



Angels, Take Control of Your VC Financing With Puts and RBFs

Jeff Joseph

Angel investors and their advisors must become more creative with their financing structures if they hope to avoid the same fate which *Forbes* magazine recently described as the current state of the venture capital industry: "A lottery system where few make unbelievable fortunes while the rest lose someone else's fortune." Angels should leverage their capital to secure better investment terms and more unique investment terms than their VC counterparts.

Previously, we identified an early-stage investment term sheet provision (a private investment "put option") that provides angel investors with the *option* of securing the return of the initial private investment capital and the accrued dividend *if* the portfolio company achieves certain pre-determined milestones. Executing such an option has a profound impact on the internal rate of return (IRR) of an angel investment, and I now consider such put options to be a requisite term for most angel financings.

Angels owe it to themselves to increase the variety of exits, as well as to decrease the elapsed time to the exits in their investments. The solution is being creative and open to alternative financing terms and mechanisms. Recently, I have been taking heed of "royalty-based financing"—the process of lending against a company's future revenue stream, as another option to increase the *optionality* of positive outcomes.

About RBF : Royalty-Based Financing

Royalty-based financing (often referred to as a "revenue loan," or RBF) is essentially debt financing collateralized by the company's IP (intellectual property) and secured against future revenues. The investor's note is repaid beginning at a certain date in time (often 6-12 months out) at a pre-negotiated percentage of the company's gross revenues, on a monthly basis, until the investor has received anywhere from two to five times the initial investment back.

Entrepreneurs are generally favorably disposed toward RBFs because they are viewed as non-dilutive to founders relative to a traditional Series A equity financing round. Moreover, the financing is obtained without having to agree to a valuation, leaves management in control of the company and typically requires no personal guarantees from management.

RBFs can be an effective bridge to profitability for companies that have already brought a high-margin product to market and want to expand their distribution. Although the company incurs an additional operating expense, it is less onerous than debt because the monthly cost is variable to revenues. The company factors the negotiated variable cost into its revenue model to ensure that the agreed upon monthly percentage of gross revenues payment to the note holder is at a rate that provides for sufficient operating capital.

The royalty-based revenue model can also be applied to seed-stage venture financings. The advantage is that the angel investor enjoys a greater certainty of return of principal and a compelling return on investment, as IRRs generally run greater than 30%.

For the angel and early-stage investor these return scenarios are highly attractive, providing repayment of principal that takes your risk off the table, monthly cash flows, a compelling return on investment and additional skin-in-the-game in the form of an equity kicker (usually no more than 1%).

Why RBFs Are Infrequently Used

However, RBFs are infrequently used and represent, at best, a negligible fraction of the funding to early-stage companies.

That's because the survival of the VC business model is predicated upon occasional high-multiple exits. For large VC funds to have any chance of posting double-digit IRRs for their LPs they have to swing for the fences to have any chance of

overcoming a 2% management fee compounded over 10 years and a 25% carry. The math just doesn't work. It's ironic that a financing approach that caps potential returns at 30% to 40% of IRRs does not work for VCs, but that is indeed the case.

The real rub here for VCs is that they have reduced their potential investment outcomes. Despite the high IRRs, 3X to 5X returns don't cut it for VCs because they don't make up for the losers. The unfortunate consequence of their LP model requires that their portfolios pursue decidedly binary outcomes composed of a vast majority of "walking-dead" and write-offs with (they hope) a handful of home runs. It is one of the reasons we so often hear that the VC model is "broken" and VC fund returns have fallen precipitously.

Angels and their advisors should not emulate the broken VC model. Rather, they should eschew VC's tired template term sheets and embrace put-options, RBF and other terms that increase *optionality*, thereby enabling a wider variety of positive (and asymmetric) exits and investment outcomes.

Jeff Joseph is a financier, entrepreneur, CEO of Prescient Advisors, and the author of the blog at www.venturepopulist.com.