gross revenue until the lender is repaid $15,000. The annual 3% of gross revenue could amount to $5,000 or it could amount to zero dollars, depending on how the business does that year. If it turned out to be $5,000 there would be a 50% return on investment, not bad for one year's time! But the lender has also assumed the risk of the annual or monthly (depending on the terms) revenue-based payment being much lower.

Is revenue-based financing appropriate for businesses in start-up stages?

The answer to this depends on the terms of the agreement specified by the community member and the business owner. **But generally, start-ups should be *very* cautious about committing to making monthly or annual revenue-based payments as part of a financing agreement. The revenue-based financing model has been typically used by mature businesses with predictable sales and profit margins.** Start-ups, on the other hand, are generally known for having less predictable revenue flows and lower profit margins. Start-ups might be hard pressed to carry on with operations normally with the burden of regular revenue-based payments. Another primary reason for caution is that start-ups are typically in debt or investing heavily in capital improvements during this stage. Revenue-based payments could detract from the start-ups ability to pay down principal on loans or make investments in farm infrastructure in a timely manner. As in any type of financing agreement, it is important for the farmer to have a detailed historical financial statements and realistic projections in place to confirm that the terms of the agreement match the ability of the business to meet the requirements of the obligation.

It will be important for an agriculture business that is considering royalty financing to understand their profit margins. Generally, this method of financing is most appropriate where a business has a large enough profit margin such that it can sustain a loss of a percentage of revenue over time, and still be able to cover the revenue-based payment and all business expenses.

Securities Law

While there appears to be some disagreement among experts about whether a royalty financing agreement is a security subject to regulation by federal and state securities laws, revenue-based financing agreements as described above are likely securities, and businesses choosing to use this tool should take steps to comply with those rules. As with other types of securities offerings, there are exemptions from registration that a small farm entering into revenue-based financing agreements with community members will likely be able to use. It is important to note that even if an exemption applies, any sale of securities is still covered by the anti-fraud provisions of the securities laws.

One interesting revenue-based financing agreement that might be considered outside securities regulation[38] is described in the book "Locavesting: The Revolution of Local Investing and How to Profit From It."[39] In the example, the lender receives repayment of the full loan amount but the revenue sharing portion of the loan repayment (i.e., the interest or royalty amount) is given to charity instead of to the lender. This could be a particularly creative way to encourage local community members to contribute to the financing of a small agricultural enterprise. In this agricultural space, an obvious choice for a local charity would be a local food bank for purchase of local agricultural products. Such a model would keep local money in the local food system as well as provide resources for local food banks to acquire and distribute local food products.

Conclusion

Revenue-based financing is one creative way for a small farm or agriculture business to raise money from members of the community. It is a flexible instrument that can reduce the burden of repayment obligation in periods of lower revenue. This is particularly well suited to an agriculture business with seasonal fluctuations in sales. However, revenue-based repayment terms are typically based on gross sales revenue, not net income, and the model might not be suitable for farms with lower profit margins.

Local Loan Funds Using Royalty or Revenue-Based Financing

Vermont Sustainable Jobs Fund: http://www.vsjf.org/what-we-do/flexible-capital-fund/financing-options

New Hampshire Community Loan Fund - Vested for Growth: http://www.vestedforgrowth.com/financing-options/deal-scenarios.aspx

38 There may be other ways to tailor specific royalty financing deals that would not implicate securities laws, however, an experienced attorney should be consulted prior to entering into any such agreement.

39 "Locavesting The Revolution in Local Investing And How To Profit From It" Amy Cortese, John Wiley & Sons, Inc. (2011).