KEY POINTS

- Revenue-based lending means that if revenue reduces the business makes a proportionately smaller payment to the finance provider.
- Credit scoring is based on algorithmic systems, a "revenue prediction engine" which looks at specific aspects of online payment transactions.
- All the analysis is conducted in real time with funders essentially looking for the signals that show a business is scaling.

Feature

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The benefits of revenue-based lending

In this article Charles Kerrigan considers the benefits of revenue-based lending.

Among the themes of the commentary regarding the consequences of the COVID-19 pandemic two stand out for finance practitioners. First, that the various government loan schemes may be a short-term fix and in the longer term more corporates with more debt may not be sustainable. Second, that there is an acceleration of digitalisation in corporate business practice. There has been less commentary, however, on the specifics of innovation in debt markets.

There are some big ideas circulating. Policymakers and regulators are being asked to consider how value can be shared in the economy where risk has been shared by the provision of government support. Thinkers outside the mainstream of banking, unsurprisingly, see answers in decentralised finance (DeFi).

But, borrowing the cliché of the call shovel-ready projects, existing innovations in debt products should be part of this debate.

One such product is revenue-based lending. This predates the pandemic but, coincidentally, has features that relieve the strain placed by debt on a business that suffers a shock in the delivery of its business plan. Revenue-based lending is designed to meet the funding needs of fast-growing early stage businesses. Traditionally, founders of these businesses have two options. They can raise funds through equity, but this is at the cost of diluting their interest in their business. Or they can borrow from a venture debt provider or a bank that provides growth debt, but this capital is either expensive or hard to come by or both. A bank may require a personal guarantee or security from a founder.

The revenue-based lending model says that there is an inefficiency in capital raising for fast growing companies because expensive capital is paying for day to day costs such as marketing and inventory that generate revenues that are very predictable. Where the business relies on a strong online presence the predictions can be tested against outcomes in real time.

The benefits for the founders are that the deals are done quickly on a platform that uses a high degree of automation. That means funds being advanced within a day or two compared to the weeks of traditional equity and debt timetables. It means documentation comprising short form terms and conditions accessible on the platform. And no security or personal guarantees are required to be given by the business owners.

The terms are different to standard debt terms in significant (and surprising) ways. A principal amount is advanced but there is no conventional maturity date. The loan is repaid from a share of revenue generated by the borrower's activities that are funded by the loan. Interest is not charged but a fee is added to the principal and likewise repaid from revenue. In this way costs are fixed with no compounding interest, exit fees, warrants or synthetic warrants. The advances are unsecured.

The model has shown a particular benefit during the current crisis. Revenue-based lending on its terms means that if revenue reduces the business makes a proportionately smaller payment to the provider. This is in contrast to borrowers with traditional debt facilities including interest payments due on a periodic basis. These borrowers have had to obtain waivers of payment defaults and financial covenants from bank lenders.

Clearly, the model relies on identifying businesses that will increase their revenues and thereby pay off the funding quickly. This is where the innovation sits. Credit scoring is based on algorithmic systems, a "revenue prediction engine". Rather than relying on the last three-year financial statements the system is looking at specific aspects of online payment transactions in the business, among other things the number and consistency of transactions and the make-up of the parties to the transactions. The system runs sentiment analysis and checks customer reviews to look for trends in the business. It uses data sources such as e-commerce engines, advertising platforms like Google or Facebook and cloud accounting solutions like Xero or Quickbooks. It gets a live feed from bank accounts using open banking APIs and from accounting and payments processors. All the analysis is conducted in real time. The funders are essentially looking for the signals that show a business is scaling. Payments are taken automatically either by direct debit or direct from the payment processor. The information flow is more transparent and fewer payments are missed because they are automatic.

In the UK Uncapped – https://weareuncapped.com/ – is the prime example. In the US Cleabanc – https://clearbanc.com/ – describes itself as "the biggest e-commerce investor in the world". Both businesses have the attention of the start-up and e-commerce business communities. Sifted reported in June 2020 that: "It's finally the moment for revenue-based startup financing".

Another cliché is that there is nothing new in finance. Revenue-based lending illustrates the old adage (periodically revisited in cautionary tales of debt distribution models) that the risk of loss in a debt deal should be held by the person who is the best judge of it. And it challenges bankers with the prospect that the best person to credit score debt deals is an expert in the industry sub-sector. Banks have built industry teams, but they have to pedal hard to stay with the pace of specialisation coming to finance.

With thanks to Piort Pizarz, CEO of Uncapped.

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