

**CAPITAL  
ENTREPRENEURS  
PLAYBOOK**

# **Innovative Financing Models for Coronavirus Recovery**

**BLUEPRINTLOCAL**



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# Introduction

Even before the COVID-19 pandemic, entrepreneurship in America was in crisis, wrought by inequities and inconsistency; creation of new firms, our economy's engine for job growth, had hit a 40-year low. Technology, specifically FinTech, showed promise for bringing credit to left-behind communities but instead opened new pathways for predatory capital. And the post-Great Recession boom in venture capital proved highly unequal: **in 2019, 78% of startup capital went to three coastal states; less than 5% went to businesses led by women; and less than 1% to businesses led by people of color (Crunchbase News)**. As is true for talent and opportunity, entrepreneurs are evenly distributed, but capital is not. More than 83% of businesses do not access "traditional" capital, according to the Kauffman Foundation; the share of Black-owned businesses has only ticked up from roughly 1 to 2% since 1970, while the share of revenue for Black firms has decreased and Black household income has flatlined.

**In 2019, 78% of startup capital went to three coastal states; less than 5% went to women; and less than 1% to people of color**

COVID-19 broke open the fractured system, further demonstrating a need for capital innovation—a broader continuum of options for a broader diversity of entrepreneurs and firms. The pandemic accelerated and reinforced multiple preexisting dynamics that stymie small firm growth: 1) businesses were forced to close, operate at limited capacity, and rely on credit; 2) PPP laid bare the failures of traditional small business finance in reaching communities of color; 3) business moved online, subject to the Digital Divide, and helping e-commerce giants dominate; and 4) private equity moved into neighborhoods, bolstering absentee landlords and the Dollar Store and Just-in-Time economies; among other headwinds.

Yet this disruption also created an opportunity to rewrite the story of American entrepreneurship. Over the past two years, the number of new firms skyrocketed, and record investment flowed to rebuild and restructure our economy, with a particular focus on communities long excluded and hit hardest by the pandemic. Furthermore, the murder of George Floyd reopened deep wounds, demanding that leaders reassess and reprioritize where they invest, who is included, and how decisions, programs, and practices either advance or hinder racial equity. Now, the critical question is whether billions of dollars in commitments, private and public, to equitably serve more Americans are having their intended, enduring impact in communities that need investment most.

To meet this moment, Blueprint Local and the Nowak Metro Finance Lab at Drexel University launched the Innovative Finance Project, with support from the US Economic Development Administration (EDA). This playbook is the culmination of a year of work, several roundtables, and countless conversations with dozens of funders and founders, all aimed to remake how

entrepreneurs access capital. This was an ambitious undertaking, looking at the full continuum of entrepreneurs, from FinTech to food trucks, and how capital products and support systems can be better structured so capital flows to diverse businesses.

Perhaps the largest challenge that this project has encountered—in contrast to other policy areas such as housing or infrastructure—is that there is no unified small business support system. Sectors such as affordable housing or health care for seniors are overseen by uniform state agencies and local authorities and agencies, have standardized channels for local delivery, and interface with the private sector in predictable ways. Private sector developers know how to qualify for Low-Income Housing Tax Credits; private sector health care providers know how to interface with Medicare and Medicaid. Despite a collection of agencies such as the EDA, the Small Business Administration (SBA), and entrepreneur support groups in every state, infrastructure support for entrepreneurs—and the capital intermediaries and innovators who help them—is much more fractured. Entrepreneur support, rules, and funding are highly fragmented, siloed, and local in nature, often leaving the private sector, Community Development Financial Institutions (CDFIs), community banks, and nonprofits to go it alone with one-off government funding or private checks to help entrepreneurs grow and start their businesses. This system fragmentation is best exemplified by the 40-some small business capital programs scattered across six federal departments, from SBA to Interior, with disparate offices and coordinators out of sync sometimes even within the same metro.

With no unified system, there is no single language or touchpoint for reform. There could be a “30-year mortgage” for small business lending—a policy breakthrough that redefines our country’s economy—but it would first need to be standardized, vetted, and distributed across a multitude of local and national, private, and public actors. This fragmentation ultimately hurts America’s entrepreneurs.

That’s the bad news. The good news is that several “capital entrepreneurs” are innovating not just **what** America’s businesses are building, but **how** they are financed. These innovators make use of alternative financial structures to fund the 83% of businesses not served by mainstream debt capital or venture capital markets. Capital Entrepreneurs—e.g., CDFIs, angel funds, private fund managers, etc.—often work in isolation, but they have expressed a hunger for routines, standards, and a community of practice.

**This playbook aims to serve as a touchpoint for this wide array of “capital entrepreneurs” around which to organize. Our goal is to help diverse founders and funders understand the breadth of resources, details of particular types of innovative models, and the best ways to support inclusive entrepreneurship. This playbook provides a guide, examples, and common language for:**

- 1. Innovative financial products** that show promise in reaching more entrepreneurs
- 2. Funders** of any type looking to invest capital and provide resources that would help grow these innovative finance models so that they can create and scale proof of concept
- 3. Policymakers** at all levels so they can support capital entrepreneurs and innovative small business finance, making public sector efforts more concentrated and accessible to founders and funders

More specifically, grounded in a new focus on investments and delivery systems, the playbook identifies promising innovative financial products that can iterate and scale to better reach more entrepreneurs, moving beyond the strict dichotomy of debt and equity products, and overly narrow risk and growth profiles, to more flexible and even sector-specific possibilities and opportunities for impactful investment.

In terms of particular products, we identify opportunities to more broadly use and standardize **redeemable equity** investments, to the benefit of diverse entrepreneurs; implement **revenue-based loans** that are more flexible in terms of repayment and collateralization, reaching more firms; and **supply chain finance**, which focuses more on firms’ potential for future revenue, a departure from rigid asset-based lending and opportunity to support diverse suppliers.

Our small business investment and support system has not significantly changed in decades, and it continues to fall short in reaching entrepreneurs who need capital most. But we also find there is an overwhelming appetite for change. With the right products, capital entrepreneurs can seize forthcoming opportunities, from the U.S. Treasury's State Small Business Credit Initiative (SSBCI) coming online to exciting technological advancement, to leverage American ingenuity across all communities, reducing barriers and reaching more entrepreneurs.



# Capital Landscape For Small Businesses



In 2022, the Federal Reserve's [Small Business Credit Survey](#) found that **59% of small businesses experienced a financing shortfall or unmet financing needs.**

According to [research](#) conducted by the Kauffman Foundation, **83% of US small businesses don't access any form of outside capital for their business.** Clearly, our systems for financing small businesses and startup companies are not sufficiently serving the needs of American entrepreneurs.



**When entrepreneurs need capital for their business, they are typically confronted with a binary choice between two vastly different capital products: [debt or equity](#).**

### **Debt Capital: A Business Loan**

#### What business sectors tend to raise debt?

Local Retail Businesses, Food and Beverage Businesses (e.g. restaurants), Manufacturing, Non-scalable Business-to-Business firms, Construction Subcontractors, Local Suppliers

#### How are debt proceeds typically used?

Equipment purchase, debt refinance, real estate purchase, tenant improvements, working capital

#### How do debt investors view risk and return?

Low risk (often with downside protections i.e. blanket liens, specific collateral, personal guarantees), lower relative returns to investor

#### What are potential benefits and risks to an entrepreneur?

Fixed interest rates plus moderate fees, typically 5-20% annual percentage rate (APR), no dilution of business ownership

### **Equity Capital: A Venture Capital or Private Equity Investment**

#### What business sectors tend to raise equity?

High growth-potential startup firms, pre-revenue companies, later stage businesses looking for acquisition/sale

#### How are equity proceeds typically used?

HR expenses, Operating Expenses, Marketing, Research and Development, Non-organic business expansion (acquisitions of other firms & intellectual property)

#### How do equity investors view risk and return?

High risk with very little downside protection (if any). Higher potential returns for investors

#### What are potential benefits and risks to an entrepreneur?

Cost of capital positively correlated with business growth, often involving entrepreneurs selling >50% of business equity

## There are **two major problems** with the current status quo of capital options for small businesses:

### PROBLEM 1

#### **Debt and equity capital markets have consistently proven themselves incapable of serving all entrepreneurs equally.**

While the days of overt [redlining](#) are behind us, small business lending is still rife with inequities. Take, for instance, racial disparities in lending outcomes:

- Business owners of color pay average interest rates that are 22% higher than white business owners (7.8% vs. 6.4%).<sup>1</sup>
- Loan denial rates for business owners of color are twice as high as those of white business owners.<sup>2</sup>
- Black-owned loan applicant firms were half as likely as white-owned applicant firms to be fully approved for loans, lines of credit, and cash advances.<sup>3</sup>
- The average loan to a POC-owned business is 39% smaller than the average loan to a white-owned business (\$363K vs. \$592K).<sup>4</sup>

**Business owners of color pay average interest rates that are 22% higher than white business owners (7.8% vs. 6.4%).<sup>1</sup>**

#### **Similar imbalances can be seen across gender lines:**

- Female business owners account for less than 5% of all capital lent to small companies—despite the fact that women own 30% of small companies.<sup>5</sup>
- Small businesses owned by women only receive 16% of all traditional small business loans.<sup>6</sup>
- Female loan applications are more likely to be rejected, or have more stringent terms, than men.<sup>7</sup>

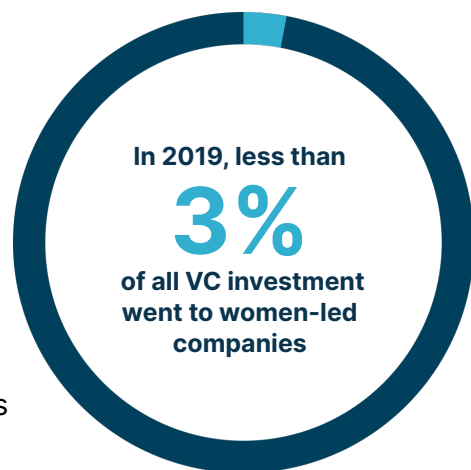
**Small businesses owned by women only receive 16% of all traditional small business loans.<sup>6</sup>**

Even access to local banks themselves is distributed unequally. A decades-long trend of closures and consolidation in the banking industry means that, today, the number of FDIC-insured banks is half what it was 20 years ago. While some major national banks have gone under, the majority of bank closures have befallen smaller, community banks; often in low-income communities. Today, [70% of minority-majority neighborhoods](#) do not have a bank branch.

Instead, one in four small businesses applying for credit these days do so through an online lender; and Latino/a- and Black-owned businesses are [more likely to use online lenders](#) compared to their white counterparts. These online lenders, typically [FinTech companies](#) and [Non-Depository Institutions](#), now comprise [more than half of all small business lending](#) in the US. While entrepreneurs certainly benefit from the ease of access to capital with online-first lenders, this trend also opens the door for more predatory pricing, as lenders can more easily reach entrepreneurs desperate for credit. Black and brown businesses are more likely to be [considered higher credit risks](#) by online lenders, and more than half of FinTech borrowers [reported](#) paying higher rates and a third reported unfavorable repayment terms. According to a [Fed report](#) online lenders have been observed levying interest rates as high as 70%, and they consistently rank the lowest in customer satisfaction of any lending type ([18% satisfied](#)).

The marketplace for equity capital, or venture capital (VC), is also highly concentrated and unevenly spread.

Take its geographic distribution for example: [78% of all venture capital goes to just three states](#): New York, Massachusetts, and California.<sup>8</sup> The distribution of equity capital across racial and gender lines is equally appalling. **In 2019, less than 3% of all VC investment went to women-led companies**, and only one-fifth of US VC investment went to startups with at least one woman on the founding team.<sup>9</sup> The average deal size for female-founded or female co-founded companies is less than half that of male-only-founded startups. And while VC investments to businesses led by Black entrepreneurs grew by more than four times in 2021, still only 1.4% of the record \$329 billion in venture capital invested in US startups in that year went to firms with Black owners.<sup>10</sup>

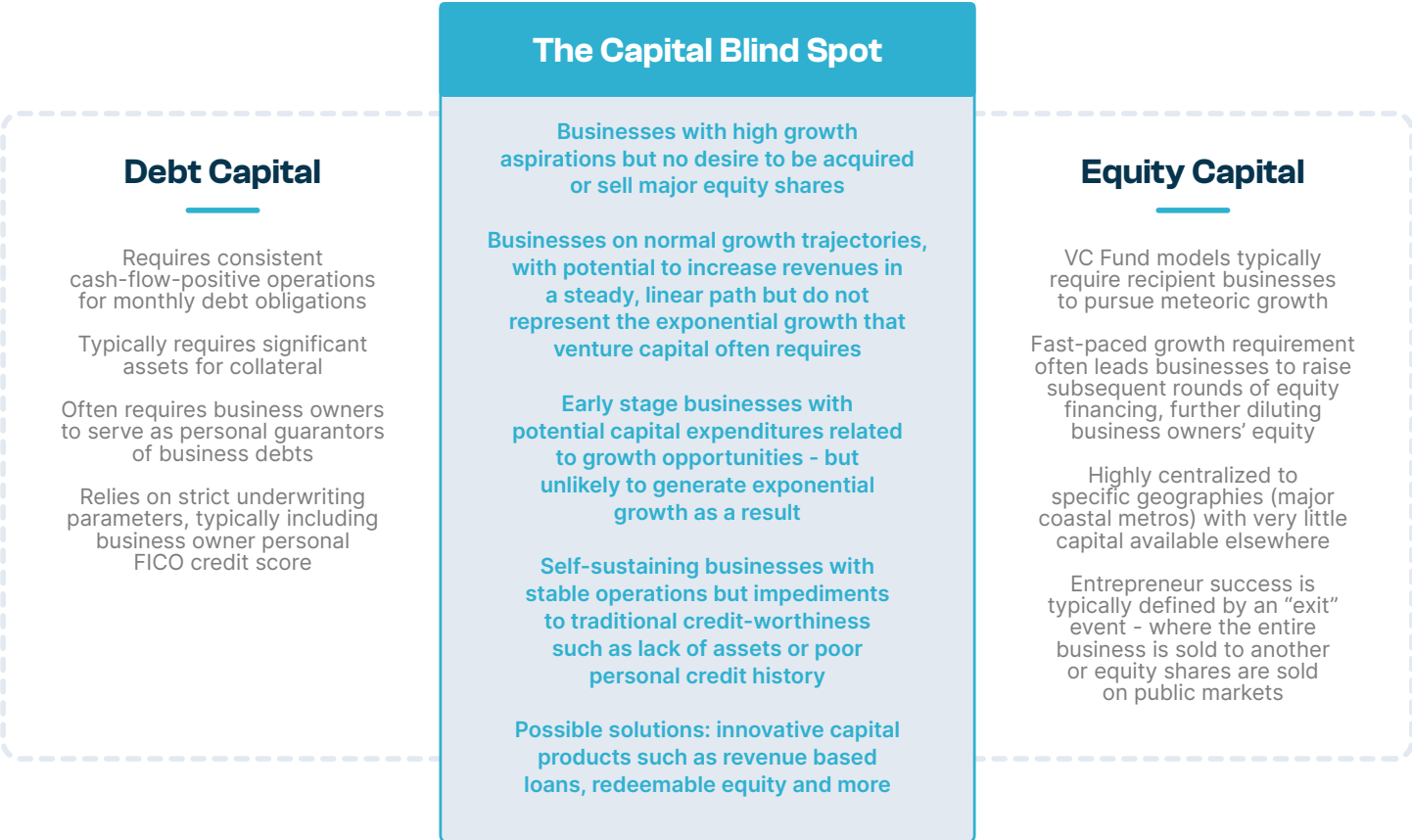


**Only 1.4% of the record \$329B in venture capital invested in US startups in that year went to firms with Black owners.<sup>10</sup>**

PROBLEM 2

## Debt and equity aren't the only options for entrepreneurs, but the market of alternative products needs to grow.

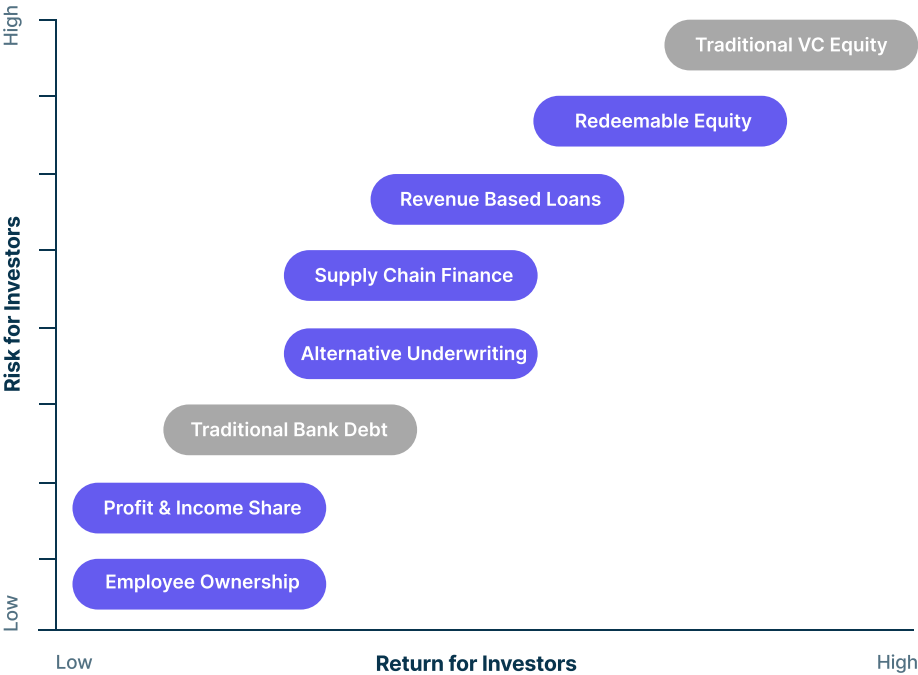
It may seem unlikely that the vast array of small businesses could all fit neatly into one bucket or the other as perfect candidates for either debt or equity. In reality, many businesses contort themselves and their finances to fit one of the two predominant capital products available to them. These days, however, we're seeing a growing trend of lenders and investors making changes to the structures of their capital products in order to meet the specific needs of entrepreneurs, instead of the other way around.



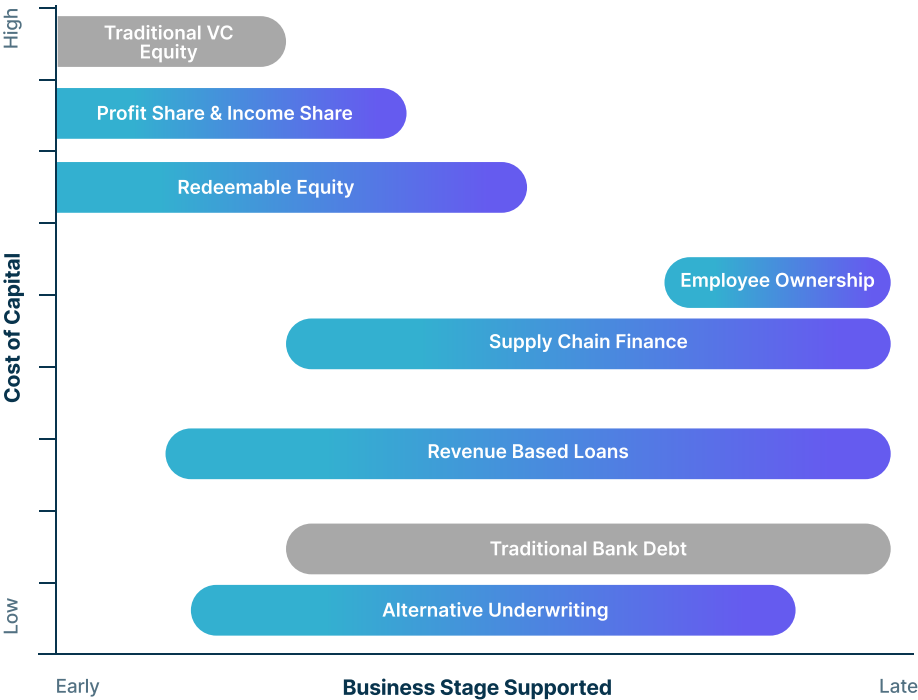
When compared to the traditional debt and equity capital products, these innovative financing models often have the ability to improve outcomes for both the capital provider and the entrepreneur.

# Product Comparison

## Funder's Perspective:



## Entrepreneur's Perspective:



The growth of these innovative capital products, and many more, demonstrate that entrepreneurial demand for capital extends far beyond the realms of traditional debt and equity. Not only do these capital products have the potential to fill gaps left unfilled by the status quo of small business finance, but they also may prove especially beneficial in bringing access to capital to the women and minority entrepreneurs who the debt and equity capital marketplaces have inadequately addressed.

## Endnotes

- <sup>1</sup> [MBDA "Disparities in Capital Access between Minority and Non-Minority-Owned Businesses" report 2010](#)
- <sup>2</sup> [Federal Reserve: Report to the Congress on the Availability of Credit to Small Businesses \(2017\)](#)
- <sup>3</sup> [2021 Federal Reserve Small Business Credit Survey](#)
- <sup>4</sup> [MBDA "Disparities in Capital Access between Minority and Non-Minority-Owned Businesses" report 2010](#)
- <sup>5</sup> <https://www.cbsnews.com/news/report-looks-at-small-business-and-the-gender-gap/>
- <sup>6</sup> <https://www.fundera.com/blog/the-state-of-online-small-business-lending-q2-2016>
- <sup>7</sup> <https://www.ondeck.com/resources/how-the-gender-gap-affects-small-business-loan-approvals/>
- <sup>8</sup> <https://news.crunchbase.com/startups/states-per-capita-startup-investment-massachusetts-new-york-california/>
- <sup>9</sup> <https://techcrunch.com/2020/11/09/startup-fundraising-is-the-most-tangible-gender-gap-how-can-we-overcome-it/>
- <sup>10</sup> <https://news.crunchbase.com/venture/something-ventured-funding-to-black-startup-founders-quadrupled-in-past-year-but-remains-elusive/>

To explore our database of tools and resources for innovative financing, visit [innovative.finance/resources](https://innovative.finance/resources) or scan here:





# Ecosystem of Stakeholders

Alternative capital solutions for entrepreneurs play a crucial role in the broad recovery efforts needed to rebuild and grow the US small business economy. While the most visible stakeholders in this arena might simply be entrepreneurs and their direct funders, several other crucial stakeholder groups exist in the broader ecosystem, without whom efforts to modernize and redesign the small business capital landscape cannot succeed.

Governmental organizations, ranging from well-known Federal institutions to hyper-local economic development entities, shape the very nature of the small business finance industry—from setting the rules for capital markets to establishing incentives and disincentives for desirable or undesirable behaviors across the industry. Various other intermediaries also occupy an essential role in this space—providing the capital and resources required to establish and execute small business capital provisions. Finally, direct capital providers themselves—in their many shapes and sizes—are the crucial last-mile delivery vehicles that distribute capital to the entrepreneurs who form the backbone of our economy.

**Each of these groups has an important role to play in the growth and evolution of the US small business capital landscape.**

## Economic Development Organizations: Federal, State, and Local Government

When it comes to supporting entrepreneurs with access to capital for their businesses, most people will think of the Small Business Administration, and with good reason. The SBA's widely successful lending support programs including 7a, 504, and Microloans, form the backbone of the US support system for extending debt capital to small businesses. Of course, these aren't SBA's only successful programs in this area; the Small Business Investment Company (SBIC) program is another standout SBA initiative, supporting investment fund managers who provide equity capital to American entrepreneurs.

Beyond the SBA, the US Federal government is rife with programming and incentives that impact financing outcomes for small businesses. The Department of the Treasury maintains the [CDFI Fund](#) with its thousands of registered entities across the country; the Department of Commerce has the Economic Development Administration, which provides support to various institutions at all levels of the capital supply chain and through programs such as [Revolving Loan Funds](#) and separately, the [Office of Innovation and Entrepreneurship](#); the Department of Agriculture, Veterans Administration, Bureau of Indian Affairs, and many more federal agencies have their own well-established and highly regarded programs to support capital access. There are many programs and initiatives at the federal level of the US government to support the debt and equity capital infrastructure for small businesses and startups.



The same can be said for many US states, territories, and municipalities as well. Creative and hardworking public servants at every level of government have devised unique and responsive programs to support debt and equity capital provisions for entrepreneurs across the country—many of which are funded by federal sources of capital. For example, at the time of writing this playbook, all 50 states—plus territories and governments—are planning for and eagerly awaiting their first distributions from the State Small Business Credit Initiative (SSBCI) program, the second, scaled-up iteration of a nationwide strategy to leverage federal investment to incentivize private capital investments into small business capital offerings. While SSBCI is a program of Treasury, administered at the state level, an even broader array of initiatives across the nation’s counties and cities are in motion, supported by the American Rescue Plan’s State and Local Fiscal Recovery Funds, supporting local small business capital markets with incentives to increase lending and equity investments.

Clearly, the vast array of entrepreneurial development agencies and support organizations across the US have a well-demonstrated ability to support and incentivize the mobilization of debt and equity capital to small businesses and startups across the economy.

We have yet to see these institutions adopting and embracing strategies to support the provision of innovative and nontraditional capital products that reach a broader and more diverse set of entrepreneurs and small businesses they intend to serve.

**Federal agencies, state governments, local and regional economic development organizations don’t need to reinvent the wheel; they just need to broaden existing programs to include nontraditional capital providers that implement intuitive innovations that better serve their constituents.**

As these various organizations become more comfortable with the definitions, parameters, and examples of the sorts of innovative financial products that we highlight in this playbook, it is our hope that these nontraditional capital products and the organizations that provide them to entrepreneurs will become increasingly likely to be included in existing and future access to capital initiatives—at all levels of government.

**For a glimpse of successful and ongoing efforts, take a look at the following examples:**

#### EXAMPLE 1

**Washington State Department of Commerce & National Development Council/Denkyem: Revenue Based Loan Fund via State Small Business Credit Initiative**

When the US Department of the Treasury announced the allocation amounts for each state under the State Small Business Credit Initiative in 2021, the Washington Department of Commerce was faced with the daunting task of determining how best to spend more than \$163M to mobilize private investment in Washington's small businesses. Additionally, Washington Commerce also had to consider another important component of this capital: the SSBCI program's incentives to reach very small businesses (VSB) and those owned by socially and economically disadvantaged individuals (SEDI).

After consulting with several organizations with deep experience providing capital to entrepreneurs in the state, the Washington Department of Commerce ultimately decided to structure a proposal which would spend approximately \$13M of its funds to support the establishment of an innovative Revenue Based Loan fund, managed by the National Development Council (a longstanding national CDFI lender with an office in Seattle) and Denkyem Cooperative (an innovative platform providing nontraditional capital products to entrepreneurs).

Together, NDC and Denkyem will raise an additional \$14M in private capital to achieve the program's minimum 1:1 public-to-private matching ratio, and will then begin making Revenue Based Loans—specifically focusing on Washington's minority-owned businesses. Washington's Department of Commerce didn't have to do this, of course. Its programs from the first iteration of the State Small Business Credit Initiative did quite well at distributing capital to entrepreneurs, when compared to peer states. However, the state was convinced that at least a portion of its spending should be dedicated to nontraditional capital products that might better suit those VSBs and SEDI businesses in ways that traditional debt or equity products simply can't.

## EXAMPLE 2

### **Baltimore City, Maryland: Baltimore Development Corporation & "Baltimore Together" CEDS**

With the publication of its most recent Comprehensive Economic Development Strategy (CEDS), titled "Baltimore Together," the Baltimore Development Corporation outlined its commitment to focus on small business growth and recovery in the post-COVID economy, especially among the city's BIPOC-owned businesses. Research from Baltimore Together shows that while over half of Baltimore City's privately held businesses are BIPOC-owned, these businesses account for only 12% of Baltimore City's total business revenue. To address this, the Baltimore Together report outlines a capital access strategy for minority businesses that includes nontraditional capital strategies.

While Baltimore Development Corporation is not a direct capital provider itself, it does have the ability to pool resources and establish incentives for existing, well-established

small business capital providers to increase their lending and investment to minority firms. Specifically, the Baltimore Together CEDS plan calls for “additional City and state funds [for] a loss reserve and bringing together several CDFIs to administer a larger fund.” Along with offering traditional debt products for small businesses, Baltimore Together also makes special note of the “need to explore other, non-debt forms of capital for early stage businesses and others adverse to taking on debt burdens.”

For local CDFIs to participate in such a program, Baltimore Development Corporation plans to pool capital—starting with more than \$3M in released EDA Revolving Loan Fund dollars—to serve as a risk-mitigating back stop for lenders and alternative capital providers, ensuring that they can take the risk of offering capital to historically overlooked entrepreneurs and issuing capital with nontraditional terms without having to bear the burden of this risk alone.

### EXAMPLE 3

## **Colorado OEDIT Venture Capital Authority: Greater Colorado Venture Fund**

At Colorado’s Office of Economic Development and International Trade (OEDIT) sits a unique state entity that has been, in recent years, the envy of many economic development professionals. The Colorado Venture Capital Authority (CVCA) is a political subdivision of the state, created by OEDIT, and a Special Purpose Authority, like the state’s Public Employees’ Retirement Association, exclusively used to invest in Colorado-specific investment fund managers.

One such investment fund that received an anchor investment from the CVCA is the Greater Colorado Venture Fund (GCVF). This innovative investment fund focuses exclusively on entrepreneurs in rural Colorado. Besides its unique focus on investing outside of the state’s urban corridors, GCVF makes use of innovative capital products for entrepreneurs. For some of its seed-stage deals, instead of using a Simple Agreement for Future Equity (SAFE) or preferred equity like traditional venture capitalists do, GCVF makes what it calls “redeemable equity investments.” These, essentially, are agreements that allow a company to sell equity to an investor but permit the entrepreneurs to buy back this equity based on a recurring share of revenues.

When the CVCA decided to make an investment in a flexible VC fund like GCVF, they opened the door for dozens of rural Colorado entrepreneurs to obtain capital that truly fits their needs in a way that traditional debt or equity may not have.

**For more detailed information about Greater Colorado Venture Fund, see the full case study on [page 63](#).**

# Indirect Capital Providers: Asset Allocators, Philanthropy, Corporations

Intermediaries such as foundations, corporations, and indirect capital providers have historically supported capital access in many different ways. Banks and institutional investors have long supported and capitalized Community Development Financial Institution loan funds dating to the mid-1990s. Foundations have generously supported small business ecosystem development, technical assistance, accelerators, and capacity building through grant programs. Corporations have developed supplier diversity programs and participated in grantmaking and capacity building for small businesses in their communities.

While this is not a comprehensive list, and many of these efforts are effective and should continue to be supported, there is opportunity for these intermediary institutions to expand their strategies to support small business capital access and play a key part in advancing the innovative finance space.

In order to increase the use of innovative products to get capital into the hands of more business owners, there is a need for risk-tolerant capital to seed such innovative strategies and the capital allocators who are using them. There are many fund managers and capital providers equipped to utilize innovative products but who struggle to identify investment capital willing to back an innovative strategy. Foundations, corporations, and other indirect capital providers can make a significant impact by writing Limited Partner (LP) checks to innovative fund managers, lending capital to innovative debt providers, or providing operating capital to last-mile capital provider institutions. In addition to investment capital, anchor institutions can utilize existing asset pools to leverage as guarantees for higher-risk new entrants or innovations within capital markets, e.g., a loan loss reserve strategy.

Many innovative capital providers that are using alternative strategies—those that do not resemble traditional venture capital or lending—have struggled to raise investment capital from traditional and institutional sources. The more these new products can be proved in the market, the more momentum will be behind the formation of new financing mechanisms that increase capital investment to underserved entrepreneurs who have been historically left behind due to their race, ethnicity, gender, socioeconomic class, and/or geographic location.

In addition to providing seed and investment capital to emerging funds, there is also significant opportunity to support this relatively nascent ecosystem through landscaping and research work, technical assistance and capacity building, and convenings and shared learnings. In this playbook, you will find a guide to understanding your local capital landscape—an important step to better understand what gaps exist in your local capital market and what strategies might be a good fit in your local context.

We have seen several great examples of how foundations and indirect capital providers have leveraged their resources to further this space, specifically those that have provided risk-tolerant capital to innovative funds to support their launching or expanding into nontraditional capital products.

**Consider a few examples below:**

#### EXAMPLE 1

### **Calvert Impact Capital – Securitizing Small Business Loans via CDFI Lenders**

Calvert Impact Capital partnered with the National Development Council (NDC), Community Reinvestment Fund (CRF), and dozens more CDFI lenders across the country. Their goal: to create various programs intended to capitalize regional loan funds and ultimately bring debt capital to the entrepreneurs who need it most. To date, these Calvert-managed programs have leveraged funds from private, public, and philanthropic investors and blended in a centralized loan purchase facility that is then used to buy a percentage of every eligible loan originated by a participating CDFI.

So far, the CDFIs have made \$240M in loans to 3,929 small businesses at an average loan size of approximately \$59K. With a special focus on lending to chronically underbanked businesses, this suite of capital programs for CDFIs have yielded an overwhelmingly positive impact, with 90% of loans going to businesses with 10 or fewer employees (i.e., Very Small Businesses) and 67% of loans to businesses owned by women and/or Black, Latino/a, Asian, or Native Americans.

Building on these programs' successes, Calvert Impact Capital is now building state-based programs to leverage SSBCI, blending the state's subordinate funds with private capital to purchase standardized loans originated by participating CDFIs. The funds will be borrowed by a state-specific special purpose vehicle (SPV) and will purchase 80% of every eligible loan originated. Calvert will arrange the warehouse line and, once there are sufficient assets across the warehouse vehicles, will sell the loans to another Calvert Impact, Inc. subsidiary to issue asset-backed notes to institutional investors. The objective is for the notes to be rated by one of the top three ratings agencies to drive the most efficient pricing in the market. Proceeds from the note issuance will be used to repay the warehouse line and replenish available state funds to recycle the funding and prolong the program.

## EXAMPLE 2

### **Kauffman Foundation Capital Access Lab**

In 2019, the Kauffman Foundation seeded the Capital Access Lab (CAL) with a \$3M grant that led to an additional \$500K raised from the Rockefeller Foundation. CAL was launched with the goal of closing market gaps for entrepreneurs in populations systematically excluded from capital markets and overlooked communities across the US. To do so, CAL identified and funded innovative strategies to support the 83% of entrepreneurs who do not have access to traditional bank loans or VC. Since inception, CAL has invested in six funds that address the access to capital problem by deploying innovative financial products to underserved entrepreneurs and communities.

Over three years in, the results speak for themselves. Within 18 months since the first investment, CAL has mobilized \$162M in private capital for its six portfolio funds as the anchor or one of the first LPs and serving as the "institutional stamp of approval" for follow-on investors. This has generated an impressive catalytic leverage ratio of 48x for a relatively small \$3.4M fund of funds (FoF). Of the portfolio companies, 20 (87% of 23 total) are led by underrepresented founders, 65% are woman-led, 78% are POC-led, and 26% are based in economically distressed areas.

Institutional investors with large assets under management and patient investment capital, especially foundations and endowments, should leverage part of their annual grant budgets to permanently seed the next generation of underrepresented fund managers through Program Related Investments (PRI) and Mission Related Investments (MRI) programs. CAL represents an innovative pilot program focused on addressing this challenge that foundations should build upon and replicate at a larger scale.

**For more detailed information about Capital Access Lab, see the full case study on [page 159](#).**

## EXAMPLE 3

### **Supply Chain Financing**

Some of the most pressing challenges that can be addressed by Supply Chain Finance (SCF) are in the construction sector. According to a [2015 study by PwC](#), construction and engineering is the industry with the longest period for sales outstanding, at an average of 73 days for firms to be able to collect on sales. Construction also shows the most potential for SCF innovation, as minority firms are concentrated in construction and, state and local

governments are expecting hundreds of billions of dollars to flow from the federal Bipartisan Infrastructure Law.

The simplest and most founder-friendly form of SCF is early payment, sometimes discounted or with a fee, by the buyer. For example, Turner Construction Companies started its own [in-house factoring](#) facility for subs, using an online platform to quickly onboard and validate invoices. This kind of buyer and large purchaser innovation, while leveraging technology, simplifies processes, pays firms faster, and is critical for meeting contractor cash flow needs in fulfilling contracts and leveraging these opportunities to help diverse firms grow.

## Direct Capital Providers: Fund Managers, Community Development Financial Institutions

The overwhelming majority of capital or financing options for a business owner/entrepreneur come from private institutional capital: bank lending and venture capital. **And yet, according to the Kauffman Foundation's Access to Capital report, at least 83% of entrepreneurs do not access bank loans or venture capital.** The majority of businesses rely on personal and family savings for startup capital, and the funding that does flow is not equitable.

While many direct capital providers are working to expand access to their existing capital products, there is still a large gap in terms of entrepreneurs who are seen as “too risky” for a loan and “not high-growth” enough for venture capital. This is a major opportunity for innovation and for capital providers (new and existing) to experiment with structures that include revenue-based sharing models, profit-sharing models, and employee ownership—all of which will expand capital access to businesses that are not currently a fit for traditional debt and equity.

Existing capital providers can use this playbook to explore new products and reach a new set of business owners and founders. Many of the innovative products discussed are incrementally different from a traditional product and would be a natural addition to an existing capital providers toolkit. New capital providers who are launching strategy should be open to an innovative or blended strategy. While there is still a strong need for technical assistance and high-touch support as this ecosystem matures, this playbook is intended to remove some of the barriers and equip a new capital provider with the practical information and tools needed to launch an innovative strategy.

## EXAMPLE 1

### National Development Council

NDC is a CDFI lender historically focused on traditional debt offerings with a unique focus on Revolving Loan Funds. Like many CDFIs, NDC frequently comes across businesses that are not explicitly a fit for their traditional loan products nor a fit for venture capital funding. These local businesses have strong potential and a solid track record yet struggle to identify the right capital fit.

NDC will capitalize these businesses by piloting a revenue-based loan fund dedicated to minority entrepreneurs—providing better tailored products to suit market demands. In Seattle, small businesses struggle to qualify for traditional loans, even from flexible CDFIs. Inconsistent cash flows, short histories, and borrower variables all work against small business owners in inhibiting creditworthiness. However, flexible revenue-based loans take into consideration the “upside potential” of small businesses and decrease reliance on historical performance. NDC plans to capitalize this fund with money or guarantees from the Washington State SSBCI 2.0 program(s); a key part of their ability to get buy-in for this innovation. NDC’s RBF strategy is a compelling blueprint for existing capital providers interested in re-tooling for new products to reach diverse businesses.

## EXAMPLE 2

### Collab Capital

There are some great examples of first-time fund managers who are designing and reinventing capital products without having to re-tool an entire organization. The team at Collab Capital is one such example, with its focus on investing in Black-led businesses. “We were very adamant that the most important thing we wanted to solve was the funding gap for Black founders,” said Jewel Burks Solomon to TechCrunch. “So we were not willing to broaden the spectrum there because we saw that there were so many firms out there for diverse founders, and even in some of those, Black founders were still marginalized.”

And so they launched Collab Capital, an Atlanta-based fund that makes profit share investments structured with performance-based equity in seed-stage, Black-owned companies across the US. The team creates growth opportunities for their companies by connecting founders to corporate and social “influencers.” They will back companies that reflect their three core areas: future of care, future of learning, and future of work; then they will focus on supporting founders in US cities that have a high concentration of Black innovators and a low concentration of capital.



Founding Partners Jewel Burks Solomon, Justin Dawkins, and Barry Givens have each experienced how bias roadblocks Black innovation and entrepreneurship. Through their hard work and resilience, this entrepreneurship trio created Collab Capital—one of the largest funds for Black-focused investment firms—to help the Black community create wealth and increase business ownership.

**For more detailed information about Collab Capital, see the full case study on [page 79](#).**

### EXAMPLE 3

## Minority Business Accelerator Fund

Housed at Cincinnati Regional Chamber, the Minority Business Accelerator has spent nearly two decades elevating outcomes for minority entrepreneurs. Since inception, MBA has increased annual regional minority business spending by more than 10x (\$1.2B in total last year) and created more than 3,500 jobs. After providing support to dozens of minority-owned firms, the MBA team saw how access to capital remained an issue and decided to launch MBA Fund 1 to help capitalize such firms.

In order to meet entrepreneurs in the "missing middle," they decided against structuring their inaugural fund along the lines of traditional venture capital, private equity, or private debt. Instead, they created a fund that will reinvent the capital marketplace for Black and brown-owned businesses by offering alternative structures.

Fund investors may share in the revenue of a growing firm, for example, instead of a highly illiquid equity investment that may not be the right fit for the vast majority of stakeholders. Additionally, the fund plans to serve as an innovative "search fund" or "business acquisition" strategy, where the MBA Fund will finance the acquisition of existing, nonminority-owned businesses for a new, racial-minority business owner.

This example creates a roadmap for how a nationally regarded regional accelerator might launch its own investment fund, designing capital products around the needs of local minority entrepreneurs it has served for decades.

**For more detailed information about MBA Fund 1, see the full case study on [page 152](#).**

# Innovative Capital Products



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# | Overview

The marketplace of capital products for businesses has historically been dominated by two extremes: venture capital, which takes high risks on early stage businesses with a high rate of failure; and bank debt, which almost guarantees modest returns and requires significant business and personal resources from business owners. Venture Capital looks for unicorns (rare, outsized return potential), and traditional lenders look for safe bets with downside protections, which excludes a massive group of businesses and creates an opportunity for innovation to help address the gap.

While these existing, traditional capital products will continue to exist and serve businesses for which they are a fit, there is space and opportunity for an expansion of capital products offered in the market. The market of nontraditional products is still in early phases of growth, and this playbook aims to aggregate and codify much of the great progress that has been made so far. In order to routinize and scale this space, there is a need for more experimentation and risk, in both funding and implementation of these products.

To explore our database of tools and resources for innovative capital products, visit [innovative.finance/resources](https://innovative.finance/resources) or scan here:

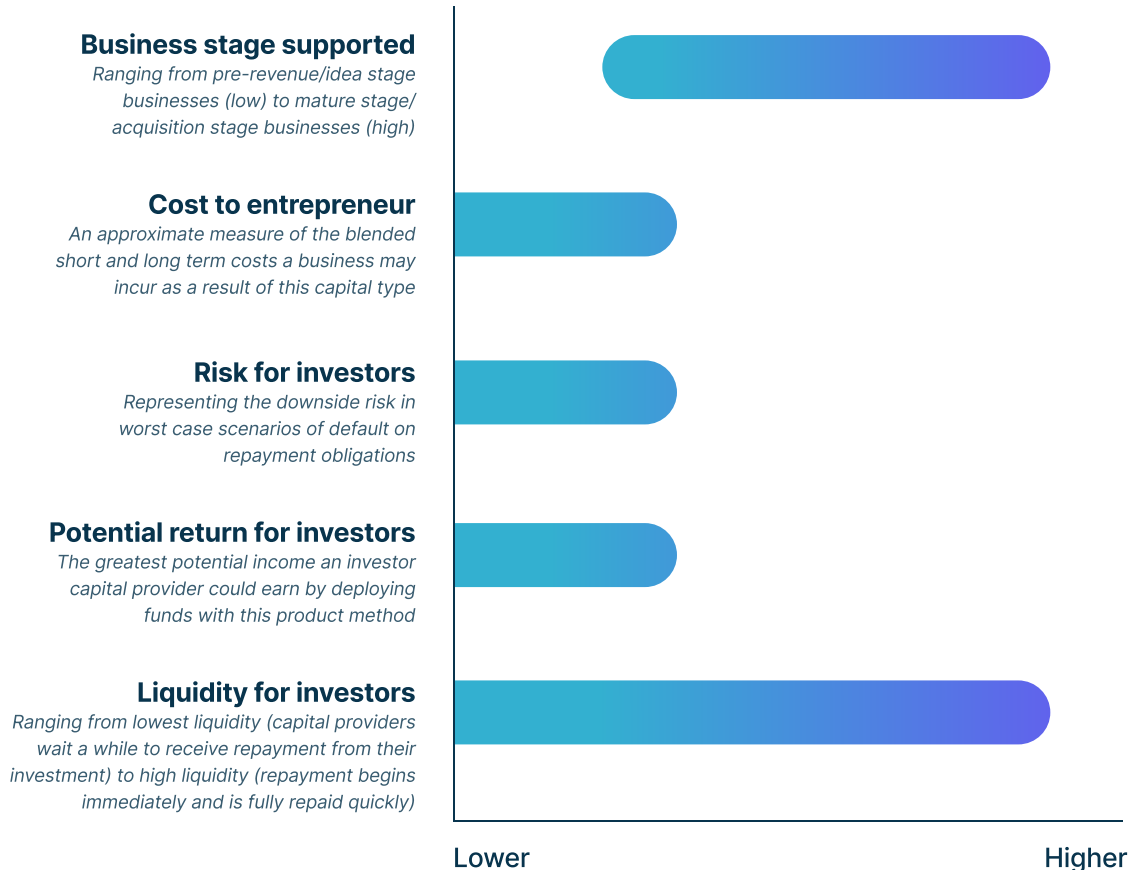


# Revenue-Based Loans



## TL;DR

A revenue-based loan is a more flexible funding model than traditional debt financing, with payments tied to a percentage of revenue instead of an interest rate.



# What is a revenue-based loan?

A revenue-based loan is like a flexible loan with no fixed interest rate. Revenue-based investors give a company capital in exchange for a percentage of the company's ongoing revenues. Similar to traditional debt financing, investors collect monthly or quarterly payments. Rather than payments set at an interest rate, revenue-based payments fluctuate with revenue. If revenue slows down, then the payments will be lower; if the revenue is higher, then the loan is repaid more quickly. Payments are made until the investor receives a predetermined multiple of the original investment or return cap. Typically, the company does not have to provide collateral for a revenue-based loan because its revenues are essentially collateral.

A revenue-based loan blends features of bank debt and venture capital, and founders should expect the cost of capital to fall within that range. Revenue-based loans are non-dilutive growth capital to bridge the path to sustainable profitability for revenue-generating businesses that do not fit the VC model.

Revenue-based financing (RBF), also known as revenue-based investing (RBI) and royalty-based financing, was used by oil investors in the early 20th century to finance oil and natural gas exploration, and later by the pharmaceutical, media, and energy industries. VCs began applying it to early-stage, life sciences companies in the 1980s and more recently to technology sectors. FinTech lenders, such as Lighter Capital and Clearbanc, have focused on bringing RBI to the Software-as-a-Service (SaaS) space, but there are a number of emerging investors offering it across other sectors.

## What are the typical characteristics of an RBF loan?

- Structured as a loan
- Principal amount is fully funded at closing
- Monthly payments equal a set percentage of monthly revenue (typically 2-8%)
- Monthly payments continue until a set dollar amount has been paid back, usually 2-3x the amount of the financing (this multiple is called the "cap")
- At maturity, which is typically 3-5 years, any unpaid amount of the cap is due
- No collateral or restrictive covenants

# Capital Fit

## What types of businesses are a good fit for a revenue-based loan?

Revenue-based loans are common among companies that use a subscription model (particularly companies selling SaaS), but they are also useful for nontech businesses, like food and manufacturing, where revenue can fluctuate. Advocates of revenue-based loans are increasingly encouraging businesses and funders to consider this model for a variety of industries. For a business growing at a moderate pace with recurring revenue in need of growth capital (like hiring, buying inventory, or conducting a big marketing campaign), revenue-based loans can be a good option.

**Profitability:** Businesses do not need to be profitable, but investors like to see a path to profitability within three to five years. Businesses need to be at least EBITDA positive.

**Recurring Revenue:** Businesses need to average at least \$10K in monthly recurring revenue (MRR). Investors like to see somewhat predictable revenues with repeatable or recurring customer contracts and customer diversity.

<b>Annual Revenue Growth:</b> 25%+	<b>Gross Margins:</b> 40%+
------------------------------------	----------------------------

**Financials:** 2+ years of financial statements

## When is a revenue-based loan not a fit for businesses?

**Too Young:** If a business does not have at least two years of financial statements, then it is difficult for a revenue-based investor to underwrite and make an investment.

**No Revenue:** If a business does not have any revenue, then it is difficult for a revenue-based investor to underwrite and make an investment. Most investors like to see \$10K+ in MRR for several months.

**Heavy R&D:** Businesses that are capital intensive and require a large amount of upfront funding to build large-scale projects or bring breakthrough technology to market.

**Blitzscalers:** Businesses that require rapid growth to take over an entire market or create a new market and need large amounts of VC funding to scale. These “Blitzscalers” typically focus on speed and growth over cash flow and profits.

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**Fundraisers:** Founders always focused on raising the next round of funding for their businesses. Investors want to write checks to builders, not fundraisers, and do not want to have to spend a lot of time convincing founders not to take the traditional VC funding path.

---

**Misaligned Cap Table:** If founders have raised \$5M+ in traditional VC funding, then their existing investors most likely will be focused on raising another VC round at a larger valuation. Revenue-based investors do not want to compete with the different return and fundraising expectations of prior or potential co-investors. On the debt side, investors do not like to navigate a crowded and complex cap table with a bunch of lenders who are more senior to them and have expensive rates and warrants.

## Why would founders want to choose a revenue-based loan?

**Non-dilutive & More Control:** Founders maintain more ownership and control over their business than traditional VC. Once the investment is paid back by founders, the investor is not on your cap table permanently. Investors typically do not take a board seat.

---

**Flexible Payment Schedule:** A revenue-based loan provides more flexible payment terms based on a percentage of revenues than term loans (containing fixed payments that do not fluctuate with revenues). Payments scale up and down along with revenue growth.

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**No Restrictive Covenants:** Unlike traditional bank loans, revenue-based loans typically do not require the borrower to agree to any restrictive covenants where the borrower must manage their business in a specific way—such as maintaining minimum liquidity levels or hitting revenue milestones. For example, venture debt lenders will require borrowers to also agree to stock warrants for upside participation in exit scenarios. Factoring or merchant cash advances also come with more restrictions and need to be paid daily or weekly compared to monthly or quarterly for a revenue-based loan.

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**Cheaper than VC:** A revenue-based loan is often cheaper for founders than selling preferred equity to VCs. Founders may believe that traditional equity costs less with no expected payments until an exit, but a revenue-based loan is most likely cheaper over the long-run on both total dollar amount and IRR basis. Revenue-based investors cap their investment at a ~2x return instead of aiming for 10x+ returns like VCs.

**Fundraising Optionality:** Founders do not need to follow the VC funding path of raising larger follow-on rounds of dilutive equity capital. Revenue-based loans offer cheaper, non-dilutive growth capital that can enable businesses to scale and eventually raise VC funding or access cheaper bank debt. These loans provide founders the optionality to pursue the funding journey that makes the most sense for their business.

**Access to Capital:** Revenue-based loans are more accessible for underrepresented founders because the underwriting process is based on the company’s revenue, margins, and other financials, not the owner’s credit score, income, or personal real estate assets. Traditional debt financing continues to use outdated and discriminatory lending practices that limit access to capital and increase the cost of capital for underrepresented founders. Revenue-based loans have improved the investment process with a more inclusive underwriting approach.

### Financing Options

Benefits	Bank Loan	Revenue Financing	Venture Capital
Retain Equity	✓	✓	
Maintain Control	✓	✓	
No Personal Guarantees		✓	✓
Flexible Repayments		✓	
Ease of Access to Capital		✓	
Large Funding Amounts		✓	✓

### What should businesses be aware of with a revenue-based loan?

**Less Predictable Payment Schedule:** Revenue-based payments fluctuate with revenues, which can provide flexibility for founders but also be harder to predict for financial projections than traditional loans, with their fixed monthly payments. Revenue-based loans have a variable interest rate instead of a fixed interest rate.



**More Expensive than Bank Loans:** Most founders seek revenue-based loans because they cannot access bank loans or VC. Revenue-based loans usually cost between 10% and 20% IRR compared to bank loans at <10% IRR and VC at 50%+ IRR. If revenue grows quickly, then payments will also. This leads to a shorter payback period but also a higher cost of capital. Founders need to be comfortable with the fixed return cap or total payment, regardless of their revenue growth rate.

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**Gross Margins > % of Revenue:** Founders need to be comfortable giving up the percentage of revenue to pay back the investment. Gross margins need to be sufficiently high enough to support the financing costs or else the investment will start to reduce the growth potential of the business.

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**Personal Guarantees & Collateral:** It depends on the revenue-based lender, but founders may need personal guarantees and potentially pledges of personal collateral. However, revenue-based loans tend to have more founder-friendly terms than traditional bank loans.

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**MCA Disguised as RBF:** There are a rising number of FinTech platforms and lenders that claim to make “revenue-based” investments for founders, but their products are closer in structure and costs to merchant cash advance (MCA). These FinTech platforms offer speed and access to capital for small businesses but can be misleading on the actual costs and financing terms for founders. Typically, these “revenue-based” products appear to be much cheaper than a revenue-based loan with return caps around 1.2x, but there is no grace period, and businesses are making daily or weekly payments instead of monthly or quarterly. The APR likely is 50%+ compared to revenue-based loans at up to 30% APR. Founders may end up taking on expensive debt that does not actually help them grow.

# Benefits for Capital Providers

## Why would fund managers choose to offer revenue-based loans?

### **Payment Flexibility:**

Repayment flexibility can be a benefit for funders as well as for entrepreneurs. Affixing payments to revenue results in borrowers who are more likely to make their payments.

### **Risk/Reward:**

RBF represents a class of investment that typically offers greater returns than traditional debt financing but lower risk than VC investing, offering a potential sweet-spot of risk/reward.

### **Liquidity:**

RBF loans can provide consistent returns and liquidity with a lower risk profile for funders that do not want to spend all their time and energy searching for “unicorn” businesses.

### **Founder Alignment:**

Greater alignment between entrepreneurs and RBF capital providers based on shared goals of revenue maximization and profitability can lead to potential for follow-on investments and cheaper debt capital.

## What should capital providers be aware of with revenue-based loans?

- By fixing returns at a cap, RBF investors experience limited upside on their investments, potentially missing out on the exponential VC-like returns.
- Lack of collateral from RBF borrowers reduces the likelihood of capital providers collecting on nonperforming loans or bankruptcies.
- Lack of familiarity with RBF terms may keep entrepreneurs from applying for RBF funding.
- Accounting nuances: In US law, revenue-based loans are subject to 26 CFR 1.1275-4 - Contingent Payment Debt Instruments, thus requiring Noncontingent Bond Method (NBM) of accounting. The NBM accounting method when applied to early stage companies makes it likely that investors would have to pay income taxes before they receive income from the company, as the accounting method requires the investor to recognize the yet unrealized income, similar to bonds with an original investment discount (OID). Interest is not computed and paid in regular intervals or at least annually.

# Terms

## What do investors typically charge businesses for revenue-based loans?

**Investment Size (Principal):** Up to 1/3 of annual revenue or up to 3x monthly revenue (typically \$50K to \$3M check sizes) *This is the total amount invested in the round.*

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**Ownership (Equity):** 0%

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**Percentage of Revenue (Payment):** 2-5% (though it can go as high as 10%)  
*Revenue can be defined as Total Revenue (Gross Revenue), Net Revenue (Net Cash Receipts), or Revenue minus COGS (Gross Profit).*

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**Return Cap (Total Payment):** 1.5x to 2.5x principal

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**Payment Schedule:** Monthly or quarterly

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**Grace Period:** 0 to 12 months  
*This is the date founders will begin making revenue-based payments. These start dates can range widely given the intent of the founders and investors. Some investors might choose to set the start date to begin immediately, while others may set it at 12 months post-investment.*

---

**Maturity (Term):** 3 to 5 years  
*This is the due date by which time the total payment (return cap) must be paid. If the company still owes capital at the due date, then investors typically have the option to either demand payment or to convert any unpaid capital into equity.*

---

**Equity Warrants:** None

**Personal Guarantee:** None

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**Financial Reporting:** The investor has access to the company's financial statements, including monthly balance sheet (plus YTD), monthly cash flow statements (plus YTD), monthly bank reconciliation report, monthly bank statements, and monthly compliance certification—certifying the information delivered.

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**Board Seats:** None

## FAQs

### How expensive are revenue-based loans?

They are often cheaper than selling equity, but more expensive than bank loans. They typically cost 10-20% IRR compared to <10% for bank loans and 50%+ for VC. If founders can get access to a cheaper fixed-rate bank loan and are willing to secure the loan with personal guarantees and collateral, then they should take it.

### What are the tax implications of revenue-based loans for investors?

A revenue-based loan is a debt product. Similar to traditional loans, taxable investors—including family offices and high net worth individuals—will have their gains taxed at their ordinary income rate, not the long-term capital gains rate.

If the company plans to raise more capital, there may be difficulty with S Corp and LLC business structures. LLCs take on the tax liability and collect 1099s annually. Investors have a strong preference for C Corps.

### What are the legal considerations of revenue-based loans for investors?

There are potential usury law issues for revenue-based loans depending on the state jurisdiction.

### Why would investors be interested in revenue-based loans?

RBI provides equity-like returns with better liquidity than traditional equity. Investors do not need to rely on an acquisition or public exit because of the self-liquidating returns for RBI. Founders pay back the investment from their company's revenues until reaching the return cap.



# Revenue-Based Loan Case Studies

Novel Capital | 38

Sage Growth Capital | 43

On Shore Technology Group | 48



Novel Co-Founders & Managing Partners:  
Keith Harrington (left) and Carlos Antequera

## Overview

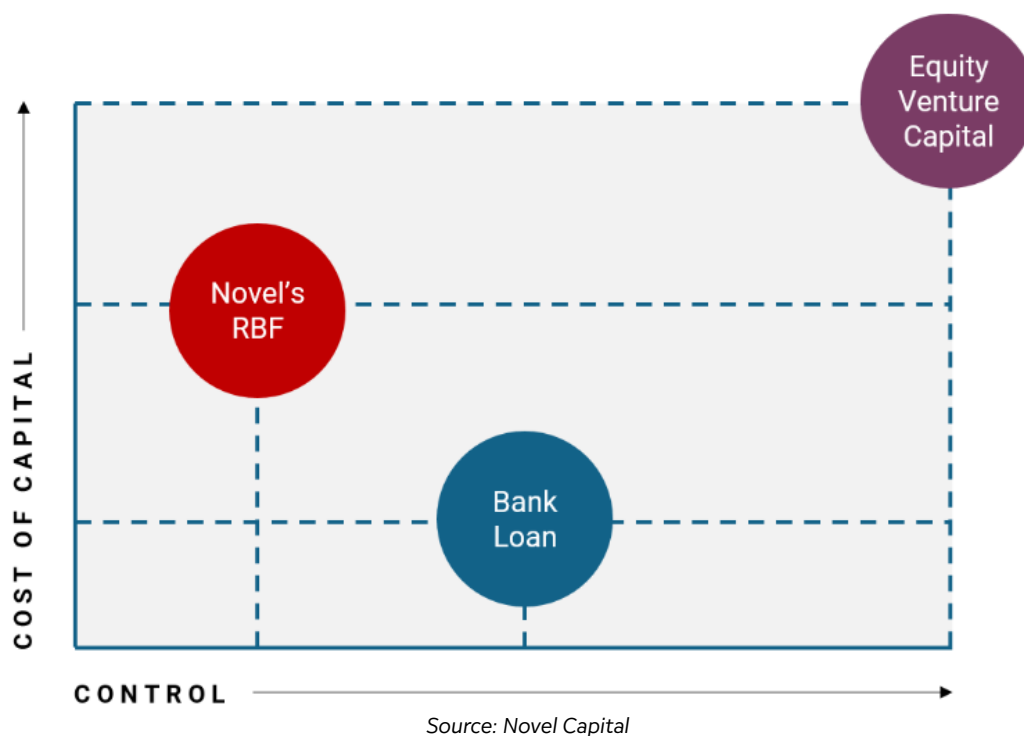
[Novel Capital \(Novel\)](#), formerly known as Novel Growth Partners, is an Overland Park, Kansas-based RBI platform that provides flexible financing to early-stage, B2B software companies in the Midwest. Novel provides companies up to \$5M in revenue-based growth capital and leverages the operational expertise of its team to provide strategic planning, sales growth, and talent support to founders via its Revenue Acceleration Platform. Novel invests in entrepreneurs focused on growing revenue and building a near-term profitable company.

Novel, founded in 2017, closed its first fund at over \$12M in 2019. Its co-founders are Keith Harrington, a former VC and Kauffman fellow, and Carlos Antequera, former CEO of education technology (EdTech) company Netchemia, acquired in 2015 by PeopleAdmin. The two wanted to bring the RBI model to the software space as an alternative to traditional VC for startups. The team has grown from the two founding partners at inception to 16 members as of March 2022.

In 2022, Novel closed \$115M in equity and debt financing from investors including Community Investment Management, Nueterra Capital, and Tenzing.vc. The team decided to move away from the traditional GP/LP fund structure that they used for their first fund and scale their RBI platform with a debt facility. This Fintech platform approach, similar to [Founders First Capital Partners](#), enables Novel to make more and larger revenue-based investments for entrepreneurs without continuously raising smaller funds from LPs.

## Investment Strategy

Novel makes revenue-based loans in early-stage, B2B SaaS companies in the Midwest. Novel provides growth capital out of their fund and direct operational support for entrepreneurs from their Revenue Acceleration Platform. The team seeks companies with \$500K+ annual revenues, 40%+ gross margin, and 30% year-over-year growth rate. Fund I will invest in 40-50 companies over its five-year investment period with an initial check size of \$100K to \$2M or up to 30% of a company's annual revenue with reserves for larger, follow-on investments. Novel is targeting a 25% gross IRR and 2.0 gross MOIC for the fund.



**Revenue-Based Products:** Based on their own entrepreneurial journeys and VC investment experience, Novel's founding partners knew the super-high growth and high failure rate of the traditional VC model overlooked a large number of entrepreneurs. They wanted to offer a different type of capital product that enabled them to help as many entrepreneurs scale their businesses as possible. Novel decided to use the RBF approach to serve as an alternative to traditional VC or bridge to the next round. Instead of buying equity and waiting for a public or M&A exit like the VC approach, Novel generates self-liquidating returns with a monthly revenue-based payment based on the company's sales. The company stops making revenue-based payments to Novel once it hits the return cap.

## Novel offers two revenue-based capital products:

1. **RevShare Capital** is patient growth capital for companies with flexible payment options. It is designed for SaaS companies with a mix of recurring and nonrecurring revenue streams. Novel provides funding of up to 30% of a company's total annual revenue structured with 4% to 9% royalty of gross cash receipts, return cap of 1.2x to 1.9x, and six- to 60-month payment schedule. If the capital is paid back earlier, then a lower return cap is used.
2. **Upfront Capital** is essentially invoice factoring for companies that turns future subscription revenue into immediate capital to help fund short-term needs. Companies can trade up to 30% of their subscription revenue for capital. Novel makes Upfront Capital investments from \$100K to \$5M in exchange for a one-time upfront fee of 8% of the company's monthly contracts over a 12-month payment schedule. The cost of capital is an 18% APR. This RBF product is a good fit for subscription-based SaaS companies with recurring revenue streams.

Novel's RBF model produces faster growth funding for companies within two months compared to a traditional VC, which typically takes at least six months. However, they can partner with VCs and lenders if it makes sense for their companies.

## RBI Product Terms

	RevShare Capital™	Upfront Capital™
<b>Minimum Qualifications</b>	Company with predictable revenue \$500,000 in TTM revenue Revenue growth of 30% YoY	Company with predictable revenue \$350,000 in ARR Revenue growth of 10%+ YoY
<b>Revenue Model</b>	Companies with a mix of recurring and non-recurring revenue	Subscription companies with recurring monthly, quarterly or yearly payments
<b>Repayment Period</b>	Variable 6-60 months	12 months
<b>Available Funding</b>	Up to 40% of your company's total annual revenue (both recurring and non-recurring)	Trade up to 40% of your subscription revenue for capital today
<b>Payment Model</b>	Variable monthly revenue share payment based on monthly gross cash receipts	Fixed monthly
<b>Repayment</b>	4% to 10% monthly revenue share, performance discounts and no early payoff penalties	Companies with monthly subscriptions: One-time fee of 8% of the annual value of contracts
<b>Equity Share or Warrants</b>	None required	None required
<b>Personal Guarantees</b>	Not required	Not required

Source: Novel Capital



## Track Record

**Novel Growth Partners Fund I (2017, \$12M):** Novel has fully invested the fund across 50+ portfolio companies as of Q1 2022.

### Portfolio companies include:

[ABODO](#) (Madison, WI) delivers a new, better way to find apartments.

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[Branching Minds](#) (NYC) is an EdTech company that helps teachers create personalized interventions for students.

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[DivyHQ](#) (Kansas City, MO) provides a content planning and production workflow tool for high-volume content teams.

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[Elevate K-12](#) (Chicago) is a live streaming learning system focused on impact and outcomes for K-12 students across the country.

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[Gremlin Social](#) (St. Louis, MO) is an integrated social media solution for financial services companies.

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[MyMajors](#) (Kansas City, MO) is an EdTech company that assists students in identifying a major, career, and college through student friendly assessment technology.

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[OpenReel](#) (NYC) provides virtual production studio technology that allows teams to direct and capture 4K video remotely through a user's phone, replacing the need for a camera crew.

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[Passage](#) (Detroit, MI) is an online and at-the-door provider of ticketing and payments for specialty events.

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[Precise Telehealth](#) (Timonium, MD) is a MedTech company that provides telemedicine to patients with highly complex conditions or multiple comorbid chronic conditions.

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[Wisboo](#) (Palo Alto, CA) provides an all-in-one solution for education businesses in Latin America to easily create a self-branded online academy.

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[Zype](#) (NYC) empowers video operations teams to build DTC video streaming services across the web, mobile, connected TV, and social media.

## More Reading & Listening

<https://novelcapital.com/category/resources/>

<https://www.forbes.com/sites/lizengel/2019/12/10/revenue-based-financing-firm-will-increase-its-tech-investment-in-the-midwest/#355cf20f0838>

<https://podcasts.apple.com/us/podcast/pearls-of-potential-with-keith-harrington/id1468541404?i=1000502750082>

<https://www.youtube.com/watch?v=kesbLZVf2mU>

<https://www.bizjournals.com/kansascity/news/2022/03/17/novel-capital-raises-115m.html>

<https://news.crunchbase.com/news/novel-capital-capchase-pipe/>

<https://news.crunchbase.com/news/vc-equity-alternative-funding>

For more tools and resources, visit [innovative.finance/resources](https://innovative.finance/resources).



## Overview

[Sage Growth Capital \(Sage\)](#) is a Boise-based RBI fund that provides flexible growth capital to companies throughout the United States.

Sage was founded in 2019 by Denise Dunlap, Molly Otter, and Kevin Learned. The three co-founders and partners bring private equity, revenue-based, and angel investment experience along with angel group administration. Dunlap and Learned have deep angel investor networks given their work at the Angel Capital Association (ACA) and Loon Creek Capital Group. Otter brings significant experience in the revenue-based space since she served as the CIO for five years at RBF lender Lighter Capital and is currently a member of their board.

In late 2019, Sage raised \$2.1 million for their first fund primarily from local angel investors. In June 2022, they closed their second fund at \$7.7 million.

## Investment Strategy

Sage makes revenue-based investments in early- and growth-stage companies throughout the US. The team seeks companies with \$300K+ annual revenues, 40%+ gross margin, and 25%+ growth rates. They wanted to provide a more flexible capital product for founders who did not fit traditional funding models, and increased options for liquidity for angel investor portfolios. Sage is industry agnostic and will invest in companies that have recurring or “recurring-like” revenue streams.

Fund I invested in seven companies over its two-year investment period, with two follow-on investments. As of June 2022, Fund II has invested in four companies. Sage will invest up to 1/3 of a company’s revenue over the previous 12 months. Check sizes range from \$100K to \$1M with reserves for larger, follow-on investments for companies who achieve their growth projections.

**Revenue-Based Note:** Sage offers a revenue-based investment product for growing businesses with the following terms.

Variable			
Amount of Investment	Revenue Rate	Investment Return	Time to Repayment
Typical Range			
up to 33% of previous annual revenue	3-8%	2X to 3X	3 to 5 years

Source: Sage Growth Capital

The “Revenue Rate” is the revenue share or percentage of the company’s cash receipts (i.e. customer payments) for monthly repayment. Sage charges between 3% and 8%.

The “Investment Return” is the return cap. Sage charges between 2x and 3x based on the risk profile of the company.

Additionally, Sage offers a grace period of up to three months and does not require personal guarantees or collateral for founders.

## Track Record

**Sage Growth Capital Fund I (2019, \$2.1M)** was fully invested across seven companies as of June 2022.

**Portfolio companies include:**

[Killer Creamery](#) (Meridian, ID) makes keto-friendly ice cream products.

[Prosperity Organic Foods](#) (Boise, ID) produces plant-based butter and cheese products for North America, South America, and Australia.

[Unity Laundry Systems](#) (Bedford, NH) produces essential and affordable appliances for the commercial laundry industry.

[Refactor](#) (Seattle, WA) is a DevSecOps software startup founded in 2017 by military veterans and industry experts in cloud and cybersecurity (paid off early).

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[eTT Aviation](#) (Boise, ID) is a software engineering company that provides airlines a fully automated and customizable air operations suite of tools (paid off early).

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[CPR Construction Cleaning](#) (Gilbert, AZ) provides construction cleanup needs in every vertical of construction.

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[Native English Institute](#) (Seattle, WA) is transforming language learning through a data-driven AI and natural language processing solution.

**Sage Growth Capital Fund II (2022, \$7.7M)** has invested in four companies as of June 2022.

**Portfolio companies include:**

[Unity Laundry Systems](#) (Bedford, NH) produces essential and affordable appliances for the commercial laundry industry (follow on to Fund 1 investment).

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[Naked Sports](#) (Vashon, WA) produces a line of high performance gear for outdoors endurance runners.

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[CyberReef](#) (Shreveport, LA) SaaS mobile data bandwidth management and secure private networking software.

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[Mign](#) (Charlotte, NC) builds personalized, digitally tailored medical wearables in the orthopedics field to enhance recovery of musculoskeletal injury.

## Fund Structure & Terms

### Fund I

**Management Company:** Sage Growth Capital, LLC (Idaho LLC)

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**Fund:** Sage Growth Capital Fund I, LLC (Idaho LLC)

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**Fund Type:** Rule 506(b)

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**GPs:** Denise Dunlap, Molly Otter, and Kevin Learned

### Terms

**Fund Size:** \$2M

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**GP Commitment:** 7.5% of fund size

**Investment Period:** 2 years

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**Fund Life:** 7 years with 3 one-year extensions

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**Management Fee:** 2% of distributions until 1x DPI; 0% thereafter

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**Carried Interest:** 10%

**Preferred Return:** None

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**Key Persons:** Denise Dunlap, Molly Otter, and Kevin Learned

## Fund II

**Management Company:** Sage Growth Capital, LLC (Idaho LLC)

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**Fund:** Sage Growth Capital Fund II, LLC (Idaho LLC)

---

**Fund Type:** Rule 506(b)

---

**GPs:** Denise Dunlap, Molly Otter, and Kevin Learned

## Terms:

**Fund Size:** \$7.7M

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**GP Commitment:** 2.25% of fund size

**Investment Period:** 3 years

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**Fund Life:** 7 years with 3 one-year extensions

---

**Management Fee:** 2% of committed capital

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**Carried Interest:** 20%

**Preferred Return:** None

---

**Key Persons:** Denise Dunlap, Molly Otter, and Kevin Learned

## More Reading & Listening

[Sage Advice: The True Cost of Equity Webinar](#)

[Game Changers Podcast: Show Me the Startup Money!](#)

[The Angel Next Door Podcast](#)

[Angel Capital Association Webinar: Revenue Based Finance, Another Option for Angel Investors](#)

For more tools and resources, visit [innovative.finance/resources](https://innovative.finance/resources).



## Overview

[OnShore Technology Group](#) (OnShore) is an independent Chicago-based consultancy founded in 2004 specializing in Independent Validation and Verification (IV&V) software services and solutions for the life science industry.

### Why a Revenue-Based Loan?

Founder & CEO Valarie King-Bailey wanted to take the company from a core service-based business to a tech-enabled, service-based business. She had taken on small amounts of traditional debt, like a bank line of credit and MCA, but needed a better financing solution to help the company grow.

King-Bailey joined the 2020 May FastPath cohort at Founders First. Her company received a \$250K revenue-based loan from Founders First in September 2020, along with a coinvestment from revenue-based lender Novel Capital, and leveraged that investment to raise another \$250K follow-on investment from Founders First in July 2021. The \$500K in growth capital enabled her to add five new team members, expand marketing, and increase annual revenue by 53% to \$3.8M. Additionally, OnShore was able to expand her team and build her own proprietary technology platform. The revenue-based funding unlocked meaningful growth for the company, and King-Bailey did not have to give up any of her ownership.

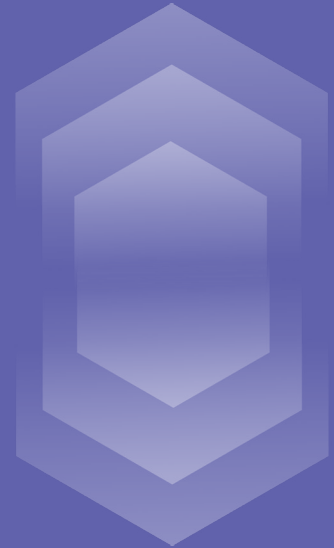
Founders First still provides post-funding advisory support as the company continues to scale to \$10M+ in annual revenue.

### Deal Terms & Performance

As of Q3 2021, OnShore has consistently made monthly revenue-based payments to Founders First post-investment and paid nearly 25% of the return cap or loan obligation. The revenue-based payments have exceeded expectations based on the 1.43x return cap (\$715K total obligation).

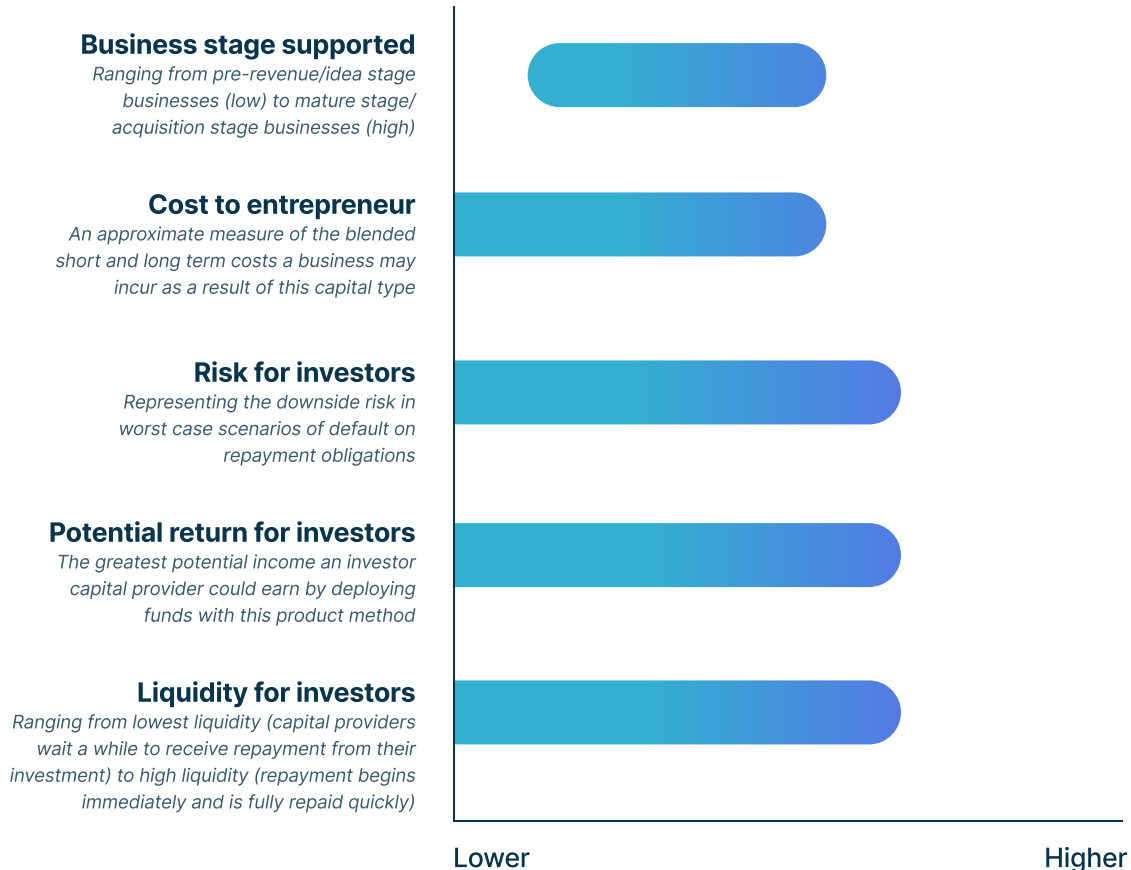


# Redeemable Equity



## TL;DR

Redeemable equity is an equity investment where the investee company agrees to buy back or redeem investors' shares over time through dividends tied to revenues or free cash flow.



# What is redeemable equity?

Redeemable equity, also known as an equity buyback, is a type of revenue-based investing (RBI) capital product designed and used by VC firms like [Indie.vc](#), [Exponential Creativity Ventures](#), and [Purpose Ventures](#). It allows funders to invest in early-stage businesses that do not yet have recurring revenues but are projecting high growth in the future. Redeemable equity investors are able to capture potential upside in these businesses, but also create visibility around liquidity and return with the timeframe of their investment. For early stage founders, redeemable equity gives them the opportunity to repurchase some or all of the shares they have sold at early stages of their companies' growth, giving them more optionality around their future funding plans than traditional equity, which requires continued equity fundraising and exponential growth.

Redeemable equity investing begins like a typical equity deal—with an investor purchasing shares of a company for a mutually agreed upon price. As part of this deal, the company agrees to gradually repurchase (i.e. redeem) some predetermined portion of these shares via regular payments of a fixed share of revenues (typically 3-10%) or free cash flow at a fixed multiple of the shares' original purchase price (typically 2-5x).

Similar to traditional debt financing, investors intend to collect monthly, quarterly, or annual dividend payments. Rather than payments set at an interest rate, these dividends are flexible (as they need to be declared by the company) and affordable (as the company can only declare them if there are sufficient retained earnings to pay the dividend). If the company's growth slows down, then these dividends will be lower; if the company's growth is higher, then the shares are redeemed more quickly. Dividends are declared until the investor receives the 2x to 5x return cap. Many investors using redeemable equity keep a percentage of the shares outstanding, or residual ownership, in order to participate in any significant upside in the future.

**Redeemable equity blends features of bank debt and venture capital, and founders should expect the cost of capital to fall within that range. Redeemable equity is less dilutive, growth capital that can bridge the path to cheaper sources of capital and sustainable profitability for both pre-revenue and revenue-generating companies that do not fit the traditional VC model.**

## What are the typical characteristics of redeemable equity?

- Structured as a convertible note or preferred equity
- Dividends are calculated as a set percentage of revenue (typically 3-10%) or Free Cash Flow
- Dividends continue until a set dollar amount has been paid back, usually 2-5x the amount of the investment (return cap or total obligation)
- Initial ownership stake of 5-15% that businesses can redeem or buy back from investors through revenue-based payments
- Residual ownership stake that investors maintain following the redemption

## Capital Product Fit

### When is redeemable equity a good fit for businesses?

**Profitability:** Businesses do not need to be profitable, but investors like to see a path to profitability within 3-5 years.

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**Annual Revenue Growth:** 50%+

**Gross Margins:** 40%+

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**Financials:** Many investors look for at least one year of financial statements, although this capital product can be used with very early stage startups as well.

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**Sustainable Growth Focus:** Founders focused on building real businesses with actual sales and sustainable growth rates instead of a growth-at-all-costs approach.

## When is redeemable equity not a fit for businesses?

**Heavy R&D:** Businesses that are capital intensive and require a large amount of upfront funding to build large-scale projects or bring breakthrough technology to market.

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**Blitzscalers:** Businesses that require rapid growth to take over an entire market or create a new market and need large amounts of VC funding to scale. These “Blitzscalers” typically focus on speed and growth over cash flow and profits.

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**Fundraisers:** Founders always focused on raising the next round of funding for their businesses. Investors want to write checks to builders, not fundraisers, and do not want to have to spend a lot of time convincing founders not to take the traditional VC funding path.

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**Misaligned Cap Table:** If founders have raised \$5M+ in traditional VC funding, then their existing investors most likely will be focused on raising another VC round at a larger valuation. Redeemable equity investors do not want to compete with the different return and fundraising expectations of prior or potential co-investors. On the debt side, investors do not like to navigate a crowded and complex cap table with a bunch of lenders who are more senior to them and have expensive rates and warrants.

## Why would founders want to choose redeemable equity?

**Preserve Equity & More Control:** Founders maintain more ownership and control over their business than traditional VC. Investors typically do not take a board seat.

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**Flexible Payment Schedule:** Redeemable equity allows companies to use dividends to redeem shares from investors. These dividends payments are based on revenues or free cash flow. Dividends can only be declared when a company has sufficient cash on hand to pay the dividend, so they can not force a company into bankruptcy.

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**No Restrictive Covenants:** Unlike traditional bank loans, redeemable equity typically does not require the borrower to agree to any restrictive covenants where the borrower must manage their business in a specific way, such as maintaining minimum liquidity levels or hitting revenue milestones. For example, venture debt lenders will require borrowers to also agree to stock warrants for upside participation in exit scenarios. Factoring or merchant cash advances also come with more restrictions and need to be paid daily or weekly compared to monthly or quarterly for redeemable equity.

**Cheaper than VC:** Redeemable equity is often cheaper for founders than selling preferred equity to VCs. Founders may believe that traditional equity costs less with no expected payments until an exit, but redeemable equity is most likely cheaper over the long run on both total dollar amount and IRR basis. Redeemable equity investors cap their investment at a 2-5x return instead of aiming for 10x+ returns like VCs.

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**Fundraising Optionality:** Founders do not need to follow the VC funding path of raising larger follow-on rounds of dilutive equity capital. Redeemable equity offers cheaper, less dilutive growth capital that can enable businesses to scale and eventually raise VC funding or access cheaper bank debt. It provides founders the optionality to pursue the funding journey that makes the most sense for their business.

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**Access to Capital:** Redeemable equity is more accessible for underrepresented founders because the underwriting process is based on the company's revenue, margins, and other financials, not the owner's credit score, income, or personal real estate assets. Traditional debt financing continues to use outdated and discriminatory lending practices that limit access to capital and increase the cost of capital for underrepresented founders. Redeemable equity has improved the investment process with a more inclusive underwriting approach.

## What should businesses look out for with redeemable equity?

**Less Predictable Payment Schedule:** Dividends fluctuate with the profitability of the company, which can provide flexibility for founders, but also can be harder to predict for financial projections than traditional loans with fixed monthly payments. Redeemable equity has a variable interest rate instead of a fixed interest rate.

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**More Expensive than Bank Loans:** Most founders seek redeemable equity because they cannot access bank loans or VC. Redeemable equity usually costs between 15% and 30% IRR compared to bank loans at <10% IRR and VC at 50%+ IRR. If revenue or free cash flow grows quickly, then the dividend payments expected will also do so. This leads to a shorter payback period but also a higher cost of capital. Founders need to be comfortable with the fixed return cap or total obligation, regardless of their revenue growth rate.

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**Gross Margins > % of Revenue:** Founders need to be comfortable giving up the percentage of revenue to pay back the investment. Gross margins need to be sufficiently high enough to support the financing costs or else the investment will start to reduce the growth potential of the business.

# Terms

## What do investors typically charge businesses for redeemable equity?

**Investment Size (Purchase Amount):** Typically \$50K to \$3M check sizes

*This is the total amount invested in the round.*

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**Initial Ownership (Equity):** 5-15%

*Subject to redemption*

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**Residual Ownership (Equity):** 0-50% of the original shares purchase or initial ownership

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**Redemption:** 3-7% (though it can go as high as 10% of revenue or 10-50% of Free Cash Flow)

- This is the percentage of revenue or free cash flow that founders will pay for redeeming the investor's shares. These payments are structured as dividends that need to be declared by the company. Each redemption reduces the investor's ownership and increases the founder's ownership. This allows founders to repurchase 50-100% of the investor's ownership percentage via redemption payments until they redeem a multiple of the investment amount (return cap or total obligation).
  - As discussed below, one of the key outstanding tax issues with redeemable equity is the reclassification issue—i.e., the outstanding possibility that the IRS would reclassify a redeemable equity investment as a debt investment, thus requiring the investor to pay ordinary income tax on the "interest" received over and above the principle. Although we do not have clear guidance on this topic, creating required payments, similar to a debt instrument, increases the likelihood of this happening. For this reason, the draft term sheet included in this playbook and the discussion in this chapter clearly labels the redemption payments as dividends that are declared by the company.
- 

**Return Cap (Total Payment or Total Obligation):** 2x to 5x purchase amount

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**Dividend Schedule:** Monthly or quarterly or annually

**Grace Period (Redemption Start Date):** Investors generally include either a time-based grace period (i.e. 6-36 months) or one that is linked to a revenue or free cash flow milestone.

- This is the date founders should begin declaring the dividends to repurchase investors shares. As discussed above, it is important to note that dividends cannot be legally declared if the company does not have sufficient retained earnings to pay the dividend.
- If the company has a failed redemption, which investors term as a specific number of redemption payments that have not been made, investors can choose to make the entire total obligation due and payable, convert the total obligation into debt with warrants, or renegotiate the terms of the deal.

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**Personal Guarantee:** None

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**Financial Reporting:** The investor has financial data access to the company's financial statements, including monthly balance sheet (plus YTD), monthly cash flow statements (plus YTD), monthly bank reconciliation report, monthly bank statements, and monthly compliance certification—certifying the information delivered.

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**Board Seats:** None

## FAQs

### How expensive is redeemable equity?

Redeemable equity is often cheaper than traditional equity, but more expensive than bank loans. It typically costs 15% to 30% IRR compared to <10% for bank loans and 50%+ for VC.

### What are the tax implications of redeemable equity for investors?

Redeemable equity is an equity-like product with debt-like features. Given the smaller size of the emerging redeemable equity space and innovative design, there is still no clear guidance from the IRS on how it should be taxed. However, most redeemable equity investors have treated their investments as equity, not debt. Therefore, taxable investors, including family offices and high net worth individuals, will have their gains taxed at their capital gains rate.

There is reclassification risk where the IRS reclassifies a redeemable equity investment as debt, which would require investors to pay ordinary income tax instead of capital gains tax.

## What are the legal considerations of redeemable equity for investors?


If structured correctly, redeemable equity instruments can mitigate some of the tax and regulatory issues presented by revenue-based loan instruments. With this mitigation comes additional complexity and potentially upfront costs, as redeemable equity agreements can have more clauses to negotiate than traditional equity investments. This is because, unlike traditional equity investments, redeemable equity agreements are doing two deals in one (i.e., taking the money in and defining the economic terms of repayment).

## How does the Indie.vc term sheet differ from the redeemable equity term sheet in this playbook?

Since 2018, fund managers have adopted and iterated on the open-sourced [Indie.vc term sheet](#). We consider the Indie.vc term sheet to be a redeemable equity product; however, there are some major differences between the Indie.vc term sheet and the redeemable equity term sheet in this playbook. The Indie.vc term sheet is structured as a convertible note with the investor receiving rights to the investee company's shares and several types of conversion events. This playbook's term sheet is structured more closely to preferred equity, with the investor receiving the investee company's shares upfront at investment, and takes a more conservative approach by avoiding mandatory redemption payments. Also, the Indie.vc term sheet does not need the company to be profitable before receiving redemption payments, unlike this playbook's term sheet.



# Redeemable Equity Case Studies



Capacity Capital | 58

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Surv | 69



Capacity CEO & Founding Partner: Jonathan Bragdon

## Overview

[Capacity Capital](#) (Capacity) is a redeemable equity fund that provides growth capital to local, revenue-generating businesses in Chattanooga, Tennessee and the Southeast. Launched in 2020 after experience working with hundreds of small businesses engaged with CO.STARTERS and Credo, Capacity is led by serial entrepreneur and solo GP Jonathan Bragdon.

Prior to Capacity, Bragdon was the co-founding partner at the management consulting company Credo, based in Chattanooga. Credo helps companies build better cities by connecting businesses that care about their community with financial and social capital, effective resources, and guidance. He has served on the boards of local ecosystem organizations CreateHere, Chattanooga Technology Council, and Chattanooga Chamber of Commerce. He also has actively engaged with other local impact organizations including CO.LAB, GigTank, UTC Entrepreneur Forum, Seed Project, Chattanooga Renaissance Fund, LAUNCH Chattanooga, and Chattanooga 2.0. Bragdon is a serial entrepreneur who was previously the co-founder at Very, Foresight.io, ReadyCart (acquired by Grapevine Inc.), Stork, Your Secret Weapon, and Tricycle Inc (acquired by Shaw Industries).

Capacity was launched to prove its model in Chattanooga with this initial pilot fund and then scale nationally by providing a playbook for other ecosystems.

Capacity is targeting \$1.5M for its first fund with over \$500K raised from the Kauffman Foundation and Rockefeller Foundation as of June 2022.

## Investment Strategy

Capacity will primarily invest in revenue-generating companies led by underestimated entrepreneurs in Chattanooga and opportunistically across the rest of the US. The team will make revenue-based investments of \$50K to \$200K in 15+ companies. Capacity will invest in SaaS, light manufacturing, or service companies that hire locally and meaningfully impact their communities. It targets companies with \$200K to \$500K in annual revenues and expects to grow them to at least \$1M after three years. The fund is targeting a 15% net IRR and 2.0 net MOIC over its seven-year life.

### **Capacity Capital will target companies with the following investment criteria:**

**Location:** Operate and hire locally and actively involved in local communities

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**Sectors:** SaaS, light manufacturing, and services

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**Metrics:** Limited collateral, <\$1M in revenue, predictable & repeatable revenue model, with a line-of-sight to double in 12-18 months

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**Founders/Owners:** Overlooked and underestimated founders seeking financial and social capital, and who want to maintain control and optionality

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**Employment:** Opportunity to add local workers as revenue grows

Capacity believes great, regular businesses build better cities and contribute more than high-risk startups. Businesses with stability and steady growth create more value through long-term growth than startups focused on disruption and “hockey stick” growth. They believe these small businesses can generate better risk-adjusted returns from a balanced RBI portfolio than a traditional VC portfolio—doing so by delivering mostly 1.5-4.0x investments with limited losses over seven years compared to the rare 10x, a few 3-5x, several 1x, and mostly 0x investments over 10+ years. Additionally, Capacity expects to generate private equity-like returns by unlocking value for underestimated companies and leveraging its local and national networks.

## Redeemable Equity

Capacity offers a redeemable equity product, inspired by Indie.vc's term sheet, for small businesses. Bragdon wanted to bring innovative capital to close a major capital gap for underfunded businesses in his Chattanooga community and the Southeast. Local entrepreneurs typically found it difficult to receive loans from banks due to low collateral assets, and difficult to receive VC investment due to lower growth and limited exit potential.

Capacity's redeemable equity approach enables the fund to hedge risk in economic downturns for small businesses. The redeemable equity structure has more predictable liquidity due to its revenue share component than the traditional VC approach, while maintaining upside opportunity with equity. Startups and investors playing the VC game rely on raising larger and larger equity rounds at higher valuations, but there are still no realizations. Even if revenues stay flat or slightly dip, Capacity will have realizations that can be recycled or distributed to LPs.

## Access to Local Capital

Prior to launch in 2020, Capacity Capital met with 60+ investors nationwide to learn more about revenue-based finance tools and partnered with Benwood Foundation, Credo, and LAUNCH Chattanooga for additional research into this model. Capacity believes redeemable equity is the best investment model to scale underestimated, revenue-generating businesses that are more likely to grow and hire locally in overlooked communities. Redeemable equity terms are more flexible than debt and provide greater liquidity than equity while better aligning founders and investors. Capacity thinks investing in disconnected local businesses is what it takes to build cities where a workforce is developed, living wages are increased, communities are connected, and long-term wealth is created for more people.

## Track Record

**Fund I (2020, \$1.5M target):** Capacity has invested \$805K in 10 portfolio companies as of Q2 2022. Six companies are already making revenue-based payments to Capacity and have produced a 0.2x realized MOIC. The rest of the portfolio companies are expected to start making revenue-based payments in the next six months. The fund is in line to produce a 2x MOIC including upcoming revenue-based payments and a 2.4x MOIC including upcoming revenue-based payments and equity investments.

## Portfolio companies include:

[BARQUE](#) (Chattanooga, TN) is a locally owned and operated neighborhood BBQ restaurant.

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[Dolly Monroe](#) (Tampa, FL) provides training and certification for estheticians.

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[Logic Products](#) (Fairfield, IA) offers effective nontoxic products made with natural ingredients that are safe for children, people, pets, and the environment.

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[ZOE Angling Group](#) (Chattanooga, TN) designs and distributes ethically sourced fishing goods and transforms lives through its supply chain

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[Omega Digital Solutions](#) (Maryville, TN) is a fully remote, cloud-native company that strives to turn complicated business problems into simple solutions using right-sized technology.

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[Surv](#) (Newport, RI), formerly Rent Sons, connects young adult workers with community members in need of moving, landscaping, junk removal, painting, and other odd jobs.

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[Watauga Butchery](#) (Vilas, NC) is a custom meat processor that offers butchery and packing services with commercial and retail quality packaging.

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[WYRE Technology](#) (Chattanooga, TN) is a security-focused managed service provider for nonenterprise companies.

## Fund Structure

**Management Company:** Capacity Management, LLC (Tennessee LLC)

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**Fund:** Capacity Capital, LP (Delaware LP)

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**Fund Type:** Rule 506(b)

**GP:** Jonathan Bragdon

## Fund Terms

**Target Fund Size:** \$1.5M

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**GP Commitment:** \$50,000 (3.33% of target fund size)

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**Investment Period:** 3 years from final close with up to 2 one-year extensions

**Fund Life:** 10 years from final close with up to 2 one-year extensions

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**Management Fee:** 2.5% of committed capital during Investment Period; 1.5% of invested capital thereafter

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**Carried Interest:** 20%

**Preferred Return:** None

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**Key Person:** Jonathan Bragdon

## More Reading & Listening

<https://www.impactterms.org/covid-19-is-a-lesson-in-why-alternative-investment-structures-are-needed/>

For more tools and resources, visit [innovative.finance/resources](#).



GCVF Co-Founders (left to right): Jamie Finney, Cory Finney, and Marc Nager

## Overview

[Greater Colorado Venture Fund](#) (GCVF) is a Colorado-based hybrid venture fund that provides seed-stage funding for rural Colorado startups. As one of the first VC funds explicitly investing in rural communities, GCVF is pioneering a new approach to unlock venture capital for rural America. In 2018, GCVF was founded by partners Marc Nager, Cory Finney, and Jamie Finney.

In 2018, GCVF won a bid for a “rural Colorado fund manager,” and with it an anchor investment from the State of Colorado Venture Capital Authority (VCA). Thereafter, they raised additional private capital, including from the Gates Family Foundation, to reach a \$17.5M Fund I. The team also raised an operating capital grant from the EDA.

GCVF is currently raising a \$25M Fund II with the same rural Colorado strategy.

## Investment Strategy

GCVF invests in seed-stage companies headquartered in rural Colorado. GCVF uses a hybrid VC model by providing flexible financing for rural companies with a mix of equity and revenue-based redeemable equity. The team expects to invest in roughly 30 companies over a five-year investment period with 50% reserved for follow-on funding for Greater Colorado Venture Fund II (Fund II). They will write initial equity checks ranging from \$250K to \$500K, redeemable equity checks from \$100K to \$250K, and follow-on checks up to \$1M. GCVF is targeting a 25% net IRR and 3.0 net MOIC for Fund II.

## Hybrid VC Model for Rural America

The traditional VC model does not work in rural communities. GCVF designed a blended portfolio model with 90%+ equity for rapid growth startups and up to 10% redeemable equity for companies not likely to exit or not seeking an exit strategy but interested in growing profitability and maintaining ownership. The redeemable equity strategy enables GCVF to offset fees, recycle capital for future investments, and generate early liquidity for LPs.

### **GCVF offers traditional seed-stage equity and redeemable equity products for rural Colorado founders:**

**SAFE / Convertible Note:** \$450K average check size with 6-10% target ownership.

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**Preferred Equity:** \$450K average check size with 6-10% target ownership.

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**Redeemable Equity (Indie.vc v3):** GCVF's typical RBI deal terms include: \$200K average check size, paid back over 3-5 years up to a 3x return cap, 3-7% of gross revenue, and 25%+ IRR target.

GCVF Fund II plans to make roughly five redeemable equity investments of \$150K on average and to cumulatively produce 25-40% IRR. They leveraged and updated the Indie.vc v3 term sheet that generates returns by collecting quarterly payments of 3-7% on gross revenue, with a grace period of 12-24 months, up to a predetermined return cap of 3x over three to five years. Additionally, they will take a 6-10% equity stake that companies can redeem via quarterly payments up to 90% of the original equity stake. For example, if GCVF takes a 10% equity stake, then the company may redeem 9% of the original 10%. This RBI approach unlocks early liquidity for the fund and allows GCVF to recycle up to 100% of invested capital during the five-year investment period, which can reduce the effective management fee from 2.3% to 1.5% for LPs.

For redeemable equity investments, GCVF will target companies with the following criteria: smaller exit size potential (i.e. unlikely to be a fund returner), profitable or clear path to profitability, high cash-flow business models, 60%+ margins, need investment capital less than 25% of gross revenue, and stable customer acquisition cost and margins.

For the majority of the portfolio, GCVF will make 25+ equity investments in companies with the following criteria: significant exit potential (i.e. can be a fund returner), high-growth potential, and capital-efficient business models.



## Overlooked Rural Founders

GCVF is targeting entrepreneurs in rural Colorado communities outside of the Front Range urban corridor (Fort Collins through Colorado Springs). They do not believe that opportunity is shared equally in Colorado and across the US. In Colorado, 83% of rural counties have median household incomes below the state average, and all of the state's distressed counties are considered rural. GCVF wants to create opportunities for underserved entrepreneurs and help build sustainable communities in rural Colorado. They will invest 100% of capital in rural areas in Colorado, of which at least 50% will go to companies in rural enterprise zones (EZ).

As of June 2022, 55% of Fund I's companies are located in rural EZs and account for 49% of invested capital. Two of the non-EZ companies, AGILE Space Industries and Revel, were located within two blocks of an EZ, and Ivy Camps is arguably the most rural portfolio company near the Fryingpan but receives mail in a non-EZ location. If included, these three companies increase the rural EZ rate to 67% and 70% of invested capital for Fund I.

The anchor LP Colorado VCA implemented investment criteria for Fund I via a Side Letter Agreement to only invest in rural Colorado-based businesses and to support job creation in rural communities.

## Track Record

**Fund I (2018, \$17.5M):** GCVF has invested \$12.5M+ in 27 portfolio companies out of its 30 portfolio size target through Q2 2022. GCVF has recycled several early exits to pay for nine additional investments and deployed 105% of capital called, meaningfully improving returns and offsetting fees for their LPs. The fund generated a 1.8x TVPI, 0.7x DPI, and 29.8% net IRR as of Q2 2022.

### Portfolio companies include:

[AGILE Space Industries](#) (Durango, CO) is an aerospace company that combines rapid propulsion development with on-site diagnostic testing to provide mission-optimized solutions.

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[Felt](#) (Telluride, CO) makes handwritten cards for the next generation of working professionals. [Glade](#) (Breckenridge, CO) makes premium ski goggles, helmets, and glasses.

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[Marble Distilling Co.](#) (Carbondale, CO) is a sustainable craft distillery and boutique luxury inn.

[MUNIREvs](#) (Dolores, CO) provides paperless automation for tax, licensing, and compliance for local governments. The company was acquired in 2021 by Austin-based GovOS.

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[REVER](#) (Eagle, CO) is “Strava for motorcyclists” with an online tracking and community app. The company was acquired in 2020 by Comoto Holdings.

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[Western Rise](#) (Telluride, CO) is a performance lifestyle apparel brand.

## Fund II Structure

**Management Company:** Greater Colorado Venture Fund GP, LLC (Colorado LLC)

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**Fund:** Greater Colorado Venture Fund II, LP (Delaware LP)

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**Fund Type:** Rule 506(b)

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**GPs:** Marc Nager and Cory Finney

## Fund II Terms

**Target Fund Size:** \$25M

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**GP Commitment:** 0.5% of fund size

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**Investment Period:** 5 years

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**Fund Life:** 10 years with up to 2 years with GP consent, and then an additional 2 one-year extensions with LP consent

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**Management Fee:** 2.5% of committed capital during investment period; 1.75% of committed capital thereafter

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**Carried Interest:** 20%

**Preferred Return:** 1x to LPs

---

**Key Persons:** Marc Nager and Cory Finney



*Glade Founder Curt Nichols*

## Overview

[Glade](#) makes premium goggles and helmets for skiers and snowboarders. Founded in 2016, the company is led by founder Curt Nichols with headquarters in Breckenridge, Colorado. Glade was a finalist startup in the inaugural 2020 Greater Colorado Pitch Series hosted by GCVF. This pitch event led to multiple follow-up conversations with GCVF and, eventually, a seed investment

### Why Redeemable Equity?

Glade's founder bootstrapped the business for the first few years by reinvesting all profits into inventory for the next ski season. Glade launched with ski goggles, which are high margin products, but needed growth capital to launch new products, diversify marketing channels, and scale inventory. Prior to GCVF's redeemable equity investment, the company raised \$150K in angel funding to expand its product offerings.

However, Glade needed more funding for marketing spend, inventory, and product R&D. The company generated solid revenue for the 2019-20 season and sustainable and improving margins, but it did not have access to more affordable capital yet. GCVF offered flexible growth capital for Glade with its redeemable equity product. The founder needed \$100K to \$200K to scale but also wanted to maintain control and ownership over his business. Redeemable equity was a better fit than traditional VC funding for the founder's vision.

Post-investment, Glade has grown its team to three full-time employees and released a line of sunglasses, making it a year-round eyewear company. It produced 112% growth in YOY revenue for the 2021-22 season as of Q1 2022 and expects to expand its product offerings and headcount in marketing and operations next season.

## Deal Performance

As of Q1 2022, Glade has made two quarterly revenue-based payments to GCVF since December 2021 and paid 27.2% of the 3x return cap. The investment has a 0.8x MOIC and 20.2% IRR from the first two payments, in line with VC return expectations, but does not need an IPO or M&A exit to generate liquidity for LPs. It is still too early in the investment lifecycle to meaningfully evaluate IRR performance. However, GCVF expects the deal to generate a 3x MOIC and 25%+ IRR over the next three to five years.

## Term Sheet

**Company:** Glade Optics LLC (converted to C-corp)

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**Investor:** Greater Colorado Venture Fund I

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**Investment or Purchase Date:** September 16, 2020

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**Investment or Purchase Amount:** \$100K

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**Initial Ownership:** 8%

**Residual Ownership:** 0.8%

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**Redemption Amount:** 5% of Gross Revenue (as defined by GAAP)

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**Repayment Cap:** 3x (\$300K)

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**Grace Period or Redemption Start Date:** 14 months + 14 days after purchase date (December 1, 2021)

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**Payment Schedule:** Quarterly

**Conversion Trigger:** \$1M preferred equity round

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**Board Seat:** None



## Overview

Rhode Island-based [Surv](#), formerly Rent Sons, connects young adult workers with community members in need of moving, landscaping, junk removal, painting, and other odd jobs. Its membership model allows workers to build long-term relationships with aging seniors. The company offers services in Rhode Island, Nashville, Wilmington, Charleston, and Jacksonville and generated \$1.3M in revenue in 2021.

## Why Redeemable Equity?

Surv needed access to friends and family capital, and its service-based business model did not fit VC criteria. As a startup, Surv did not generate enough revenue or have a long enough financial history to fit lending criteria. It was incredibly challenging for the startup team to access traditional sources of capital, and they had to seek alternative, less dilutive sources such as revenue-based financing. In 2020, Capacity provided critical seed capital by participating in the \$1M pre-seed round with a \$200K redeemable equity investment.

Surv used the pre-seed capital to expand into new markets along the East Coast, including Tennessee, and double its headcount. This capital unlocked meaningful revenue growth and the opportunity to raise a [\\$2.5M community seed round](#) on Wefunder. As of July 2022, SURV has raised \$1.1M in commitments out of its \$2.5M target preferred equity round at a \$15M pre-money valuation. The company will continue to focus on sustainable growth instead of hyper growth to reduce cash needs and reinvest capital from its cash flow.

## Deal Performance

As of Q2 2022, Surv has consistently made monthly revenue-based payments to Capacity since June 2021 and paid nearly 25% of the 2x return cap. The investment has a 0.5x MOIC, and Capacity expects it to produce a 2x MOIC via revenue-based payments while still maintaining 3.4% in equity upside for the rapid growth VC scenario.

## Deal Terms & Performance

**Company:** Surv

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**Investor:** Capacity Capital

**Investment Date:** March 2020

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**Investment Amount:** \$200K

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**Initial Ownership:** 10%

**Residual Ownership:** 1%

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**Redemption Amount:** 3.75% of gross revenue

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**Repayment Cap:** 2.5x (\$500K) reduced to 2x (\$400K) following converted equity of 3.4% in January 2022

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**Grace Period:** 3 months (deferred by 12 months during COVID)

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**Payment Schedule:** Monthly

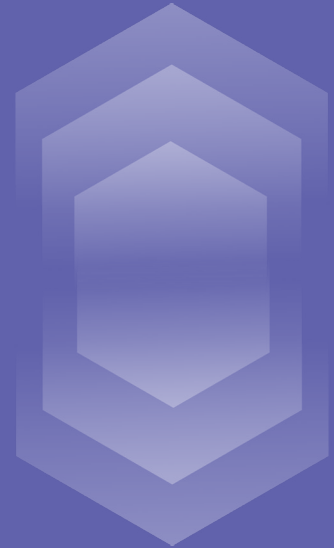
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**Conversion Trigger:** \$1M preferred equity round

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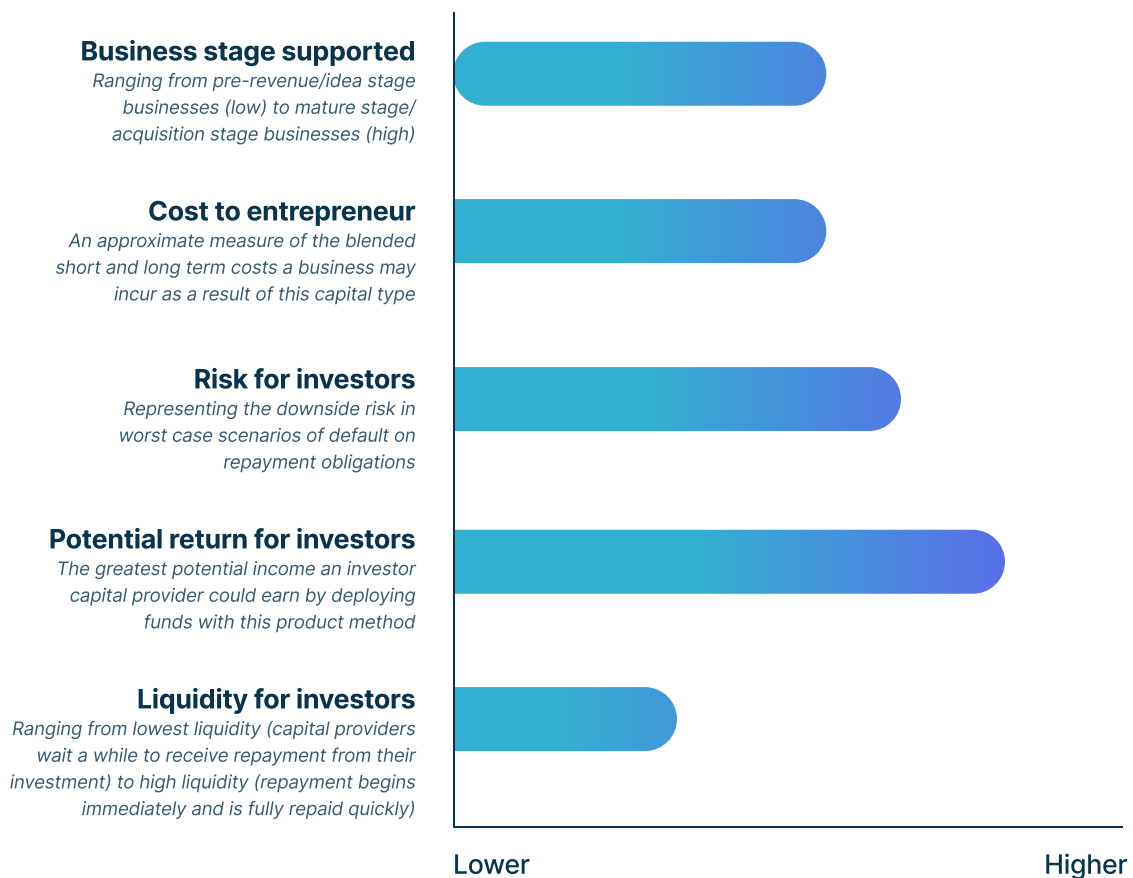
**Board Seat:** None

# Profit Share



## TL;DR

Profit sharing is a flexible funding model with payments tied to a percentage of profits instead of an interest rate.



# | What is profit sharing?

Profit sharing is a flexible capital product with no fixed interest rate. Profit sharing investors give a company growth capital in exchange for a percentage of the company's ongoing profits. Similar to traditional debt financing, investors collect monthly or quarterly payments. Rather than payments set at an interest rate, profit-based payments are flexible because they fluctuate with profits. If profits slow down, then the payments will be lower; if the profits are higher, then the loan is repaid more quickly. Payments are made until the investor receives a predetermined multiple of the original investment or return cap. Typically, the company does not have to provide collateral or personal guarantees for profit sharing because its profits are essentially collateral.

Similar to revenue-based financing, profit sharing blends features of debt and venture capital, and founders should expect the cost of capital to fall within that range. Profit sharing represents non- or less-dilutive growth capital to bridge the path to sustainable profitability for growing businesses that do not fit the VC model.

The Income Share Agreement (ISA), like the Convertible Income Share Agreement (CISA) created by Chisos Capital, is much closer to profit sharing than revenue-based financing, with the caveat that it more directly relies on founder income rather than business profitability. Another innovative capital product, the Shared Earnings Agreement (SEAL) created by Calm Company Fund, blends features of both profit and income sharing.

Profit sharing is not a novel idea and historically was used to invest in companies with predictable cash flow and high profit margins in the media, entertainment, food & beverage, and restaurant industries. Recently, profit sharing has been adopted by a small number of early-stage investors looking to provide optionality and allow founders to maintain control as they build sustainable and profitable companies over the long term.

## What are the typical characteristics of profit sharing?

- Structured as a convertible note or debt
- Quarterly or biannual payments equal a set percentage of profits (typically 10-30%)
- Payments start following a grace period of 6-12 months
- Payments continue until a set dollar amount has been paid back, usually 2-10x the amount of the financing (this multiple is called the "cap")
- At maturity, which is typically 7-10 years, any unpaid amount of the cap is due
- No collateral or restrictive covenants



# Capital Product Fit

## When is profit sharing a good fit for businesses?

**Profitability:** Businesses do not need to be profitable, but investors like to see a path to profitability within three years. Businesses need to be at least EBITDA positive.

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**Recurring Revenue:** Businesses need to average at least \$10K in monthly recurring revenue (MRR). Investors like to see somewhat predictable revenues with repeatable or recurring customer contracts and customer diversity.

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**Annual Revenue Growth:** 25%+

**Net Margins:** 40%+

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**Exit Value:** \$50M+ business within 10 years

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**Financials:** 1+ years of financial statements

## When is profit sharing not a fit for businesses?

**Too Young:** If a business does not have at least one or two years of financial statements, then it is difficult for an investor to underwrite and make an investment.

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**No Revenue:** If a business does not have any revenue, then it is difficult for an investor to underwrite and make an investment. Most investors like to see \$10K+ in MRR for several months.

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**Heavy R&D:** Businesses that are capital intensive and require a large amount of upfront funding to build large-scale projects or bring breakthrough technology to market.

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**Blitzscalers:** Businesses that require rapid growth to take over an entire market or create a new market and need large amounts of VC funding to scale. These “Blitzscalers” typically focus on speed and growth over cash flow and profits.

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**Fundraisers:** Founders always focused on raising the next round of funding for their businesses. Investors want to write checks to builders, not fundraisers, and do not want to have to spend a lot of time convincing founders not to take the traditional VC funding path.

**Misaligned Cap Table:** If founders have raised \$5M+ in traditional VC funding, then their existing investors most likely will be focused on raising another VC round at a larger valuation. Profit share investors do not want to compete with the different return and fundraising expectations of prior or potential co-investors. On the debt side, investors do not like to navigate a crowded and complex cap table with a bunch of lenders who are more senior to them and have expensive rates and warrants.

## Why would founders want to choose profit sharing?

**Less-Dilutive & More Control:** Founders maintain more ownership and control over their business than traditional VC. Once the investment is paid back by founders, the investor is not on your cap table permanently. Investors typically do not take a board seat.

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**Flexible Payment Schedule:** Profit sharing provides more flexible payment terms based on a percentage of net income, rather than term loans with fixed payments that do not fluctuate with net income. Payments scale up and down along with net income growth.

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**No Restrictive Covenants:** Unlike traditional bank loans, profit sharing investments typically do not require the borrower to agree to any restrictive covenants where the borrower must manage their business in a specific way, such as maintaining minimum liquidity levels. Factoring or merchant cash advances also come with more restrictions and need to be paid daily or weekly compared to monthly or quarterly for profit sharing.

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**Cheaper than VC:** Profit sharing is often cheaper for founders than selling preferred equity to VCs. Founders may believe that traditional equity costs less with no expected payments until an exit, but profit sharing is most likely cheaper over the long-run on both total dollar amount and IRR basis. Profit share investors cap their investment at a 2-5x return instead of aiming for 10x+ returns like VCs. Also, profit sharing enables startups to leverage more of the investment capital to scale during the early years than RBI. Depending on the grace period, revenue-based products typically require faster and larger repayments upfront than profit sharing since they are linked to top-line revenue and do not factor profitability into the deal terms.

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**Fundraising Optionality:** Founders do not need to follow the VC funding path of raising larger follow-on rounds of dilutive equity capital. Profit sharing offers cheaper, non-dilutive growth capital that can enable businesses to scale and eventually raise VC funding or access cheaper bank debt. It provides founders the optionality to pursue the funding journey that makes the most sense for their business.

**Access to Capital:** Profit sharing is more accessible for underrepresented founders because the underwriting process is based on the company's revenue, margins, and other financials, not the owner's credit score, income, or personal real estate assets. Traditional debt financing continues to use outdated and discriminatory lending practices that limit access to capital and increase the cost of capital for underrepresented founders. Profit sharing has improved the investment process with a more inclusive underwriting approach.

## What should businesses look out for with profit sharing?

**Less Predictable Payment Schedule:** Profit-based payments fluctuate with net income, which can provide flexibility for founders but also be harder to predict for financial projections than traditional loans with fixed monthly payments. They have a variable interest rate instead of a fixed interest rate.

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**More Expensive than Bank Loans:** Most founders seek profit sharing investments because they cannot access bank loans or VC. Profit sharing usually costs between 15% and 30% IRR compared to bank loans at <10% IRR and VC at 50%+ IRR. If net income grows quickly, then payments will also do so. This leads to a shorter payback period but also a higher cost of capital. Founders need to be comfortable with the fixed return cap or total payment, regardless of their net income growth rate.

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**Net Margins > % of Profits:** Founders need to be comfortable giving up the percentage of net income to pay back the investment. Net margins need to be sufficiently high enough to support the financing costs or else the investment will start to reduce the growth potential of the business.

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**Equity Warrants:** It depends on the investor, but founders may need to agree to equity warrants in addition to the profit sharing. The equity warrants provide upside participation for investors and are typically tied to hitting revenue and/or net income milestones and exit scenarios. Profit sharing with equity warrants will drive up the cost of capital for founders, but it will likely remain cheaper than traditional equity and tends to have more founder-friendly terms than bank loans or venture debt.

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**Further Down the Income Statement than RBI:** Profit sharing can lead to more potential conflicts of interest between investors and founders than RBI. Net income is further down the income statement than revenue, which means more line items that impact the repayment amount to investors. Gross revenue is an easier, top-line metric to measure and track than bottom-line net income. There needs to be an ever greater level of transparency and trust between investors and founders.

# | Terms

## What do investors typically charge businesses for profit sharing?

**Investment Size:** up to 1/3 of ARR rate (typically \$25K to \$3M check sizes)

<b>Initial Ownership (Equity):</b> 0%	<b>Percentage of Net Income (Payment):</b> 10-30%
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**Return Cap (Total Payment):** 2-10x

**Payment Schedule:** Quarterly or bi-annually

**Grace Period:** 6 to 12 months

*This is the date founders will begin making profit-based payments. These start dates can range widely given the intent of the founders and investors. Some investors might choose to set the start date to begin immediately, while others may set it at 12+ months post-investment.*

**Equity Warrants:** Up to 15% ownership based on predetermined milestones

**Personal Guarantee:** None

**Financial Reporting:** The investor has financial data access to the company's financial statements, including monthly balance sheet (plus YTD), monthly cash flow statements (plus YTD), monthly bank reconciliation report, monthly bank statements, and monthly compliance certification—certifying the information delivered.

**Board Seats:** None

## FAQs

### How expensive is profit sharing?

It is often cheaper than selling equity but more expensive than bank loans. They typically cost 15% to 30% IRR compared to <10% for bank loans and 50%+ for VC. However, profit sharing can be as expensive as traditional equity if the founder chooses to raise follow-on VC funding, triggering the conversion of any outstanding debt to equity. If founders can get access to a cheaper fixed-rate bank loan and are willing to secure the loan with personal guarantees and collateral, then they should take it.

### What are the tax implications of profit sharing for investors?

Profit sharing instruments like SPACE, SEAL, and CISA are structured as a convertible note with a mix of debt and equity-like features. Unlike traditional debt, they do not have a fixed repayment schedule, maturity date, or personal guarantee. These innovative capital products are structured as equity, which means taxable LPs will likely have their investment returns taxed at the capital gains rate. However, royalty-like, profit sharing products without a convertible equity mechanism likely fall into the debt category where returns will be taxed at the ordinary income rate.

### Why would investors be interested in profit sharing?

Profit sharing provides equity-like returns with better liquidity than traditional equity. Investors do not need to rely on an acquisition or public exit because of the self-liquidating returns for profit sharing. Founders pay back the investment from their company's net income until reaching the return cap.

# Profit Share Case Study



# collab



*Collab Managing Partners: Justin Dawkins, Jewel Burks, and Barry Givens (left to right)*

## Overview

[Collab Capital](#) (Collab) is an Atlanta-based, early-stage investment firm backing Black founders building innovative, high-growth companies. Collab was founded in 2019 by Managing Partners Jewel Burks, Justin Dawkins, and Barry Givens, who bring a complementary mix of entrepreneurial, operating, and technical backgrounds. Jewel was the CEO and founder of Partpic, a computer vision startup that made it easier to find industrial parts; she sold it to Amazon in late 2016 before becoming the US Head of Google for Startups. Barry founded and developed Monsieur, an automated bartender startup, before licensing his IP and leading Techstars as the managing director for its social impact accelerator. Justin is a 20-year software developer and co-founder of Goodie Nation, the entrepreneur development program focused on social good.

In May 2021, they successfully closed their oversubscribed first fund at \$51M with the support of 99 LPs, including the Mellon Foundation, Capital Access Lab, Goldman Sachs, Mailchimp, Bank of America, Google, Apple, Foot Locker, PayPal, and Carta Ventures.

## Investment Strategy

Collab makes early-stage investments in Black-owned companies in the US. Collab creates growth opportunities for its companies by connecting founders to growth partners with industry expertise or social capital. The team seeks companies that have a viable path to

annual revenues above \$1M within one year of their investment and \$10M within three years at 40%+ profit margins. The fund will invest in 50 companies over its five-year investment period with an initial check size of \$500K to \$1M, with the remaining 30% of the fund reserved for follow-on checks of up to \$2M. Collab is targeting a 30% gross IRR and 3.0 gross MOIC for the fund.

Collab aims to close the market gap for Black founders who lack the assets to receive traditional lending, lack access to personal, friends, and family capital, and do not fit into the traditional VC investment criteria. Their mission is to create, grow, and sustain wealth in the Black community by investing in and building technology-enabled companies through the development of connections between Black innovators, investors, and influencers.

Collab invests in the top 25 American cities with a high concentration of Black entrepreneurs and a low concentration of risk capital. Their target city list includes Atlanta, Charlotte, Chicago, D.C., Detroit, Houston, Miami, New Orleans, St. Louis, and other cities that fall outside of the most venture funded regions such as the Bay Area, NYC, and Boston.

Collab backs technology-enabled products and services across the following three themes: future of work, future of learning, and future of care. They selected these as themes of interest based on where they believed the team and influencers can make the most impact. However, Collab will also consider companies that may not perfectly fit into these categories. They will not invest in biotechnology, cannabis and tobacco, cryptocurrency and tokens, food and beverage, gambling, liquor and spirits, professional services agencies, and real estate industries.

## SPACE

Collab created a novel profit share funding approach called the “Shared Profits and Collaborative Endorsement” (SPACE) agreement that they wished existed when they were raising capital as founders. Collab believes the “binary construction of venture leaves too much value on the table and has the potential to destroy businesses that would otherwise be solid, ‘calm’ businesses.” They want to increase the odds of success for their founders by offering optionality and flexibility baked into the SPACE agreement for their fundraising journey.

The traditional VC model expects at least 80% of their portfolio companies to fail and a couple 10x+ outcomes to generate 3x+ returns for LPs, but Collab wants the majority of their portfolio to become “sustainable, profitable businesses with tens of millions in annual revenue and double-digit year-over-year growth—businesses that create jobs in predominantly Black communities and that founders can pass down to their children.”



Collab expects to generate venture-like returns with a more founder-friendly, resilient portfolio construction approach with self-liquidating, profit share instruments. Pre-investment, Collab works with founders to agree on key success metrics and then identifies a team of influencers, advisors, and service providers to work with the founders. Post-investment, the manager executes on its growth plans to add customers while focusing on profitability.

For their SPACE term sheet, Collab makes investments structured with a profit share and an equity target. Collab starts the 20% to 25% profit share at the predetermined revenue target that produces enough profit to sustain the optimal late-stage operational structure. Collab reserves the right to defer profit share payments and will do that when they believe the money would be better used going back into the business.

Collab also targets a 10% to 15% equity stake, agreed upon with companies pre-investment, to protect their upside for potential exits like acquisitions and IPOs. Companies have the option to redeem or buy back up to 10% of the equity target as the companies return multiples to the fund. For example, if a company has returned 3x the initial investment via profit share payments, it can redeem 3% of the total 15% equity target.

For each SPACE deal, Collab uses a SPV to make an investment into the portfolio company. They cap the growth partner equity stake at one-third of each SPV's ownership in a portfolio company. For example, if Collab has 15% equity in a company, then growth partners can receive up to 5% equity and up to one-third of Collab's profit share rights in the company.

### **Collab's target SPV structure typically looks like the following:**

- **10% to 12% Collab equity target:** The fund will provide all of the capital for each investment with an initial check size of \$500K to \$1M with reserves up to \$2M.
- **1% to 3% Growth Partner equity target:** The Growth Partner(s) will be selected and compensated based on their ability to help the company grow efficiently and rapidly. These partners will commit to specific actions as corporate partners, industry advisors, industry experts, and/or social influencers. The percentage of equity per partner will be determined by factors such as decision-making power, depth of influence on the company's target audience, and time commitment available. Collab manages a performance-based vesting schedule with the Growth Partners.

## Here are two [SPACE deal examples](#):

**VC Pathway:** Collab invests \$500K for a 10% target ownership in Company A. They work with the business over the course of a year and see that it is growing 30% month-over-month and is attracting attention of Series A investors. After the first year, Collab determines the business needs more money to continue to grow marketing spend and add more team members. This is a perfect case to continue on the venture path, and in this case they will help the founders raise the next round and then convert into 10% ownership before dilution. In this deal example, Collab operates similarly to a traditional pre-seed VC.

**Profit Share Pathway:** Collab invests \$500K for a 10% target ownership in Company B. They work with the business over the course of the year and see that it is growing steadily, but at 10% month-over-month. The founder is able to keep costs low, and the company's Growth Partner has helped them crack the code on organic growth methods. As Collab learns more about the industry the business is operating in, they see that the opportunity is more narrow than originally thought, and instead of the \$30B TAM originally forecast, the market opportunity is more likely less than \$1B. Collab and the founder come to a collective decision that it doesn't make sense to raise another round of funding, but instead they should focus on continuing to grow revenue and increase profitability.

Under this scenario, Collab begins a profit share at the point the business is sustainably profitable, meaning it can pay its employees at full salaries and has built up the proper infrastructure. The profit share allows Collab to generate returns on its investment and allows for the founder to redeem his or her equity. For every multiple on investment returned, Collab's equity target goes down by 1 percentage point, until reaching an agreed upon ownership floor across an agreed upon period of time.

## Track Record

**Collab Fund I (2020, \$51M):** Collab has invested \$15M+ in 24 portfolio companies and made three follow-on investments through June 2022. Collab has made 10 SPACE deals out of the 27 total investments with the remaining deals structured as SAFEs, convertible notes, or equity.

**Portfolio companies include (six out of 11 are SPACE deals):**

[BrightUp](#) (Boston) is an emotionally intelligent financial wellness benefit provider that believes that how people feel about themselves affects how they treat themselves—particularly when finances are involved. They provide a full suite of financial wellness tools, rooted in an uplifting mobile experience. BrightUp's flagship offering is a low-cost loan that is repaid through paycheck deductions.

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[Boost](#) (Oakland, CA + Detroit, MI) is the Quickbooks for Gen Z side-hustlers. Boost is a platform that combines personal finance, SMB accounting, and business management in a brand-forward, mobile-first experience designed for a fast-growing, yet underserved Gen Z market.

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[FanFest](#) (NYC) is a platform for creators to host live shows with fans from their website where they can invite anyone, sell anything, and stream anywhere.

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[Hairbrella](#) (Atlanta) is a reinvented rain hat that combines fashion and function to keep hair dry and style protected no matter the elements.

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[Healthy Hip Hop](#) (Atlanta) is a platform that infuses technology, music, literacy, and cultural competency to improve student-learning environments and increase classroom engagement.

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[Jax Rideshare Rentals](#) (Atlanta) is a car rental platform that services rideshare gig workers. By providing tailored benefits and increased flexibility, Jax takes an innovative approach to car rentals and is poised to fill a major gap in the nearly \$500B gig economy market.

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[Music Tech Works](#) (Atlanta) is a B2B SaaS and machine learning company solving the challenge of music licensing in content creation across film, TV, and social media.

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[Please Assist Me](#) (Washington) is an all-in-one home management service for apartment complexes.

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[Revry](#) (Los Angeles) is the premier streaming network for the world's LGBTQ+ community.

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[Safer Management](#) (Dallas) is a software company that accurately tracks student attendance data with the power of AI and Machine Learning. Safer's mission is to provide schools, districts, and states with an accurate and complete picture of student attendance data.

[Stack Influence](#) (Miami) is a micro-influencer platform that facilitates user-generated promotional marketing campaigns. Their community of over 50K managed micro influencers are compensated with only products that match their profile and interests.

## Fund Structure

**Management Company:** Collab Capital, LLC (Georgia LLC)

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**GP Vehicle:** Collab GM, LLC (Georgia LLC)

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**Fund:** Collab Fund I, LLC (Georgia LLC)

**Fund Type:** 506(b)

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**SPACE SPVs:** Each Collab SPACE investment is done through a separate LLC (SPV) managed by the fund. Each member of the SPV is given a percentage of the new Collab SPV based on dollar commitments. Once payouts begin, the company will pay into the respective Collab SPV and then those proceeds will be distributed pro-rata to the members of that Collab SPV. The Collab Fund I portion will deposit into the dividend pool for the LPs of the fund. The fund manager will make quarterly distributions to LPs. Follow-on investments are made through the same Collab SPV.

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**GPs:** Jewel Burks, Barry Givens, and Justin Dawkins

## Fund Terms

**Fund Size:** \$51M

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**GP Commitment:** 2% of fund size

**Investment Period:** 5 years

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**Fund Life:** 10 years with up to 3 one-year extensions

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**Management Fee:** 2% of committed capital

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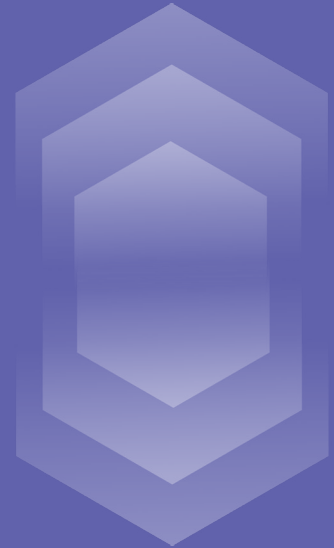
**Carried Interest:** 20%

**Preferred Return:** 8%

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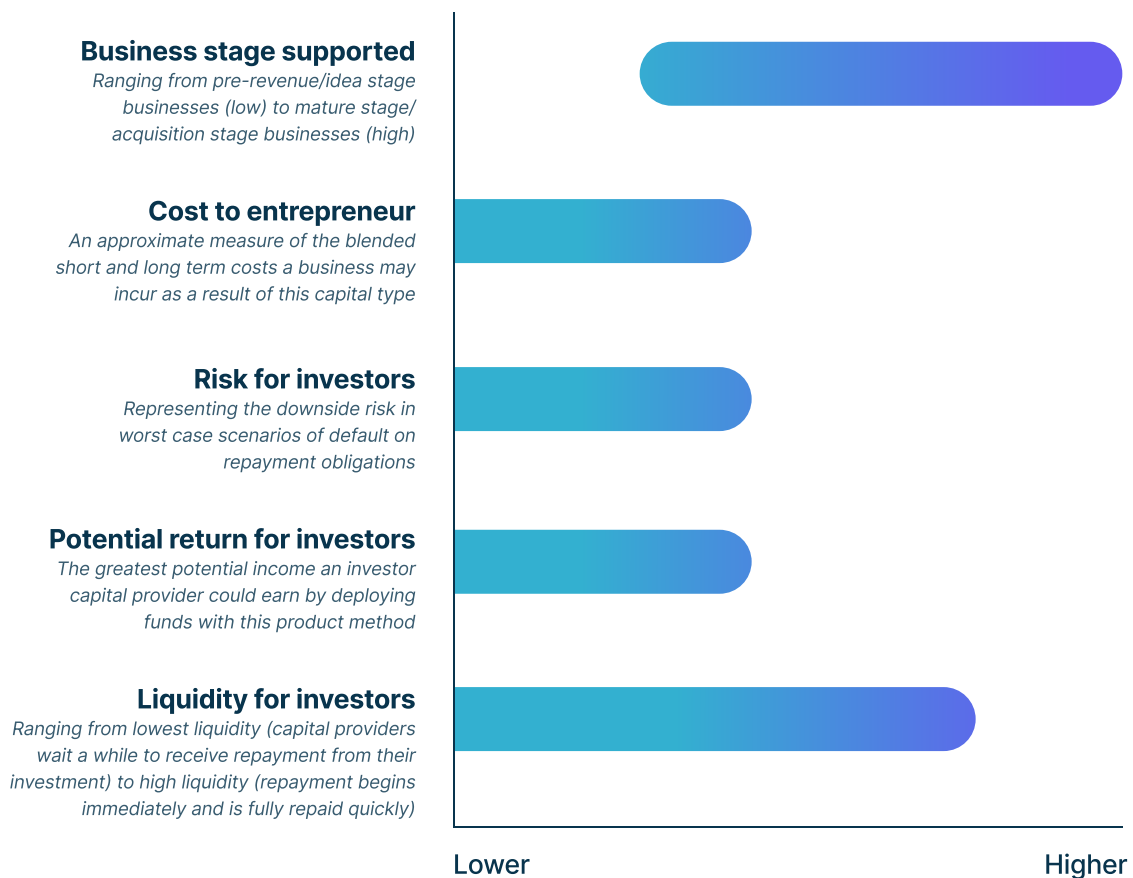
**Key Persons:** Jewel Burks, Barry Givens, and Justin Dawkins

# Employee Ownership



## TL;DR

Employee ownership financing allows owners to sell their businesses and workers to become owners.



# What is employee ownership?

Employee ownership financing is equity or debt capital that supports businesses transitioning to employee ownership. Employee ownership provides owners an exit pathway, working capital to businesses to rebuild post-COVID, and workers access to business ownership.

Employee ownership models have been around for decades and can help rebuild a more equitable and resilient economy. They can shift ownership to workers of color and transition to diverse leadership to close the racial wealth gap. Employee-owned businesses are an overlooked and tiny segment of the US with only 6K Employee Stock Ownership Plan (ESOP) businesses, 460 worker-owned cooperatives (co-ops), and Employee Ownership Trusts (EOTs). Employee-owned businesses have higher productivity, more committed workers, less firings, wealth that stays in communities, and better wages.

However, there is still limited financing available to US small business owners looking to transition their businesses to employee ownership. Expanding the number of financing opportunities available for transitioning businesses to employee ownership structures would create more opportunities for equitable business ownership.

## Here are the three major forms of employee ownership:

1. **Employee Stock Ownership Plans (ESOPs)** are qualified retirement plans used to transfer all or part of the company's shares to a trust, administered on behalf of the employees. Employees earn their shares as a retirement benefit. ESOPs come with significant tax benefits, which, coupled with regulation, mean they can be a fit for companies with more than 30 employees, given higher set up and ongoing costs.
2. **Worker Cooperatives (Co-ops)** are 100% employee-owned and governed by the people who work there. Employees pay a small equity buy-in and the board of directors is made up of a majority of employee-owners who are elected by the full membership. Profit-sharing is built into the model and is based on hours worked. Worker cooperatives have lower transaction and ongoing administration costs than ESOPs. Co-ops can be the right structure for companies of all sizes, but they are primarily used by smaller companies with fewer than 30 employees.
3. **Employee Ownership Trusts (EOTs)**, sometimes called Perpetual Employee Trusts, preserve the business over the long term for the benefit of the employees. Employees don't pay for their ownership benefits, and they receive a share of the company's annual profits. EOTs have lower transaction and ongoing administration costs than ESOPs.

Employee ownership financing from private equity, lenders, and other capital providers helps fund these business conversions. Typically, the employees do not have enough savings or access to capital to purchase all or the majority of the shares from the small business owner(s). Beyond whatever the employees can afford to contribute, they need to raise outside financing from a local bank, venture capital, private equity, etc. to acquire the business.

### **Here are the three basic components of a worker co-op conversion:**

1. **Business Entity Creation:** The creation of a business entity that is a worker-owned cooperative. This can be accomplished by converting the existing business or by forming a new cooperative entity.
2. **Sales Transaction:** A sales transaction executed between the current owner(s) and the new worker co-op to sell the existing business to the worker co-op and execute a Purchase & Sale Agreement. Each worker-owner “buys in” to the co-op and receives a single voting equity share. The sales transaction is typically financed by a group of lenders.
3. **Governance & Cultural Shift:** A transition of roles and culture among the new worker-owners to take on the ownership responsibility of the new entity and run it under democratic governance.

There are financing nuances depending on the employee ownership model. Worker co-ops must avoid raising equity and selling controlling shares of the company to anyone who is not an employee-owner. This means venture capital, private equity, and common stock offerings are typically off-limits. However, co-ops can raise preferred equity with nonvoting stock that does not include any ownership or control rights. Given the equity restrictions and smaller nature of worker co-ops, they are usually funded by a group of lenders like banks and CDFIs with a mix of secured and unsecured loans.

Unlike worker co-ops, ESOPs can actually raise equity from investors like VC and PE to finance the business conversion.

## Here are the four basic components of an ESOP conversion:

1. **Trust Creation:** In an ESOP, a company sets up a trust fund, into which it contributes new shares of its own stock or cash to buy existing shares. Alternatively, the ESOP can borrow money to buy new or existing shares, with the company making cash contributions to the plan to enable it to repay the loan.
2. **Sales Transaction:** Owner(s) use an ESOP to create a ready market for their shares and sell their shares directly to employees. The company can make tax-deductible cash contributions to the ESOP to buy out an owner's shares, or it can have the ESOP borrow money to buy the shares. In the borrowing scenario, the employees then make tax-deductible contributions to the ESOP to repay the loan, meaning both principal and interest are deductible.

In almost all ESOP transactions, the seller finances the ESOP's acquisition by taking the majority of proceeds in the form of a Seller Note, which is paid down out of the company's cash flow over the next five to 10 years. Compared to a traditional acquisition event, business owners are sacrificing cash upfront at exit to share ownership with their employees. The owners' liquidity event is spread out across five to 10 years.

However, a private equity-backed ESOP offers full cash proceeds for the acquisition of the company. A PE firm such as Mosaic Capital Partners or Apis & Heritage Capital Partners raises all of the capital to acquire the company and lends it through the company to a newly formed ESOP Trust, which then purchases the company from the selling shareholders. Over the next three to five years, the company creates equity value by paying down the acquisition debt, including the PE's investment. Once this debt is fully paid off, the company is free of external stakeholders and can remain an ESOP-owned company in perpetuity.

3. **Employee Vesting:** Shares in the trust are allocated to individual employee plans. Allocations are made either on the basis of relative pay or some more equal formula. As employees accumulate seniority with the company, they acquire an increasing right to the shares in their account or vesting. Employees must be 100% vested within three to six years, depending on whether vesting is all at once or gradual.
4. **Employee Departure:** When employees leave the company, they receive their vested stock, which the company must buy back from them at its fair market value. Private companies must have an annual outside valuation to determine the price of their shares.



# Benefits vs. Costs

## Benefits

**Tax Advantages / No Federal Taxes for ESOPs:** A small business that is 100% owned by workers and structured as an S-Corp ESOP does not pay federal income taxes. This meaningful tax savings generates immediate capital that can build cash reserves or be reinvested for growth. The small business owner will have significant federal tax benefits by selling at least 30% of the business to the ESOP; he or she can then defer capital gains indefinitely, and other tax benefits kick in as the ESOP ownership increases. For example, an S-Corp ESOP with 100% ownership pays no federal income tax. ESOPs are also free to workers who receive gifted shares as a retirement benefit.

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**Wealth Creation / Workers Become Owners:** Employee ownership buyouts provide business owners with a cash exit and higher wages and job preservation for workers. It offers owners a clear succession plan and exit pathway without giving up ownership to a private equity firm or larger corporation outside their community. Employee-owned businesses incentivize workers to create value for the business because their ownership stakes can increase in value as the business sustainably grows over time. Workers can sell their stakes back to the business for cash when they either retire or leave the business. This model can build more resilient local economies and help close the racial wealth gap with a path to business ownership for workers of color.

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**Access to Capital / Resilient Jobs & Communities:** Employee ownership buyouts offer growth capital for small businesses that face significant barriers to accessing capital from VCs and lenders. This growth capital can help businesses rebuild from the COVID-19 pandemic and preserve local jobs in underserved communities.

## Costs

**Regulations / Complex & Regulated ESOPs:** There are a number of benefits for owners, workers, and investors with an ESOP business transition, but ESOPs remain complicated and highly regulated. This complexity and regulation comes with higher set up costs, starting at \$40K, and administrative costs.

# Capital Product Fit

## When is employee ownership financing a good fit for businesses?

**Annual Revenue:** \$2M+

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**Employees:** 30+ for ESOPs; <30 for co-ops and EOTs

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**Financials:** 2+ years of financial statements

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**Business Entity:** C Corp or S Corp for ESOPs; more flexibility for co-ops and EOTs

## When is employee ownership financing not a fit for businesses?

**Too Young:** If a business does not have at least two years of financial statements, then it is difficult for an employee ownership investor to underwrite and make an investment.

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**Too Small:** For ESOPs, businesses need to have at least 40 employees and \$2M in annual revenue to take advantage of the tax benefits compared to the legal and regulatory costs.

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**Blitzscalers:** Businesses that require rapid growth to take over an entire market or create a new market and need large amounts of VC funding to scale. These “Blitzscalers” typically focus on speed and growth over cash flow and profits.

## Why would business owners want to choose an employee ownership deal?

**Community Succession Plan:** Small business owners looking to retire or take a step back from their business have the opportunity to transition and sell it to employees. Employee ownership can keep these businesses and jobs in local communities and enable the next generation of leaders.

## FAQs

### What is an Employee Ownership Buyout?

An employee ownership buyout offers full cash proceeds for the acquisition of the target company. In this style of transaction, a private equity firm such as Apis & Heritage Capital Partners raises all of the capital to acquire the business and lends it through the company to a newly formed ESOP Trust, which then purchases the company from the selling shareholders. In effect, it is similar to buying a house with a 100% mortgage. Over the next three to five years, the company creates equity value by paying down the acquisition debt, including the private equity firm's investment. Once this debt, which is similar in structure to any company that has recently been acquired through a leveraged buyout, is fully paid-off, the company is free of external stakeholders and can remain an ESOP-owned company in perpetuity.



# Employee Ownership Case Studies

**Apis & Heritage Capital Partners (A&H) | 93**

**The Local Butcher Shop | 96**

# A&H

## Apis & Heritage Capital Partners



*A&H Co-Founders & Managing Partners:  
Todd Leverette (left) and Philip Reeves*

## Overview

Bethesda, MD-based [Apis & Heritage Capital Partners](#) (A&H) helps small and mid-sized businesses with large workforces of color transition to employee ownership. A&H is a Black-led firm with founding partners Todd Leverette and Philip Reeves.

A&H is seeking to raise \$50M for its Apis & Heritage Legacy Fund I to invest in at least eight employee ownership buyouts over five years. In June 2021, A&H held its first close at \$30M for its first fund, including its anchor LP the Rockefeller Foundation via the Zero Gap Fund (\$3M), Ford Foundation, Skoll Foundation, Capricorn Investments, Gary Community Investments, Ascension Investment Management, and others. Co-investment capital for A&H's portfolio companies will come from a strategic partnership with the Local Initiatives Support Coalition's New Markets Support Co. (NMSC). NMSC will provide the senior debt tranche of the employee-led buyouts.

A&H expects to hold a final close later in 2022.

## Why Employee Ownership?

The founding team at A&H wanted to help close the racial wealth gap for workers of color in the US through employee ownership. For many communities of color in the US, the primary ways to generate wealth—home ownership and entrepreneurship—have historically been blocked. The average white family has nearly 8x the wealth of the average Black family and 5x the wealth of the average Latino/a family. Additionally, roughly 60% of Black workers and 75% of Latino/a workers retire with no retirement savings. A&H aims to reduce this wealth gap by financing the conversion of companies with large workforces of color into 100% employee-owned businesses. This innovative capital model helps workers of color build wealth and potentially retire with \$70K to \$120K in savings, according to A&H.

A&H has been successful in raising LP capital from mission-driven investors, such as foundations that leveraged their PRI programs to back this employee ownership model. However, the team has struggled to secure funding from larger institutions such as endowments and pension funds—those requiring longer track records and larger fund sizes.

## Investment Strategy

A&H makes employee ownership investments in small- and mid-sized, essential-service businesses with workforces of color across the US. The team seeks companies with \$1-4M EBITDA, healthy gross margins, strong cash flow, and 30+ employees, of which at least one-third of the workforce are BIPOC and 50% low income. The fund will invest in up to 10 companies over its five-year investment period with \$3M+ check sizes. A&H is targeting 15% net IRR and 2.0 gross MOIC for the fund.

Their “employee-led buyout” (ELBO) model helps close the racial wealth gap by converting workers of color into owners. It also supports retiring business owners looking for liquidity and an exit by transferring ownership to employees at a fair market price. A&H primarily finances businesses transitioning to the ESOP model. Post-investment, the Oakland-based Democracy at Work Institute (DAWI) will support portfolio companies in building strong ownership cultures and other employee ownership services. These technical assistance services help companies become more resilient, pay higher wages, produce higher profits, and lower turnover.

## Track Record

**Apis & Heritage Legacy Fund I (2021, \$50M target)** has closed its first two deals as of June 2022. The two portfolio companies employ a total of 170 workers, who will now own 100% of each company.

### Portfolio companies include:

[Apex Plumbing](#) (Denver) was founded in 1985 and is a sewer and water systems company with roughly 50 employees, 50% of whom are Latino/a. As of May 2022, the company became 100% employee-owned.

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[Accent Landscaping Contractors](#) (El Paso, TX) is a commercial landscaping company founded in 1982 with roughly 120 employees, the majority of whom are lower-income Latino/a workers, and serves the states of New Mexico, Colorado, and Texas. Founder Cameron Stevens wanted to retire and transfer ownership to his employees at a fair market price. He said, “I could have sold my business to a competitor or private equity, but I know what can happen next—the culture changes and people get laid off. I didn’t want that for my employees.” channels, and scale inventory. Prior to GCVF’s redeemable equity investment, the company raised \$150k in angel funding to expand its product offerings.

## More Reading & Listening

<https://impactalpha.com/black-and-brown-employee-ownership-for-the-post-covid-economy/>

<https://www.notion.so/Apis-Heritage-Resource-Library-93a5fc269f28466aa1e6b99d3ed2a310>

For more tools and resources, visit [innovative.finance/resources](https://innovative.finance/resources).

## THE LOCAL BUTCHER SHOP



Photo credit: The Local Butcher Shop

## Overview

Founded in 2011 by Monica and Aaron Rocchino, [The Local Butcher Shop](#) is an independent butcher shop in Berkeley, California. They offer locally sourced, sustainably raised meat, and cooking classes to the East Bay community.

### Why Employee Ownership Transition?

The two founders and previous owners were dedicating most of their lives to the store, but they wanted to spend more time with their young child. So the Rocchinos started exploring ways to sell their business and, eventually, got connected with Oakland-based nonprofit Project Equity, which offers programs to support transitions to employee ownership.

When they learned about this exit strategy in 2019, the Rocchinos wanted to transfer ownership to their deeply dedicated and hard-working team. They prioritized giving back to their workers and maintaining the store's legacy of locally sourced meat for their customers. However, the transition was too costly for them to justify until the COVID-19 pandemic disrupted the food industry. More people in their neighborhood started cooking their meals at home, and the store's revenue ramped up by 50% in 2020. The revenue boost allowed the founders to afford the employee ownership transition.



## Worker-Owned Business

In January 2021, the “transition team” of five employees began to meet with Project Equity for weekly classes on business, finance, and worker cooperatives. The transition team included butchery manager Caleb Avalos, value added products manager Jason Fallock, butcher Koji Fujioka, butcher Merl Goodsell, and general manager Scott Miller.

Project Equity helped the transition team raise a grant through the City of Berkeley and partnered with full-spectrum impact investment fund manager Mission Driven Finance (MDF) to form the Employee Ownership Catalyst Fund that would provide financing for the transition.

The national Employee Ownership Catalyst Fund supports businesses throughout the US that want to transition to employee ownership and need capital to finance the transition and transaction. Short term, the fund will also help companies that are transitioning to employee ownership with working capital to support their strong footing coming out of the pandemic and to bridge the costs associated with an ownership transition.

Employees don't need to come up with the financing themselves; the Employee Ownership Catalyst Fund fills this gap. When business owners understand there is capital available to make this transition, more possibilities and opportunities open up.

MDF performed due diligence and underwriting, while Project Equity led the pre- and post-transition advisory. The Employee Ownership Catalyst Fund provided a \$213K loan to the company for the transition.

In October 2021, The Local Butcher Shop became an employee-owned business. Overnight, the five transition team members officially became owners and the rest of the staff had the opportunity to buy-in and become owners until February 2022. The founders took a step back to focus on their family and transitioned from owners to board members and mentors.

The profit-sharing model of the worker co-op has helped retain the store's staff and made it easier to afford to live locally with higher compensation.

## Deal Terms

**Company:** The Local Butcher Shop

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**Investor:** Employee Ownership Catalyst Fund

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**Investment Date:** November 2021

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**Investment Type:** Loan secured with a blanket UCC

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**Investment Amount:** \$213,150

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**Employee Ownership Structure:** Worker Cooperative

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**Ownership:** None

**Interest Rate:** 5.5% per year

**Grace Period:** None

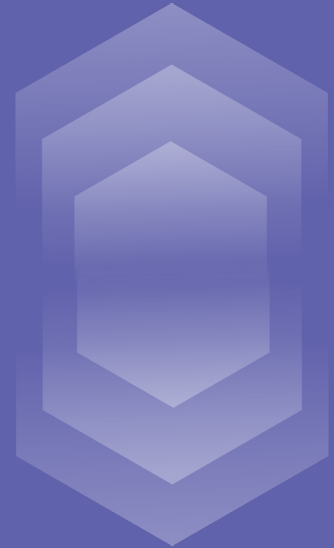
**Payment Schedule:** Monthly

**Maturity:** 5 years

**Board Seat:** None

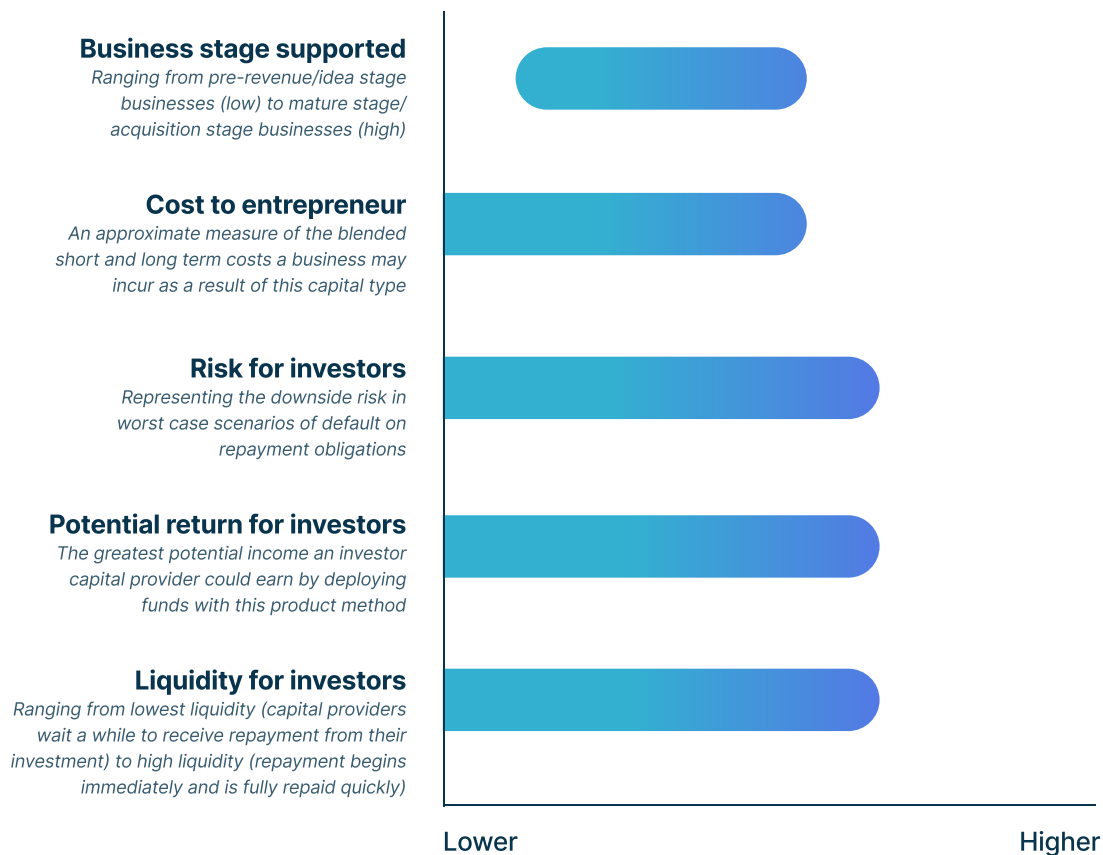
**Use of Proceeds:** Financing will be used for the transition to employee ownership

# Alternatively Underwritten Loans



## TL;DR

A fixed interest, term loan offered to small business borrowers but underwritten by lenders based on novel and often nuanced criteria that exclude typical measures of creditworthiness such as FICO or asset collateralization.



# What is alternative underwriting?

The “status quo” capital product in small business finance is the term loan. Entrepreneurs are generally familiar with the basic features of a term loan—probably the most common and widely understood form of capital—thanks to the ubiquity of auto and home loans in the United States. The essential elements of the business term loan are straightforward: a single distribution of capital upon loan closing is followed by immediate recurring repayments of principal loan amount plus interest, based on a fixed interest rate and a pre-established amortization table. There aren’t many surprises to be found in the fundamental economics of small business term loans today, especially from the perspective of the borrower.

There are, however, some significant innovations taking root across the country related to which businesses receive term loans and how lenders assess an entrepreneur’s creditworthiness. Chief among these innovations is a growing trend away from traditional underwriting methods—which tend to rely on historically discriminatory features such as asset-collateralization and individual borrower credit metrics (eg. FICO score)—and toward alternative underwriting measures. While the fundamental capital product remains the same as a typical term loan, an Alternatively Underwritten Loan (sometimes called “Character-Based Loan”) features a distinct and more in-depth underwriting process. This process often foregoes the elements of collateral and credit score entirely, in exchange for an intense focus on individual borrowers’ competencies, business plans, cash flow, and potential trajectory.

Unlike many modern trends in small business finance, innovations in the Alternative Underwriting space aren’t coming from the likes of Silicon Valley FinTech firms, but rather from local and regional CDFIs, nonprofits, and grassroots entrepreneur support organizations in pockets across the country.

## Two Types of Alternatively Underwritten Loans: Standalone & Programmatic

When a lending institution decides to offer debt capital to small business borrowers using an alternative assessment of creditworthiness, they have essentially two options:

1. **Standalone Loan Product:** The lender establishes a systematic application process, underwriting policies, and fund structure to offer a streamlined alternatively underwritten loan product. Business owners apply for capital from the lender just as they would from a bank, and are directed by the lender to submit information in accordance with the underwriting policies. The lender makes loan offer decisions internally based on the underwriting criteria they have decided upon, and the entrepreneur repays the loan exactly the same as any term loan.

2. **Programmatic Alternatively Underwritten Lending:** An organization with the capacity and structure to provide longer-term direct technical assistance to small businesses may decide to incorporate alternatively underwritten debt capital into their offerings for the entrepreneurs they serve. Over the course of a support program or small business development curriculum, debt capital is offered to entrepreneurs based on predetermined program milestones or measures of business success. Entrepreneur creditworthiness is assessed interpersonally, over the course of the program, and is often informal in nature.

## Why Alternative Underwriting?

### Benefits for entrepreneurs:

- These loans are sometimes the only formal capital a business owner can access. Nonprofit lenders who offer alternatively underwritten loans are referred to as the “lenders of last resort,” and outside of this option an entrepreneur may be forced to consider astronomically expensive credit card debt or other predatory sources of capital.
- In many cases, these loans and the programs within which they exist are designed to provide technical assistance and support in addition to the lending capital.
- Upon successful repayment, such lenders often have processes to “graduate” borrowers to a more traditionally underwritten loan, or to make warm introductions on behalf of the borrower to larger, more traditional lending institutions for additional capital needs.

### Benefits for lenders:

- Incorporating alternative underwriting practices allows lenders to serve another segment of the market that traditionally processed loans might overlook or disqualify—allowing the organization to increase the total addressable market.
- Alternative underwriting practices allow funders to reach some of the most credit-challenged businesses, which is often core to the mission of nonprofit lending institutions.
- Addressing nontraditionally-creditworthy borrowers improves CDFIs' abilities to reach target demographics and geographies, increasing likelihood of re-certification and grant awards.

## Costs for entrepreneurs:

- Alternatively underwritten loans frequently have a complicated and lengthy application process. Often very little decision-making is automated or based on algorithmic decisions; most commonly, lending decisions are made by a team of lenders and underwriters based on a set of nuanced facts and calculations.
- Typically charge higher interest rates than traditional bank loans.
- May include additional obligations such as ongoing reporting and communication with lending institution, recurring check-ins, and participation in technical assistance programming.

## Costs for lenders:

- Alternatively underwritten loans often lack collateral and personal guarantees, which can significantly diminish the enforceability of default obligations and recuperation of principal.
- Lending teams must be re-trained, and staff obligations are significantly higher for this more nuanced and subjective lending process. The underwriting process is not typically as formulaic as with traditional debt capital, and as such, automation or technological support systems may be more difficult to engineer.

The single most obvious benefit of Alternative Underwriting in small business lending is that it enables lenders to offer capital to viable and important small business borrowers who otherwise would not qualify for a term loan under traditional underwriting guidelines.

Unlike in the mortgage industry, there is no national public database of small business lending by race and ethnicity, gender, or other key demographic variables. However, based on consumer surveys and private research endeavors, we know that female business owners account for less than 5% of all capital loaned to small companies. This comes despite the fact that women own 30% of small companies—six times as much as the share of funding they receive. Furthermore, small businesses owned by women only receive 16% of all traditional small business loans. Women's applications for business loans are also more likely to be rejected, or have more stringent terms, than those for men. Black business owners struggle with debt financing too: in 2018, only 31% of them received all the funding they applied for, compared with 49% of white-owned businesses, 39% of Asian-owned firms and 35% of

Latino/a-owned businesses, according to a 2019 report from the Federal Reserve Bank of Atlanta. Beyond application success, Black business owners also pay higher average fees and interest, due in part to the lack of personal assets to collateralize loans, attributable to the significant racial wealth gap.

## Capital Product Fit

### When is an alternatively underwritten loan a good fit for businesses?

#### Entrepreneurs who tend to benefit most from alternatively underwritten loans typically:

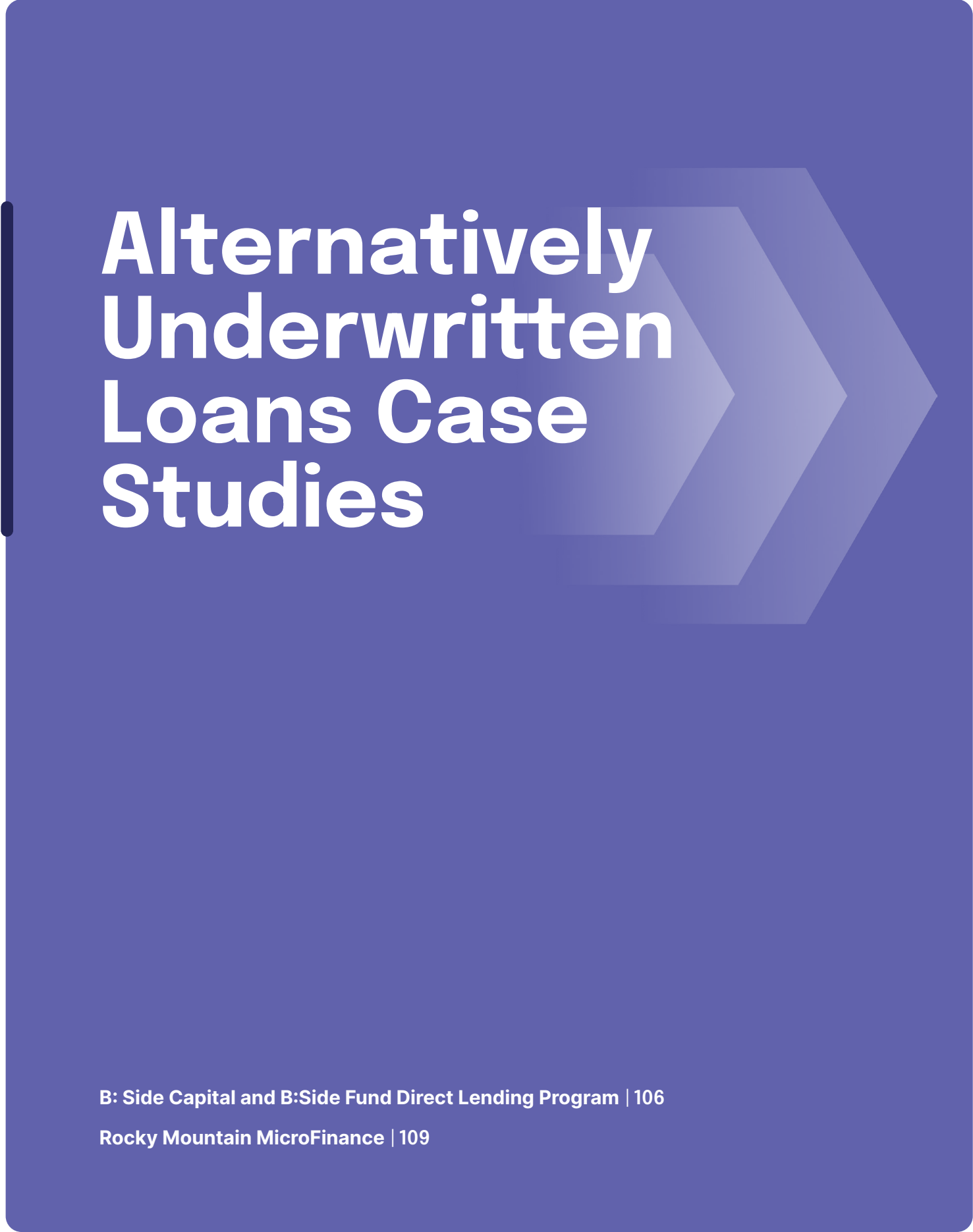
- Have a nonspeculative business with a clear pathway to growth and stability. Most often these businesses are generating revenues and are near break-even on their balance sheet.
- Lack significant formal assets necessary to collateralize a traditional term loan (business assets, home equity, personal assets such as vehicles, etc).
- Have a lower than average personal credit score, sometimes with historical blemishes including bankruptcies, collections, or late payments.
- Have young businesses without the 2+ years of track record many lenders require.
- Lack formal bookkeeping systems to efficiently track business transactions and verify financials.
- Are interested in working closely with a lender to build credit, improve business financials, and graduate to a traditional debt product upon repayment.

## When is an alternatively underwritten loan not a fit for businesses?

- If a business is speculative in nature, including pre-revenue startup firms. These are typically not a fit because repayment of loan principal plus interest typically begins immediately.
- If a business does not want to participate in hands-on programming with the lending institution, or does not want to provide intimate and personal information as a part of the loan application process.
- If the entrepreneur(s) have strong personal credit and assets, which would likely mean they could access lower cost capital elsewhere.
- If the business' revenues are highly seasonal, with significant peaks and troughs throughout the year. Fixed monthly payments can squeeze already slim cash flows during down times if an entrepreneur cannot afford to budget for future debt obligations.

Small business balance sheets across the country have seen historically challenging circumstances made only more grave by the economic effects of COVID-19. In the wake of an economic crisis that hit small businesses especially hard, entrepreneurs have found themselves spending down assets, liquidating reserves, and defaulting on personal debt obligations—all of which pose significant challenges within the context of a traditional underwriting process for a small business term loan. However, these challenges—whether incurred due to COVID or otherwise—do not necessarily reflect poorly on a business entity's ability to repay a loan. Adopting alternative underwriting practices allows lenders to look past these challenges to still identify and provide mutually beneficial capital products for small businesses.





# Alternatively Underwritten Loans Case Studies

**B: Side Capital and B:Side Fund Direct Lending Program | 106**

**Rocky Mountain MicroFinance | 109**



*Brittany Phelps and a client at Thrive Yoga in Crested Butte, Colorado*

## Overview

[B:Side Capital](#), (formerly Colorado Lending Source) is a highly regarded nonprofit Certified Development Company (CDC) lender based in Denver, Colorado. Over its 30+ year history, B:Side has funded thousands of loans to entrepreneurs in Colorado, most of which have been under the SBA through the 7(a), 504, and Community Advantage programs.

Since 2011, B:Side has offered a standalone direct lending product that has become a staple institution for local economic development, known especially for its alternative underwriting process. These loans, which B:Side refers to as “responsible lending” or “pre-bankable lending,” provide capital to entrepreneurs who have viable businesses but may not yet qualify for typical, low-rate bank loans. Over the direct loan product’s 10-year history, B:Side has reached hundreds of Colorado entrepreneurs with nearly \$9.4M in capital deployed. In 2019, it created a sister nonprofit entity, now called [B:Side Fund](#), to house its direct lending programs moving forward, with a plan to become a Community Development Financial Institution (CDFI) in the near term. B:Side offers funding options according to the following terms:

- Loan amounts ranging from \$20K to \$100K
- Guaranteed interest rate maximum of 12%
- Typical term length of 7 years
- Funding may be used for: working capital, asset purchases, inventory, business acquisitions, and debt refinance

Ultimately, the B:Side Fund is a highly self-sufficient engine for economic development, yet it still relies on philanthropic and grant capital to subsidize its cost of doing business. This is common for CDC and CDFI loan funds and is typically one of the principal uses of grants from the CDFI Fund.

## B:Side Direct Lending Underwriting Process

B:Side Fund's direct loans differ from traditionally underwritten term loans primarily in the underwriting process. Lenders on B:Side Fund's Direct Lending team think more like venture capital investors; they give credence to entrepreneurs' business plans and potential for future growth. They assess the project in its entirety and are not deterred by borrowers who have taken a nontraditional path and need the extra space to tell their whole story. The B:Side lending team weighs the following key elements heavily in its Alternatively Underwritten loan decisions:

- Business plan and financial growth projections
- Entrepreneurs' industry experience and historical business background
- Business and borrower character assessments

### Example B:Side Loan: Thrive Yoga, Brittany Phelps

In 2017, the opportunity to purchase a yoga studio in Crested Butte presented itself to local resident Brittany Phelps, who, at the time, was working several jobs in the outdoors and fitness community. She immediately started working on financial planning and jumped on the opportunity. Eight months later, Brittany became the proud owner of Thrive Yoga. She opened a second studio location in town and went on to open a third location in Fruita. However, at this stage in her growth, Brittany found her business cash flows squeezed by an unfavorable licensing agreement with the former owners of the business. Ultimately, the former owners of the business wanted Brittany to buy them out, and she needed to refinance their aggressive sellers' note to be able to continue operating the business.

Despite owning and running a successful and growing business, Brittany was unable to secure a traditional bank loan due to her less than perfect credit history. However, when B:Side took a look at Brittany's financials and her business plan, they could see that refinancing her outstanding debt could cut her monthly debt expense in half, freeing up a substantial portion of monthly cash flows for essential business expenses. Ultimately, B:Side lent Brittany \$95K over eight years at an interest rate of 7.5% to pay off her debts, which resulted in a monthly savings of roughly \$1,500 for the business. With these funds, Brittany was able to continue her plans of growing the business, and B:Side accomplished its goal of bringing lending capital to a borrower who represented multiple target demographics (rural-based, woman-owned).

## B:Side Direct Lending Fund Outcomes

20% of loans made to pre-revenue enterprises

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39% of loans made to early stage enterprises—defined as less than 24 months in business

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48% of loans made to women-owned businesses

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42% of loans made to rural-based businesses

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58% of loans were made to businesses located in low-to-moderate income census tracts or CDFI investment areas

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After 10 years of history, the loan write-off rate is 5.9% (based on \$ amount of initial charge-off, not including recovery efforts)



## Overview

[Rocky Mountain MicroFinance Institute](#) is a Colorado-based CDFI, founded in 2008 with the mission to enable people of all backgrounds to realize their unique potential through the power of entrepreneurship. RMMFI focuses on very small businesses in the early/idea stage in and around Denver—providing a multifaceted suite of support services and products. Over its 14 year history, RMMFI has supported more than 300 small businesses, representing a diverse background:

- 100% low income
- 82% people of color
- 68% women
- 57% previously denied a business loan when seeking traditional capital
- 48% households with children
- 10% formerly incarcerated



## RMMFI's programmatic Alternatively Underwritten Lending program is offered in phases, corresponding to the three distinct stages of business support they provide:

1. **Idea | Program:** 24 hours of education, coaching, and pitch practice through a five-session Business Idea Lab, focused on the foundations of business ownership. Mentorship to encourage both personal and business development. Connections to partner organizations for help overcoming business barriers. Coaching support for preparing an application for Launch bootcamp.

**Capital:** \$500, 0% interest "seed loans" to test viability of business idea

2. **Launch | Program:** 15 hours per week for 12 weeks of mentorship, instruction, and coaching from volunteers and staff according to a proven and specialized curriculum. Discounted accounting services to establish business financial practices. Additional graduate resources include a peer support group, skill-building workshops, a free coworking space, virtual and live marketplaces, and promotion through RMMFI's business directory. In total, the Launch phase of RMMFI programming lasts 15 months.

**Capital:** Access to Launch microloans (up to \$2,500), available to all program participants. Low to no interest, flexible repayment terms.

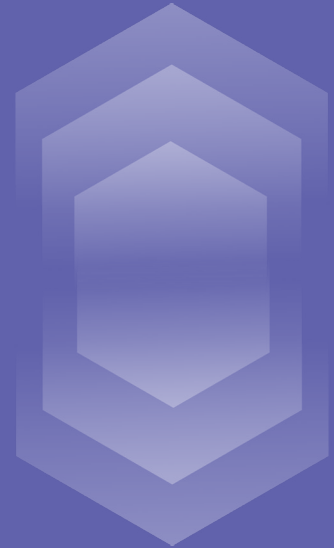
3. **Thrive | Program:** Cohort-based educational programs focused on the unique issues businesses face as they move from startup to expansion. Relevant mentorship and technical assistance to help navigate the challenges that come with a growing business. Expert-led workshops to continue developing the entrepreneurial and leadership skills necessary for business success.

**Capital:** Microloans ranging from \$5K to \$75K, to support the continued growth of the business.

## RMMFI Loan Fund Outcomes

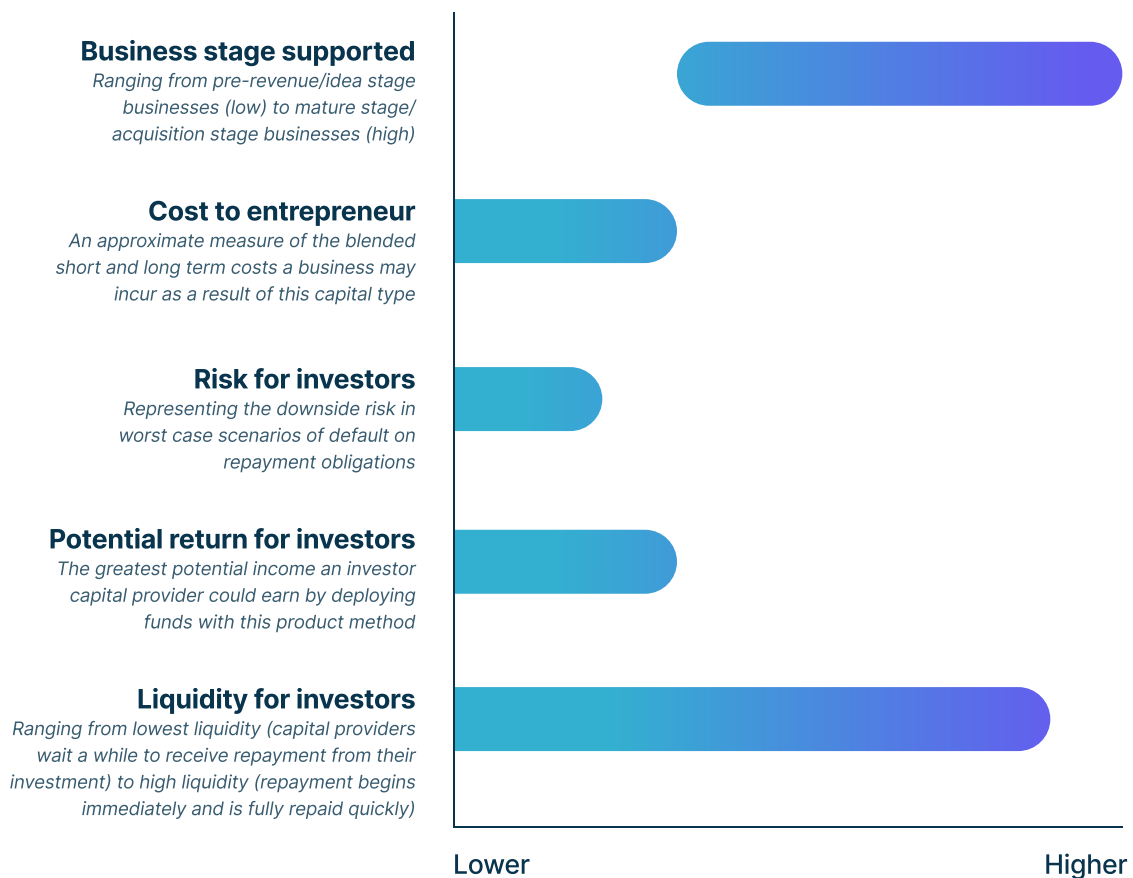
- \$878K lent
- 94% loan repayment rate
- 84% business survivorship four years after participation
- 72% of entrepreneurs report increasing their household income

# Supply Chain Finance



## TL;DR

Supply chain finance (SCF) refers to a set of financing options for businesses to access working capital by using existing customer orders.<sup>11</sup>

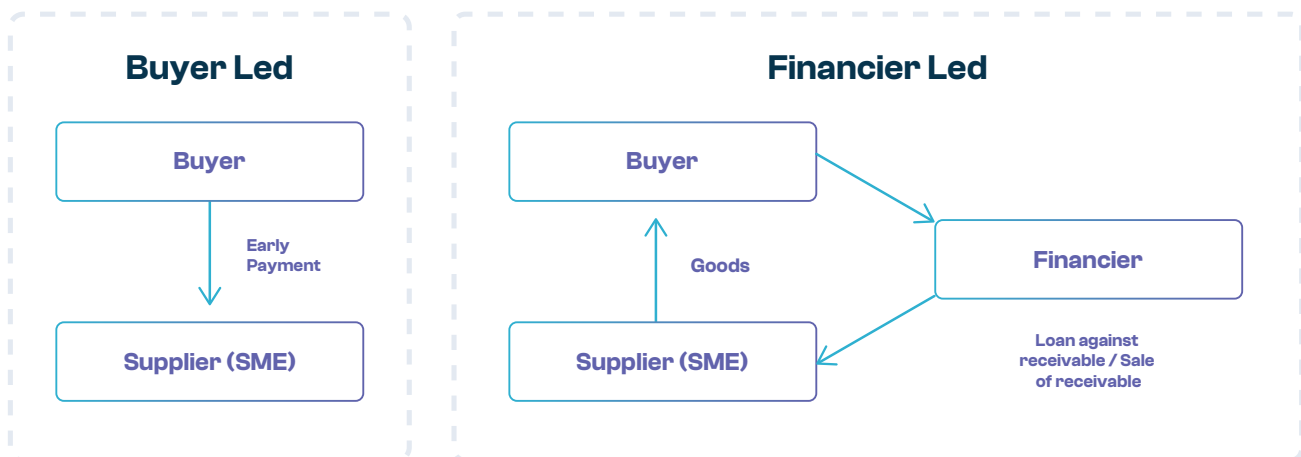


# | What is supply chain finance?

Supply chain finance (SCF) is an approach to financing that has been developed over centuries. It allows small businesses to access working capital in a timely fashion by using existing orders from customers. The use of SCF has been traced to Phoenicia and the Roman Empire, when farmers and merchants would obtain financing from lenders based on their future harvests, productions or shipments.

There are three distinct categories of SCF agreements: advanced payable, receivables purchase, and loans. In essence, businesses can negotiate an early payment from a customer, sell their receivables, or borrow against them.

Early payment SCF transactions are “Buyer Led” i.e. buyers offering early payments to suppliers. These early payments might be discounted or the buyer will assess a fee based on how early the supplier is paid. Selling or borrowing against receivables are generally “Financier Led” transactions, where private financiers step in to provide capital and facilitate payments between buyers and suppliers.

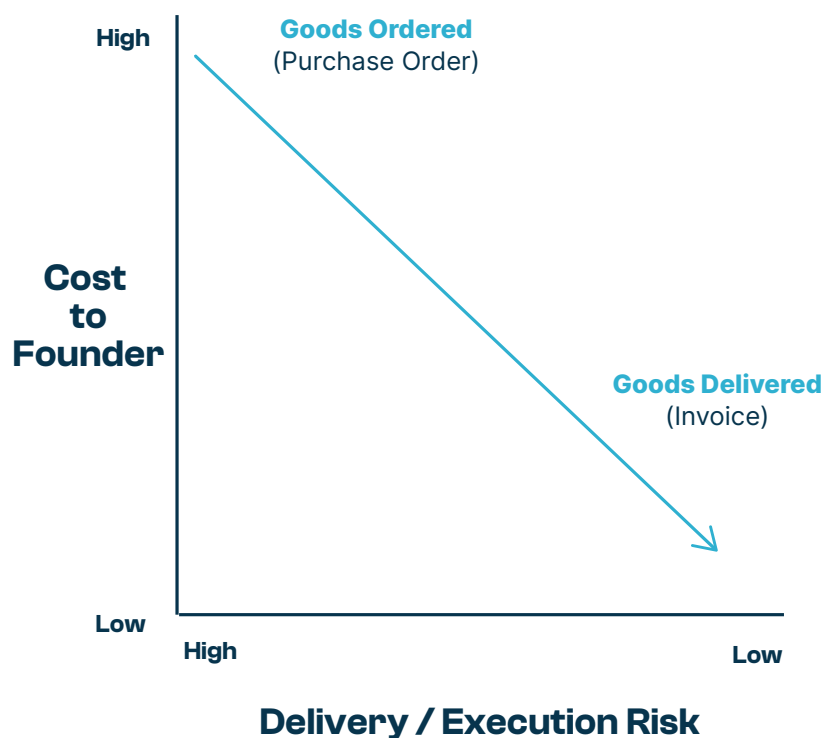


Within these categories, the timing of payments is important to the riskiness and the cost of the transactions. Payments that are made after the goods are delivered (i.e. using an invoice) are significantly less risky for buyers and financiers than payments made before goods are delivered (i.e. using a purchase order).

For financier-led approaches, if the transaction involves an invoice for goods or services that have already been delivered, the primary risk is nonpayment by the buyer. If it is buyer-led, there is essentially zero risk, as the buyer has already received the goods or services and is simply paying earlier than their usual terms.



If the transaction involves a purchase order, i.e. the goods and services have yet to be delivered, the level of risk is higher for both buyer-led and financier-led SCF. This risk level should be reflected in the pricing of the SCF.



SCF often solves a problem that many large buyers do not recognize. For a supplier, a 90-day payment term upon invoicing can effectively mean up to six months of pre-financing requirements for the delivery of a service or product. Such amounts of cash can come at steep interest expenses for smaller suppliers that do not have the track record or credit history of their large buyers.

SCF can help funders and buyers implement systems of prompt payment, ensure transparency across their suppliers of who is paid when, and create predictability and access to timely capital for small businesses. Although it is a short-term funding solution, it can help businesses manage cash flow for their operational needs and help stimulate growth.

SCF is used extensively outside of the US, particularly in Latin American markets. This is primarily an outcome of the developments in electronic tax invoicing, which allowed for e-invoicing to be used in different segments of the economy, enabling SCF to take root, given standardized and verifiable documentation of transactions for which credit can then be extended.<sup>12</sup> Latin American countries hold a significant proportion of the trade finance market, but over half is concentrated in the Asia-Pacific markets. China in particular

has a strong influence on SCF not just due to their large trade activities globally, but as a result of their technological capabilities in the digitisation of SCF. Within Africa, overall SCF activities were negatively affected by the banking regulations following the global financial crisis, but there is a lot of opportunity in the market following the signing of the African Continent Free Trade Agreement (AfCFTA). There is also room to adopt more integrated practices within European markets, with regard to legal frameworks as well as the limited uptake with digitization. Despite all these global developments, 80% of eligible assets in the market remain untapped, with an estimated global trade financing gap of \$1.7T. This is where nonbanking players such as FinTech have come in to try to fill the gap in the market, but there is still substantial work to be done to provide capital to the companies that need it the most.

SCF is often used for cross-border transactions; in these cases it is often referred to as trade finance. Historically there has been significant confusion around the terminology surrounding SCF. The Global Supply Chain Finance Forum has been created by a number of industry associations to create a standard language for stakeholders and establish best practices. As much as possible, we have used their language and definitions in this chapter.

## Capital Product Fit

### When is SCF a good fit for businesses?

**Bridging:** It should be used to bridge a cash gap or allow companies to maximize production capability to scale.

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**Profitability:** SCF changes the timing of payments, not the underlying economics of the company, so companies need to either be profitable or have the reserves necessary to fund any overall loss for the company.

---

**Seasonality:** Seasonal businesses or those that have significant spikes in demand are good candidates for SCF.

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**Procurement:** For large public and private contracts with formal procurement processes, suppliers without documentation or track record to prove they are financially trustworthy enough to deliver the contract will be excluded from the bidding competitive process. This includes smaller providers and those historically underserved by traditional financial institutions, including Black-, brown-, minority-, and/or women-owned businesses.

## When is SCF not a fit for businesses?

**Long Term Financing:** At a foundational level, SCF is primarily a short-term source of cash flow for a business for its operational needs. It does not solve core financial issues that a business may find affecting its balance sheet.

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**Complexity:** SCF shifts forward the timing for companies to receive payments. If the company's financial team does not account for this shift, the company might not be able to cover their costs in a given month. This means that finance departments of small businesses need a level of sophistication; they must do more sophisticated forecasting and planning to account for the variations in cash flow.

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**Personal guarantees:** When funders request a personal guarantee, founders might need to evaluate the risk that this represents to them when considering signing a funding agreement.

## Why would founders want to choose SCF?

**Timing:** When founders want to access timely working capital secured against future orders.

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**Affordability:** If the cost of SCF is affordable compared to alternative funding options.

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**Opportunity:** When the profit from a sales or procurement opportunity is higher than the cost of SCF.

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**Customer size:** When founders have large customers with a good track record in terms of purchases.

## What should businesses look out for with SCF?

**Cost:** SCF can be predatory in its pricing. For many companies, this is the only option for financing for a large project, so they may be inclined to pay exorbitant fees. There exists a need for affordable SCF for small suppliers.

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**Fit for Purpose:** Because SCF is a form of short-term financing, when used over periods longer than a few weeks or months, it can become expensive for businesses.

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**Guarantees:** If personal guarantees are requested by funders and the risk is considerable.

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**Timing:** As SCF moves payments forward, sometimes prior to the delivery of the goods and services, the complexity of accounting may increase. Companies will need to ensure their accounting team accurately records and forecasts payments against expenses.

## | Types of Agreements

As discussed above, there are three distinct categories of SCF agreements: advanced payable, receivables purchase, and loans. In essence, businesses can negotiate an early payment from a customer, sell their receivables, or borrow against them.

Within each of these categories, payments can be made using invoices (i.e. paid after the goods have been delivered) or purchase orders (i.e. paid before the goods have been delivered).

### Advanced Payable

*Early payment of an invoice or purchase order.* This is a buyer-led program where sellers in the buyer's supply chain can, at their option, access liquidity by receiving a discounted early payment.

This early payment can be completed using invoices or purchase orders. The cost of the financing should reflect the risk of the transaction and the cost of capital for the buyer. As discussed previously, the risk to buyers of an invoice-based advanced payable transaction is effectively zero; thus the cost to the suppliers should reflect the cost of capital for the buyer and the administrative cost of the program. For buyers with excellent credit records and thus the ability to access capital cheaply, the delta between their financing cost and their suppliers' financing cost will likely be considerable. This represents a significant opportunity for large buyers, including corporations and governments, to create affordable supply chain financing programs that leverage their low cost of capital.

For purchase order-based advanced payable transactions, there does exist execution risk on the part of the supplier, so the cost of financing should reflect this risk.

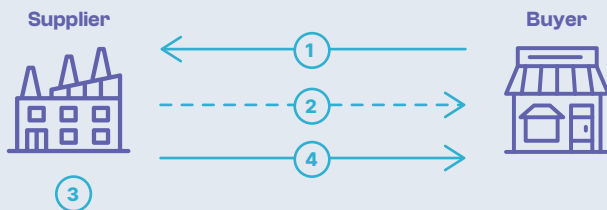
Many of the buyer-led options with early payments that can be used in this case include Corporate Payment Undertaking, Dynamic Discounting, and Bank Payment Undertaking.<sup>13</sup>

## SCF - Early Payable - Invoice



1. Supplier delivers goods to buyer with invoice
2. Supplier elects to receive payment immediately at a % discount (dynamic discounting)

## SCF - Early Payable - Purchase Order



1. Buyer issues purchase order for goods from supplier
2. Supplier requests early payment at a % discount
3. Supplier uses the early payment to fund working capital for the order
4. Once production is finalized, supplier delivers it to the buyer

## Receivables Purchase

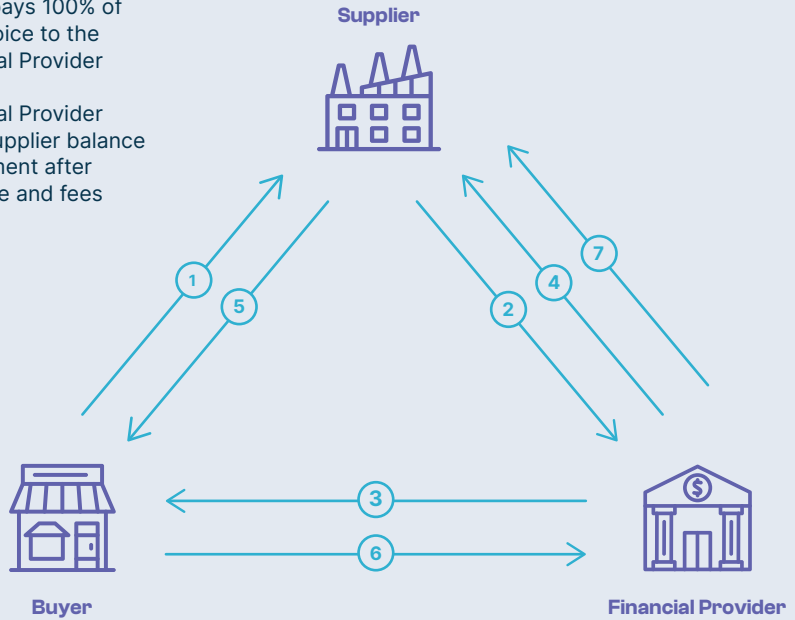
A receivables purchase is an agreement between a finance provider and a client (supplier) to fund the purchase of an individual or a portfolio of receivables in order to receive cash flow advancement to fund working capital needs. Unlike an early payable arrangement, which is buyer-led, a receivables purchase is a financier-led program where there is funding against invoices or purchase orders as a form of collateral.

In this case, a supplier generates a purchase order or invoice for the buyer, and a financial provider comes in as a third-party to finance the supplier's purchase order or invoice based on the buyer's credit quality. This allows the financial provider to obtain the final payment from the buyer once the supplier fulfills their obligation or has reached the payment term. The financier can then claim their fee and return the rest of the proceeds to the supplier. This form of financing often includes Forfeiting, Factoring, Receivables Discounting, and Payable Finance.

## SCF - Receivables Purchase - Purchase Order

1. Supplier and Buyer enter into a commercial agreement and purchase order is generated
2. Supplier requests cash advance on the Buyer's order
3. Financial Provider assesses Buyer's payment capabilities and credit track record to structure a financing solution for the supplier
4. Financial Provider advances X% of purchase order in cash
5. Supplier delivers the goods to the buyer once production is done

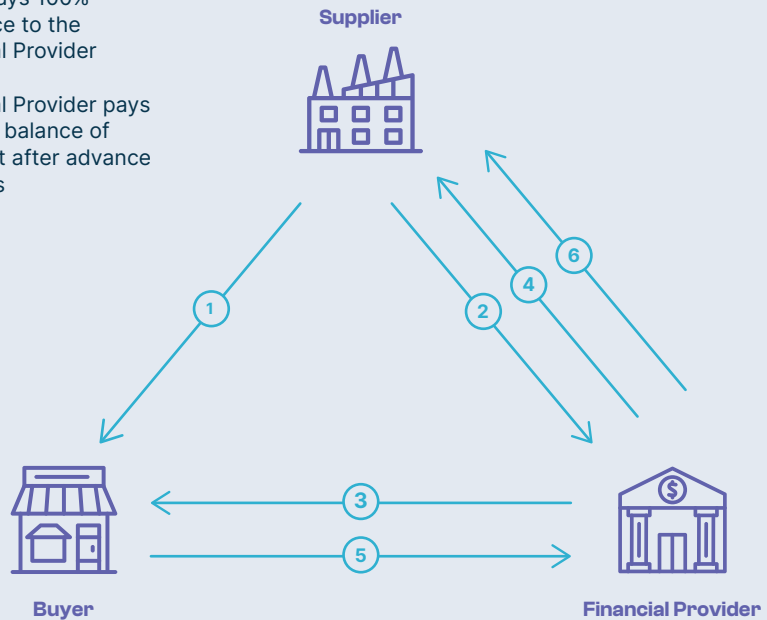
6. Buyer pays 100% of the invoice to the Financial Provider
7. Financial Provider pays Supplier balance of payment after advance and fees



## SCF - Receivables Purchase - Invoice

1. Supplier delivers goods to a buyer and issues an invoice
2. Supplier requests cash advance on the Buyer's order
3. Financial Provider assesses Buyer's payment capabilities and credit track record to structure a financing solution for the supplier
4. Financial Provider advances X% of invoice in cash

5. Buyer pays 100% of invoice to the Financial Provider
6. Financial Provider pays supplier balance of payment after advance and fees



## Loan

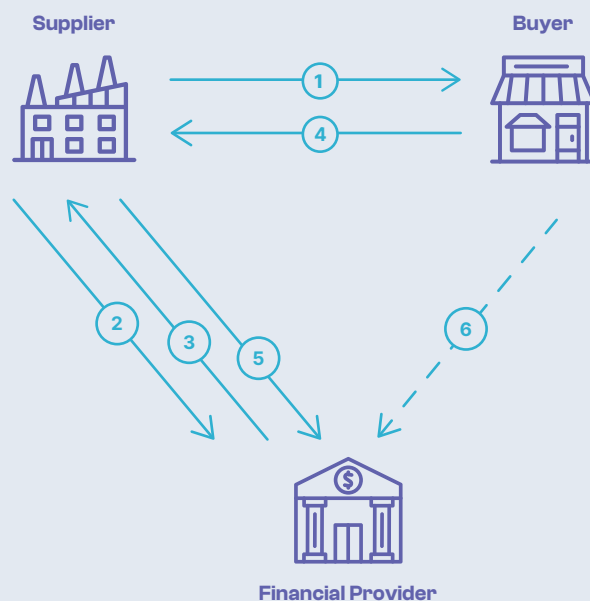
Loans make money available to another party in exchange for future repayment of the principal amount with interest or other finance charges. A loan may be for a specific, one-time amount or can be available as a variable credit line or overdraft up to a specified ceiling amount. It is also possible to make loans of actual real and financial assets.

While a loan can take many forms, there are some similarities in the mechanics of a receivables purchase, except loans often rely on the credit quality of the supplier as opposed to that of the buyer. These include loans against receivables, distributor finance, loans against inventory, and pre-shipment finance.

### SCF - Loan - Invoice

1. Supplier delivers good to Buyer and issues an invoice with payment details
2. Supplier submits loan drawdown request with any agreed documents
3. Financial Provider provides funds to the supplier
4. Buyer pays for goods received
5. Supplier repays Financial Provider at maturity using the funds received from Buyer

6. *In some cases, the Financial Provider may receive funds directly from Buyer or debit the Supplier's account held with it of invoice to the Financial Provider*



# | US Landscape

**Currently underdeveloped market:** The US supply chain finance landscape is underdeveloped compared to peer, OECD economies; the SCF industry is generally limited to one-off financier-led arrangements, with few systematized or even buyer-led arrangements.

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**Lack of standardized, e-invoicing:** A significant reason for this country's limited SCF options stems from its lack of electronic invoicing. "E-invoicing" is widely used elsewhere and [even mandated across many nearby Latin American countries](#). Standardized e-invoicing provides confidence to third-party financial institutions that contracts are legitimate and easily transmitted, creating a market for SCF.

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**Innovations in public procurement:** Large public purchasers in Los Angeles—LA World Airports, LA Metro, the City, and the County—[are innovating to create economies of scale](#) across their organizations and underwriting against their promise of payment, with a dedicated funds administrator, to create lower cost of funds and directly connect contracts to capital.

- LA's Contract Finance Assistance Program, as reported [here](#) (specific programs: [Los Angeles World Airports](#); [City of LA](#)), directly connects public contracts to financing via a dedicated third-party funds administrator.
- New York State's [Bridge to Success Loan Program](#) creates short-term bridge loans that boost the ability of Minority/Women-owned Business Enterprises (MWBs) to participate in state contracts. This program helped the state double MWBE contracting between 2011 and 2013 in conjunction with the state's [Bond Guarantee Assistance Program](#), supported by State Small Business Credit Initiative funds from the federal government.

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**Recent initiatives:** In 2015, the US Office of Management and Budget [called for all-electronic invoicing](#) for all federal procurement by 2018, detailing inefficiencies of paper invoicing for the US government's 19M invoices per year: the difficulty of managing mixes of digital and manual processes; [\\$266M in annual federal government savings](#) from a transition to all-electronic processes; and concomitant business costs and losses from slow payment to suppliers, with the average paper invoice [costing \\$10 and taking 10 days to manually process](#). The federal mandate appears to have gone into effect with little fanfare. Whether e-invoicing will be widely adopted by the private sector or state and local governments remains to be seen, and is the subject of an [ongoing project](#) of the Federal Reserve Banks.



While the FedPayments Improvement program has [focused](#) recently on topics such as digital currency and peer-to-peer payment (e.g., Venmo), the group looks to [implement a document exchange](#) by 2023, to modernize US B2B payments, potentially facilitating the growth of an SCF US market.

## FAQs

### How expensive is supply chain finance?

It depends on the technique used. In an early payable case, the cost represents the discount the seller provides for receiving an early payment for its goods/services. In a receivables purchase case, the cost is the fee that the financial provider charges to deliver an advanced payment on the corresponding invoice, which can vary from 3% to 5%. Finally, in a loan case, the cost would be the corresponding interest rate payable on the loan, which can vary depending on the funding provider, ranging from 15% to 25%.

### Why would funders be interested in supply chain finance?

SCF can strengthen the relationship between buyer and supplier, since the buyer may be able to negotiate longer payment terms or price discounts with its suppliers and thereby improve its own working capital position.

Furthermore, SCF offers high-quality, transaction-based, short-term financing based on the credit of a primary buyer and supporting the business objectives of both trading parties.

SCF can also be a tool to drive racial equity by supporting local diverse businesses and strengthening local supply chains. Efforts to re-shore production in light of global supply chain disruptions and concern over racial inequities have converged on SCF as an ideal tool to channel local purchasing and demand toward long overlooked BIPOC-owned firms.

## **How might SCF help alleviate the effects of other macroeconomic issues and worldwide problems?**

SCF solutions could help globally by offering alternatives to cover increasing upfront costs for production.

World inflation has been increasing consistently due to production costs and energy prices. Moreover, climate change effects such as floods and droughts have increased food insecurity, which further threatens the sustainability of food production systems by destroying lands, livestock, crops, and food supplies. Finally, the war in Ukraine and sanctions on Russia are disrupting shipments and production delivery of nearly 30% of world wheat exports and 18% of corn.

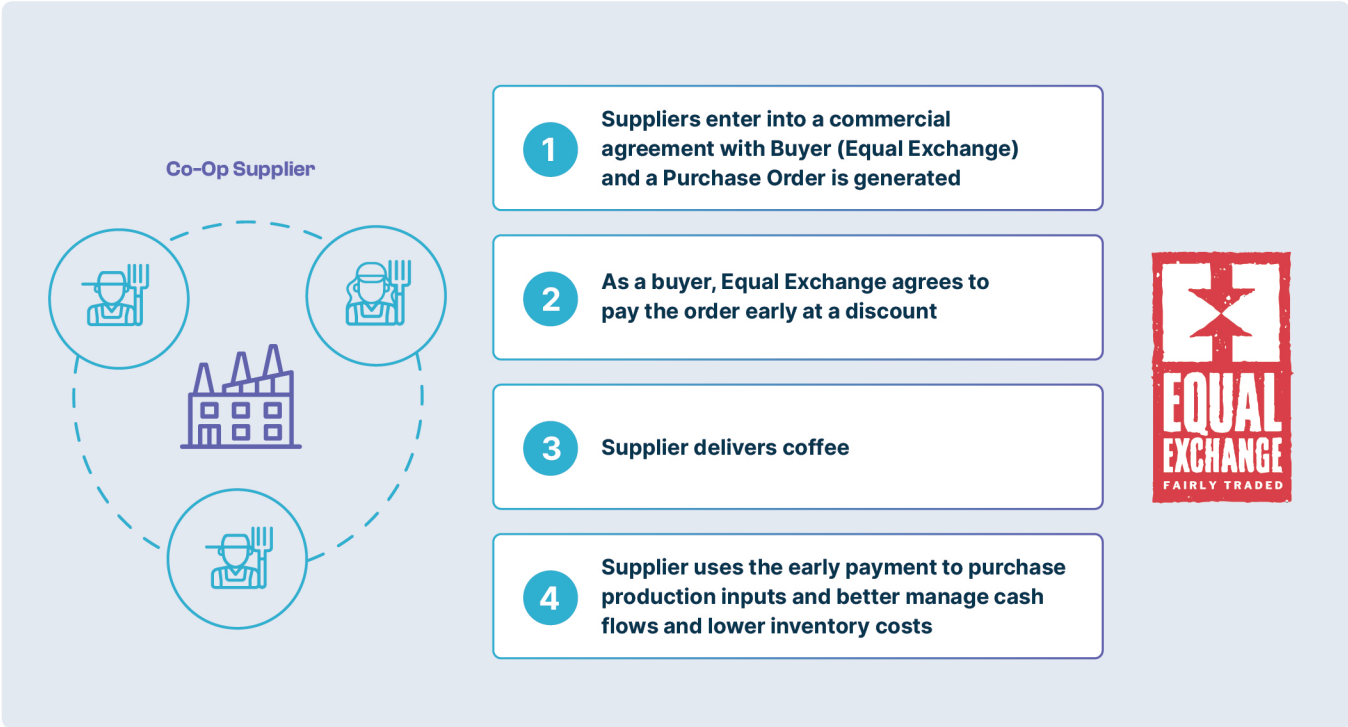
Finally, there are opportunities to use SCF with a climate, gender, racial equity, or development lens to address global crises and structural inequities within our current financial system.

# Supply Chain Finance Case Studies

## Case Study 1 - Equal Exchange - Advanced Payable

Coffee farmers in Latin America constantly need working capital during their planting and harvesting seasons to be able to pay for the products, equipment, and labor required to grow their coffee crops. These farmers' options for accessing local funding are extremely limited and often unaffordable. Equal Exchange, a US-based fair trade coffee company that regularly purchases coffee from these farmers, decided to use its own company balance sheet to help these farmers by purchasing their coffee early with some discount.<sup>14</sup>

Equal Exchange intentionally bought stock from farmers soon after harvesting, many months before it expected to sell it in the US, and stored it in its own warehouse facilities. This approach is distinct from traditional coffee companies, which purchase coffee beans on demand when they need to sell them. The traditional on-demand approach keeps the large coffee companies' inventory low but requires the farmers to bear the cost of storing the coffee and managing their cash flow while they wait for buyers to purchase their stock. Equal Exchange's approach shifts the inventory burden off farmers' balance sheets and onto those of Equal Exchange.



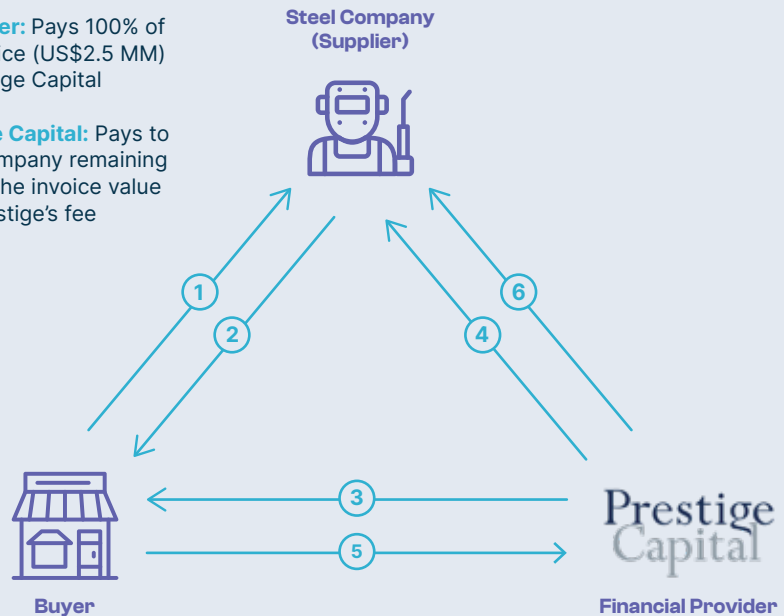
## Case Study 2 - Prestige Capital - Receivables Purchase

A steel company with projected sales of \$10M with historically cash-on-delivery terms with customers is suddenly forced to offer net 60-day terms<sup>15</sup> to retain key customer accounts. One of the steel company's customers places an order of \$2.5M, after which the steel company delivers the product and sends the corresponding invoice. However, the steel company needs the cash flow now to support the daily operating expenses and inputs for the steel production to fulfill the customer order.

Prestige Capital, as a factoring services provider, analyzes the customer's credit quality, not the steel company's, in order to structure the right financing solution. Prestige Capital advances \$2M (80% of the order) to the steel company in order to finance the operating expenses and inputs for production. Once the customer pays 100% of the invoice to Prestige Capital, not to the steel company, Prestige Capital sends to the steel company the remaining 20% of the invoice value less Prestige Capital's fee (1.5%, but this varies based on the deal size and invoice days outstanding) of the total invoice value. As a result, the liquidity that Prestige Capital provided to the steel company empowered it, by enabling it to leverage an opportunity for growth.

- 1. Customer:** Sends US \$2.5 MM order to steel company
- 2. Steel Company:** Sends invoice to customer for US \$2.5 MM with a 60-day payment agreement
- 3. Prestige Capital:** Analyzes customer's credit quality, not precisely the client's, in order to structure the right financing solution
- 4. Prestige Capital:** Advances US\$2 MM (80% of invoice) to steel company

- 5. Customer:** Pays 100% of the invoice (US\$2.5 MM) to Prestige Capital
- 6. Prestige Capital:** Pays to steel company remaining 20% of the invoice value less Prestige's fee

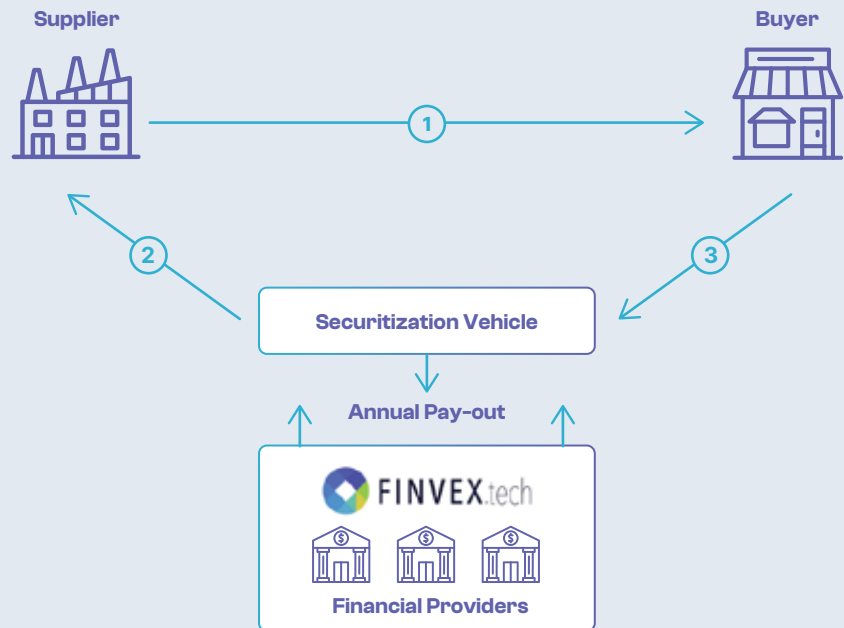


## Case Study 3 - Finvex.tech - Receivables Purchase

A furniture manufacturer is looking to expand its sales to its largest clients (big-box stores). In order to do this, it offers its clients better payment terms of 30 days. The furniture manufacturer would traditionally need to fill this gap with shareholder capital or bank debt. To deal with this, the manufacturer gets in touch with Finvex.tech, a company that provides a tech- integrated impact financing solution to help companies improve their working capital and strengthen their supply chain.

Finvex.tech's solution can create its own receivables financing and attract financiers into a joint finance structure. A joint program with the manufacturer and Finvex.tech's Securitization Vehicle is created. This is a mezzanine structure with equity and a senior tranche. With this program, the manufacturer sends an invoice to its client with a 30-day payment term. The joint financial structure purchases these receivables from the manufacturer and charges a 1% rate per month. The big-box store can then pay directly into the finance structure. After this, the securitization vehicle can then provide external financiers with a return of 7% due to the strong credit ratings of the big-box stores.

1. Manufacturer (Supplier) sells furniture to buyer on 30 day terms and issues them an invoice
2. The SV pays immediately against delivery with a discount of 1% per month
3. Pays full amount in instalments or on invoice due date

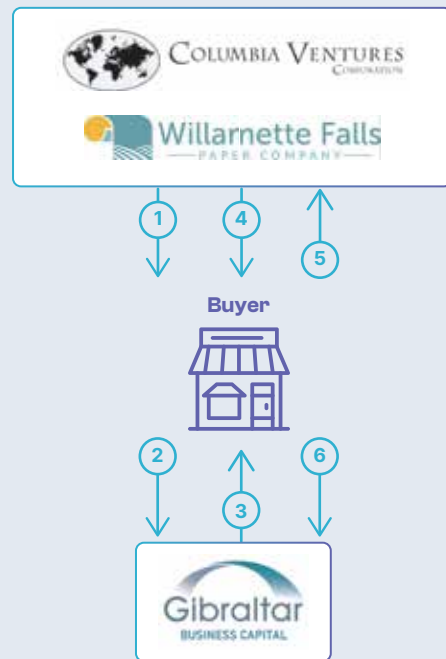


## Case Study 4 - Gibraltar Business Capital - Loan

An Oregon-based independent manufacturer that utilizes sustainable and recycled fibers to produce coated freesheet, offset, envelope, packaging, and specialty papers was on a solid growth trajectory driven by rapid sales demand. Its core financial sponsor was the family office Columbia Ventures Corporation, but the company needed liquidity to fund its production inputs; thus it sought a lender for a \$7.5M asset-based loan.

Gibraltar Business Capital provided the credit facility supported by advances against accounts receivable and inventory. Additional flexibility was provided to the company through a no-covenant structure since the company's financial sponsor was a reputable family office. Gibraltar Business Capital turned out to be the right lender because of its borrowing base creativity and its ability to provide a loan without tying up all the company's assets.

1. WFPC (Supplier) enters into a commercial agreement with a Buyer and a purchase order is generated
2. Supplier seeks working capital loan from GBC
3. Provides \$7.5M Loan with flexible terms
4. WFPC delivers the finished products to the Buyer once production is done
5. Buyer pays for goods received
6. Repays GBC at maturity using the funds received from Buyer plus interest



# Resources

## Models

[Equal Exchange](#)

[Prestige Capital](#)

[Finvex.tech](#)

[NY State's Surety Bond Assistance Program](#)

[LA Metro Contractor Development and Bonding Program](#)

[US EXIM Supply Chain Finance Guarantee](#)

[Business Development Bank of Canada Purchase Order Financing](#)

[Adventure Finance](#)

[Gibraltar Business Capital](#)

## Reports

[Global Supply Chain Finance Forum Guide](#)

## More Reading & Listening

[Global Supply Chain Finance Forum](#)

[Bank of America Supply Chain Finance Resource Center](#)

[Asian Development Bank Trade and Supply Chain Finance Program](#)

[World Bank Blogs: Supply Chain Financing](#)

[SupplyChainBrain Podcast](#)

For more tools and resources, visit [innovative.finance/resources](https://www.innovative.finance/resources).

## Endnotes


<sup>11</sup> Definition adopted from the [Global Supply Chain Finance Forum Standard Definition](#): the use of financing and risk mitigation practices and techniques to optimize the management of the working capital and liquidity invested in supply chain processes and transactions. Definition from IFC 2019: SCF refers to the techniques and practices used by financial intermediaries to manage the capital invested into the supply chain, reducing the risk for the parties involved. These aim to lower financing costs and improve efficiency for buyers and sellers by automating transactions and tracking invoice approval.

<sup>12</sup> Barreix, A., & Zambrano R. (2018). [Electronic Invoicing in Latin America](#). Inter-American Development Bank

<sup>13</sup> <http://supplychainfinanceforum.org/techniques/corporate-payment-undertaking/>

<sup>14</sup> Equal Exchange case adapted from Adventure Finance (<https://www.adventure.finance/>)

<sup>15</sup> The customers will now have 60 days to pay for the order once the invoice is received.



# Innovative Fund Models

**506(c) Funds & Rolling Funds | 130**

**CDFI Funds | 142**

**Donor Advised Funds | 154**

**Small Business Investment Companies | 165**



## Overview

In addition to the innovative products offered by capital providers to small businesses, there are innovative fund structures and models that can be utilized as part of the strategy for expanding capital access to more businesses. The list of fund structures included is not comprehensive but represents a handful of nontraditional fund structures that have strong potential to address gaps in capital access.

Each of the following fund types has a different aspect of innovation: some enable underrepresented and emerging fund managers to break into the asset management space, often resulting in a broader range of businesses supported; other structures utilize government-backed securitization to de-risk the use of innovative products or investment in underserved areas.

To explore our database of tools and resources for innovative fund models, visit [innovative.finance/resources](https://innovative.finance/resources) or scan here:



# 506(c) Funds & Rolling Funds



## TL;DR

506(c) Funds, including “rolling funds,” are innovative fund models that enable managers to publicly fundraise and therefore lower the barriers to entry for emerging fund managers.

## What is Rule 506(c)?

The Jumpstart Our Business Startups (JOBS) Act of 2012 aimed to create jobs by allowing small and mid-sized businesses to crowdfund their capital needs. One of the rule changes of the JOBS Act split Rule 506 of Regulation D into two exemptions: Rule 506(b) and Rule 506(c).

### **Rule 506(b) closely follows the existing rule already in place.**

- Does not allow general solicitation (aka public fundraising)
- Does allow up to 35 nonaccredited investors

### **Rule 506(c) reduced fundraising barriers for fund managers but increased barriers for nonaccredited LPs.**

- Does allow general solicitation (aka public fundraising)
- Does not allow nonaccredited investors
- Funds can raise an unlimited amount of money provided that the fund takes reasonable steps to verify the accredited investor status of each investor

# What is a 506(c) Fund vs. Rolling Fund?

Relaxed regulations, including Rule 506(c), and improving technology are driving investment vehicle innovation in the alternatives space and a rise in first-time fund managers. In 2020, venture investment platform AngelList launched Rolling Funds as a new product for fund managers that leverages Rule 506(c). Since inception, more than 70 Rolling Funds have publicly launched on AngelList.

Traditional commingled blindpool funds that follow Rule 506(b) prohibit fund managers from publicly fundraising. However, a 506(c) Fund allows fund managers to publicly fundraise from accredited investors.

A Rolling Fund is a type of 506(c) Fund that allows managers to publicly fundraise from accredited investors on a quarterly subscription basis. A Rolling Fund is structured as a consecutive series of limited partnerships under a master entity: at the end of each quarterly investment period, a new fund is offered on substantially the same terms, for as long as the Rolling Fund continues to operate. Fund managers can continuously accept new LP capital in the form of subscription-based quarterly commitments.

## Fund Criteria

### When is this fund model a good fit for fund managers?

Rolling Funds are an innovative fund product that can serve as a launching pad for emerging VCs deploying traditional equity products like SAFEs and convertible notes. This product can accelerate fundraising and building a track record for fund managers with its public marketing feature, and offer lower upfront and operating fund costs.

However, they currently do not work well with funds deploying innovative capital products, such as revenue-based loans and redeemable equity. These capital products generate additional legal, reporting, and other back office costs for fund administration platforms exclusively focused on VC funds.

Fund managers do not need to follow the more popular subscription model for Rolling Funds. RareBreed Ventures, led by Mac Conwell, launched a \$10M 506(c) fund to publicly solicit capital targeted toward his 50K+ Twitter followers, but he did not implement the subscription model. The Calm Company Fund, led by Tyler Tringas, built its own quarterly subscription product rather than use AngelList to launch a second fund.

# Benefits vs. Costs

## Benefits

**Fundraising / Democratizes Fundraising Process for Micro VCs:** Fund managers can accelerate their fundraising process with Rolling Funds because they are allowed to generally solicit or publicly market their fund during fundraising, unlike the traditional 506(b) VC fund structure. More pre-seed and seed-stage fund managers have started to launch and raise Rolling Funds by leveraging their personal brands and networks on Twitter and other social media platforms. They can access a larger and more engaged audience remotely for free instead of navigating the ambiguous institutional LP world in person. They can also raise smaller checks from a larger number of LPs—up to 2K Qualified Purchasers (QP) and 100 non-QP, accredited investors—across multiple funds, than traditional VC funds, with up to 100 accredited investors.

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**Fundraising / Improves Access to Alternatives & Predictability for Smaller LPs:** Rolling Funds typically have smaller minimum LP commitment sizes of \$10K to \$25K per quarter compared to \$1M+ for traditional VC funds. This flexible fund structure can be more inclusive for smaller LPs writing smaller checks that do not meet the traditional fund criteria. LPs typically need to commit at least \$5K to \$25K per quarter for up to four quarters, and they have the optionality to adjust their quarterly commitment size over time. LP capital calls are more predictable than the longer-term, chunky nature of capital calls for institutional funds.

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**Investment Strategy / Build a Track Record Faster:** Rolling Funds can help first-time fund managers build a track record faster than the traditional fundraising path. They can raise a smaller amount of capital than a traditional fund and start investing in companies immediately instead of waiting months or years to hold a meaningful first close.

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**Fund Service Providers / Frictionless and Lower Costs:** Rolling Funds can be cheaper for first-time fund managers than raising a traditional VC fund or a series of SPVs on a deal-by-deal basis. AngelList charges an admin fee for the life of each quarterly vehicle that is 0.15% of LP contributed capital, with a \$20K quarterly minimum fee, for a standard 10-year term. After the first two quarters, when the minimum is waived, fund managers will pay the \$20K minimum fee until they raise \$1.33M per quarter. For example, fund managers raising \$1M or less annually will pay at least 4.75% of contributed capital in the first year and at least 8% in the following years. Fund managers should consider targeting at least \$250K per quarter; otherwise, AngelList's admin fees will start to take over their investable capital and/or management fee.

## Costs

**Investment Strategy / Complex Portfolio Construction for GPs & LPs:** The recurring nature of Rolling Funds makes it more difficult for GPs to execute on a portfolio construction approach. Volatile LP subscriptions limit the ability of fund managers to forecast the amount of investable capital in a quarter, which leads to ramping up their investment pace or passing on great deals in certain quarters. Rolling Funds provide flexibility and optionality for LPs, but LPs only participate in new deals made in that quarter for each fund. Later LPs that did not commit to earlier quarterly funds will not have exposure to those portfolio companies unless the GP makes a follow-on investment at a likely higher valuation than early LPs.

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**Fundraising / Limited Downstream Scalability:** Rolling Funds can work well for smaller pilot funds targeting between \$5M and \$25M, but it is hard to pivot out of a Rolling Fund to accept larger institutional LP checks. The smaller fund sizes drive down the average check size and typically force fund managers to focus on investing at the pre-seed and seed-stage. Fund managers focused on the Series A round or later will have a difficult experience raising larger Rolling Funds and most likely will need to pursue the traditional fundraising path.

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**Legal / Auditing & Infrastructure Costs:** The recurring nature of Rolling Funds increases the number of vehicles managed by fund managers and auditing costs. Rolling Funds create a new vehicle and K-1 tax form every quarter. Additionally, all LPs must be accredited investors, and the GP must take additional steps not required for traditional 506(b) funds to confirm that LPs are accredited. The more rigorous LP verification and onboarding process requires strong infrastructure to mitigate regulatory and friction issues, but AngelList is starting to solve this problem for VCs.

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**Legal / Need to be an Accredited Investor:** Fund managers need to be an accredited investor to launch a Rolling Fund. This creates another barrier to entry for aspiring investors from underrepresented groups who bring a strong brand and founders want on their cap tables but lack the accredited investor status.

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**Fund Service Providers / Limited Ability to Support Alternatives to VC:** AngelList is the leading platform to support back office services—including fund administration, tax, accounting, and reporting—for Rolling Funds deploying venture investments such as SAFEs, convertible notes, and priced equity. Outside of traditional VC, AngelList cannot handle alternative investment structures, including revenue-based loans and redeemable equity, that require more back office complexity.

# Fund Pricing & Terms

## What do 506(c) Funds and Rolling Funds typically charge LPs?

**Subscription Amount:** \$1K - \$25K per quarter

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**Subscription Period:** 1-16 quarters

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**Management Fee:** 2% of committed capital

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**Administrative Fee:** 0.15% of committed capital, subject to a \$20K minimum flat fee

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**Carried Interest:** 20-30% based on an LP's subscription period. The subscription period is the number of quarters to which an LP subscribes in advance. LPs will pay carry only after receiving back 100% of their investment in the fund over their subscription period. Fund managers will not share any carry with AngelList for their own LPs, but they will share 5% carry with AngelList for LPs sourced on its platform.

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**Preferred Return:** None

## What are the other typical terms for 506(c) Funds and Rolling Funds?

**Fund Size:** \$1M - \$10M per year

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**GP Commitment:** \$1K - \$25K per quarter

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**Investment Period:** 5 years from final close

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**Fund Life:** 10 years

	Traditional Funds	Rolling Funds
Earn management fees	✓	✓
Earn fund carry	✓	✓
Accept capital anytime		✓
Start deploying right away		✓
Auto-renewing capital		✓
Publicly fundraise		✓

Source: Angelist

## AngelList Venture Pricing

Traditional Funds	Rolling Funds™	Syndicates
<p><b>Admin fee:</b> 1% of fund size</p> <ul style="list-style-type: none"> <li>✓ No carry on your own LPs</li> <li>✓ 5% carry on AngelList LPs</li> </ul>	<p><b>Admin fee:</b> 0.15% annual of AUM</p> <ul style="list-style-type: none"> <li>✓ No carry on your own LPs</li> <li>✓ 5% carry on AngelList LPs</li> </ul>	<p><b>One-time</b> \$8k setup fee</p> <ul style="list-style-type: none"> <li>✓ No carry on your own LPs</li> <li>✓ 5% carry on AngelList LPs</li> </ul>

Source: Angelist

## FAQs

### Does a Rolling Fund have to invest all its capital every quarter?

The short answer is no. If a fund does not invest all its capital in a given quarter, the remaining capital balance is automatically rolled into the next quarterly fund as additional capital from the fund's currently participating subscribers. LPs receive a corresponding contribution to the new quarterly fund in addition to their subscribed-for capital contribution.

### How do Rolling Funds make distributions?

Distributions for Rolling Funds are similar to traditional 506(b) funds. Rolling Funds are structured as a series of limited partnerships, so subscribing LPs receive distributions, net of fees, from the quarterly funds in which they have invested.

### What's the difference between Rolling Funds and Evergreen Funds?

An Evergreen Fund is a different kind of fund structure that marks-to-market or adjusts the value of its portfolio, typically every few years, and allows new LPs to invest during this funding window. However, this fund structure is unrelated to Rolling Funds.

### What is an accredited investor?

An accredited investor means owning \$1M in net assets, not counting primary residence, or at least \$200K in annual income (\$300K with a spouse). Recently, the SEC updated the accredited investor rule to include "knowledgeable employees" of a VC fund, and these employees are exempt from the 100 LP limitation.

### What is carried interest?

Carried interest, or "carry," is the share of profits from a fund that is paid out to its fund manager as a performance fee. A fund administration platform like AngelList also charges carry as part of its fee structure for managing a fund's operations.



## What is a limited partner?

A limited partner, or “LP,” is an investor who commits capital to a fund.

## What is a general partner?

A general partner, or “GP,” leads the management of a fund, while LPs have no active role or day-to-day involvement. GPs charge both a management fee and carry for managing their fund.

# Opportunities to Build & Improve

**Regulatory:** Rule 506(c) was a step in the right direction by the SEC, but many regulatory hurdles remain enforced today that need to be updated to level the playing field for GPs and LPs, including the accredited investor requirements.

**Fund Service Providers:** There is an opportunity for another fund administration platform to build another version of AngelList focused on revenue-based investing and other innovative capital products for fund managers.

## More Reading & Listening

<https://news.crunchbase.com/news/you-keep-hearing-about-rolling-funds-and-syndicates-heres-how-they-work/>

<https://minal.substack.com/p/will-rolling-funds-roll-over-the>

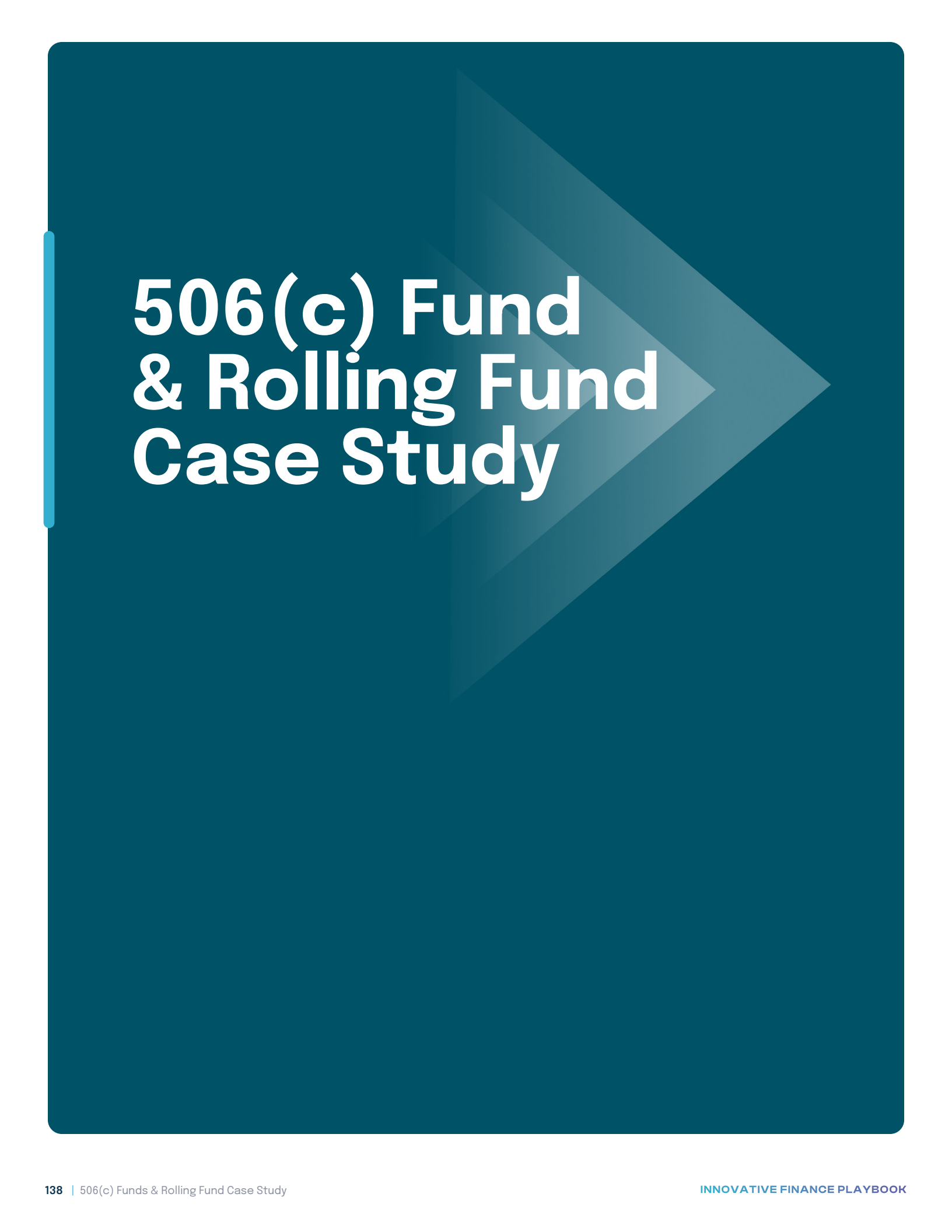
<https://s-h-l.notion.site/How-to-Raise-a-Rolling-Fund-99220e692e5e40598c2230e5c7e8dce7>

<https://calmfund.com/writing/for-investors-introducing-quarterly-subscriptions-to-the-calm-company-fund>

[https://www.linkedin.com/pulse/new-rules-equity-crowdfunding-2021-chris-harvey/?trk=public\\_profile\\_article\\_view](https://www.linkedin.com/pulse/new-rules-equity-crowdfunding-2021-chris-harvey/?trk=public_profile_article_view)

<https://www.investor.gov/introduction-investing/investing-basics/glossary/rule-506-regulation-d>

For more tools and resources, visit [innovative.finance/resources](#).



# 506(c) Fund & Rolling Fund Case Study

# RARE BREED



RareBreed Founder & Managing Partner: Mac Conwell

## Overview

McKeever “Mac” Conwell II, is the founder and managing partner of [RareBreed Ventures](#) (RareBreed), a pre-seed stage venture fund based in Baltimore, Maryland. Previously, he was a seed-stage fund manager at the Maryland Technology Development Corporation (TEDCO), software engineer, and two-time founder. RareBreed invests early in founders outside of the large tech ecosystem of Silicon Valley, New York, and Boston. With early meaningful cash upfront, wraparound services to increase capacity, and institutional knowledge, RareBreed aims to accelerate a company's growth at the earliest stages.

In September 2020, Mac left TEDCO to launch his first venture capital fund and structured it as a 506(c) fund. He primarily built his LP network from scratch by publicly marketing RareBreed on Twitter. In Q1 2022, he closed \$10M for Fund I with the support of Alpaca VC, Carta, Insight Partners, Plexco Capital, and a number of individual LPs. He plans to launch his second fund at \$75M+ later in 2022.

## Why a 506(c) fund?

The 506(c) fund enabled Mac to more quickly launch and accelerate fundraising for his \$10M pilot fund than he would have with the more traditional and expensive 506(b) fund. He leveraged his [Twitter community](#)—20K followers at launch and 75K in June 2022—as a catalyst to raise his fund with 80% of LP capital coming from Twitter connections. The 506(b)

approach would have restricted his ability to publicly market his fund and deals and required larger upfront costs to pay for institutional fund service providers.

However, it was not an easy fundraising journey at all for Mac. During the first year, he had 1K+ meetings and upward of 25 meetings per day.

## Investment Strategy

RareBreed is a pre-seed fund that invests in underrepresented founders outside of large tech ecosystems, earlier than everyone else. RareBreed takes a concentrated portfolio approach by writing checks from \$50K to \$250K as the first or one of the first investors.

## Track Record

**RareBreed Ventures Fund I (2021, \$10M):** RareBreed has invested in 28 portfolio companies and generated a 1.64x MOIC and 1.57 TVPI as of December 31, 2021.

### Fund I diversity metrics:

- 64% have an underrepresented founder
- 75% are located outside major tech hubs
- 43% have a POC executive
- 32% have a female executive

### Portfolio companies include:

[Faubion](#) (Boston) creates premium custom-made engagement rings.

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[Jefa](#) (Mexico City) is a FinTech startup offering digital accounts designed for women living in Latin America.

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[Juno Medical](#) (NYC) is a primary care company.

## Minority Business Pre-Seed Fund at TEDCO (2016-20)

Mac was the fund manager of the Minority Business Pre-Seed Fund (MPBF), which is a VC fund created through a partnership between TEDCO and Harbor Bank Community Development Corporation to address the capital needs of minority entrepreneurs in Maryland. The MBPF program makes investments of up to \$40K to help minority entrepreneurs take a technology-based idea or concept that represents a viable business opportunity and develop it into a product that can be tested with potential users.

### Fund Structure & Fund Terms

**Fund:** RareBreed Ventures LP (Delaware LLC)

**GP:** Mac Conwell

**Fund Size:** \$10M

**Minimum LP Commitment:** \$10K

**Investment Period:** 5 years

**Fund Life:** 10 years

**Management Fee:** 2% of committed capital

**Carried Interest:** 20%

**Preferred Return:** None

**Key Person:** Mac Conwell

# CDFI Funds



## TL;DR

CDFI Funds are certified by the US Treasury as organizations dedicated to providing capital to underserved communities. Many CDFIs make use of grants in addition to earned income to sustain their operations.

## Overview

The Community Development Financial Institutions (CDFI) Fund is an agency of the US Department of the Treasury, established through the Riegle Community Development and Regulatory Improvement Act of 1994. The mission of the CDFI Fund is to increase the capacity of financial institutions to provide credit, capital, and financial services to underserved markets.

Financial institutions, including banks, credit unions, loan funds, and venture capital funds, can apply to the CDFI Fund for formal certification as a CDFI. In recent years, CDFI-certified institutions have proven their worth to the economy as a key resource for excluded populations. On average, CDFIs extend nearly 75% of their lending capital in distressed areas and to underserved communities, with a special focus on rural areas, persistent poverty counties (PPCs), and high poverty census tracts. As participant lenders in the 2020-21 Paycheck Protection Program (PPP), CDFIs outperformed traditional financial institutions on nearly every measure of program effectiveness, especially in reaching very small and minority-owned businesses.

The CDFI Fund offers a variety of financial programs to provide capital to registered CDFIs. Two common and relevant CDFI institution structures are loan funds and venture capital funds.

## What is a CDFI Loan Fund?

Community development loan funds (CDLFs) provide debt financing and development services to businesses, organizations, and individuals in low-income communities.

There are four main types of loan funds: microenterprise, small business, housing, and community service organizations. Each is defined by the client served, though many loan funds serve more than one type of client in a single institution. CDLFs tend to be nonprofit and governed by boards of directors with community representation.

CDLFs must designate at least 60% of financing activities to one or more low- to moderate-income or underserved communities.

## What is a CDFI Venture Capital Fund?

Community development venture capital (CDVC) funds provide equity and debt with equity features for small and medium-sized businesses in distressed communities. They can be either for-profit or nonprofit and typically include community representation. Many, but not all, seek and receive certification from the CDFI Fund of the Department of Treasury.

The largest group of investors in CDVC funds is banks, followed by foundations, government and other socially motivated institutions, and individuals. Banks that invest in CDVC funds are motivated to do so in large part by the CRA. More than half of the capital invested in community development venture capital funds comes from banks, so banks constitute a vital component of investors in the industry.

CDVC Funds must designate at least 60% of financing activities to one or more low- to moderate-income or underserved communities.

## CDFI Fund Programs

The following programs from the Department of the Treasury's CDFI Fund *directly* provide capital and other resources for certified CDLFs and CDVCs:

**CDFI Program:** The CDFI Program offers both Financial Assistance and Technical Assistance awards to CDFIs. These competitive awards support and enhance the ability of these organizations to meet the needs of the communities they serve.

Financial Assistance awards are made in the form of loans, grants, equity investments, and deposits that CDFIs are required to match dollar-for-dollar with nonfederal funds. This requirement enables CDFIs to multiply the impact of federal investment to meet the demand for affordable financial products in economically distressed communities. Both Financial and Technical Assistance awards empower CDFIs to grow, achieve organizational sustainability, and contribute to the revitalization of the communities they serve.

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**Small Dollar Loan Program (SDL):** The Small Dollar Loan Program (SDL Program) is a new program authorized by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. The fiscal year (FY) 2021 funding round is the first award round of the program. The SDL Program was created to help Certified CDFIs address the issue of expanding consumer access to mainstream financial institutions and provide alternatives to high-cost small-dollar loans. The program was also created to help unbanked and underbanked populations build credit, access affordable capital, and allow greater access into the mainstream financial system.

Through the SDL Program, the CDFI Fund will provide:

- **Grants for Loan Loss Reserves (LLRs):** The awards will enable a CDFI to establish a loan loss reserve fund in order to defray the costs of establishing or maintaining a small dollar loan program.
- **Grants for Technical Assistance (TA):** The awards will support technology, staff support, and other eligible activities to enable a Certified CDFI to establish and maintain a small-dollar loan program.

SDL Program grants may only be used to support small dollar loan programs offering small-dollar loans to consumers that:

- are made in amounts that do not exceed \$2,500
- must be repaid in installments
- have no prepayment penalty
- have payments that are reported to at least one of the consumer reporting agencies that compiles and maintains files on consumers on a nationwide basis



**Capital Magnet Fund:** Through the Capital Magnet Fund, the CDFI Fund competitively awards funds to CDFIs and qualified nonprofit housing organizations. These awards can be used to finance affordable housing activities as well as related economic development activities and community service facilities, with the objective of attracting private capital to economically distressed communities, including underserved rural areas. Funding for the Capital Magnet Fund comes from allocations made by the government-sponsored enterprises Fannie Mae and Freddie Mac and varies from year to year.

Capital Magnet Fund awards must be used to leverage housing and economic development investments at least 10 times the size of the award amount. Award recipients are able to utilize Capital Magnet Fund awards to create financing tools such as loan loss reserves, loan funds, equity funds, risk-sharing loans, and loan guarantees. At least 70% of Capital Magnet Fund dollars must be used to finance affordable housing, and recipients may use up to 30% of funds to finance economic development activities linked to affordable housing.

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**New Markets Tax Credit (NMTC):** Through the NMTC program, the CDFI Fund allocates tax credit authority to Community Development Entities (CDEs) through a competitive application process. CDEs are financial intermediaries through which private capital flows from an investor to a qualified business located in a low-income community. Organizations that are CDFIs automatically qualify as CDEs and need only register electronically via the CDFI Fund's website. CDEs use their authority to offer tax credits to investors in exchange for equity in the CDE. Using the capital from these equity investments, CDEs can make loans and investments to businesses operating in low-income communities on better rates and terms and more flexible features than the market. In exchange for investing in CDEs, investors claim a tax credit worth 39% of their original CDE equity stake, which is claimed over a seven-year period. A certain form of CDE, called a New Markets Venture Capital (NMVC) Fund, operates much like a CDVC fund but is exclusively dedicated to investing in NMTC-eligible businesses and entities.

**The following programs from the CDFI Fund *indirectly* provide capital and other resources for certified CDLFs and CDVCs:**

**CDFI Bond Guarantee Program:** Unlike other CDFI Fund programs, the CDFI Bond Guarantee Program does not offer grants or direct loans; instead, it is a federal credit subsidy program. Qualified entities (large CDFIs or their designees) issue bonds that are guaranteed by the federal government and use the bond proceeds to extend credit to the broader CDFI industry for community development purposes or to refinance certain existing obligations. As a Qualified Issuer, a Certified CDFI applies to the CDFI Fund for authorization to issue bonds worth a minimum of \$100M. The CDFI Fund provides

a 100% guarantee on these bonds, up to \$1B per year. The Qualified Issuer then sells the government-backed bonds to the Federal Financing Bank. Each bond has a maximum maturity of 30 years. The Qualified Issuer must use the proceeds from the bond sale to extend credit to other CDFIs. As a result, Qualified Issuers serve as a “go-between” financier to the broader CDFI industry. Most CDFIs participate in this program as secondary borrowers.

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**Bank Enterprise Award Program (BEA):** Rewards FDIC-insured banks and thrift banks for increasing their investments in CDFIs—thereby increasing capital sources for CDFI loan funds and CDVC funds.

Additional programs from the CDFI fund include: [Native Initiatives](#), [CDFI Rapid Response Program](#), & [Capacity Building Initiative](#)

## Fund Criteria

### When is this fund model a good fit for fund managers?

CDLFs and CDVCs are typically associated with economic development initiatives and, as such, are most often managed by nonprofit organizations or fund managers with some affiliation with community development. Because of the unique organizational structure of these funds and their mission-oriented nature, CDLFs and CDVCs are often spun-out of existing nonprofits, governmental entities, or other community economic development organizations. One such example is the Cincinnati Minority Business Accelerator, which, after running an accelerator program for 16 years, ultimately decided to launch its own CDVC fund to invest in local Black-owned businesses.

Successful CDLF managers tend to have backgrounds in banking, private credit, and economic development work. Top CDVC fund managers share many of the same traits—especially experience in traditional venture capital and impact investing. For fund managers with a strong economic development mission and a comfort interfacing with federal government entities, CDFI funds may be a good fit.

# Benefits vs. Costs

## Benefits

**Low Cost of Capital:** Grants and low-interest loans via the CDFI Fund can offset operational expenses related to higher costs of customer acquisition, marketing and outreach, and loan loss reserves—all of which are associated with the task of bringing capital products to otherwise underserved markets.

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**High Quality Communities of Practice:** Industry trade groups for CDVC fund managers (CDVCA) and for CDLF managers (OFN). Well publicized events, industry leaders, and a high degree of industry camaraderie.

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**Community Reinvestment Act (CRA) Capital:** Banks and other depository institutions often invest in, lend to, or make donations to CDFI entities to satisfy requirements of the Community Reinvestment Act—a source of capital that many CDFIs heavily rely upon.

## Costs

**Bureaucracy:** CDFI certification can be a tedious process, and annual compliance reporting does create an administrative burden for fund managers.

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**Demographic Limitations:** Obligations to deliver at least 60% of financial products to business or individuals of low-to-moderate income or from underserved communities can be challenging in certain geographies or business sectors.

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**Higher Costs of Doing Business:** Bringing capital products to historically underserved entrepreneurs and market segments can often mean increased costs of doing business.

# Fund Pricing & Terms

## CDFI Loan Funds (CDLFs)

**Average Fund Size:** In 2019 the average CDFI loan fund had assets of \$49M.

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**Subscription Amount:** Typically minimum fund-level investment around \$100K, although third-party pooled funds such as [CNote](#) collect smaller investments from nonaccredited investors and allow secondhand exposure to CDFI funds at much smaller subscription amounts.

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**Subscription Period:** Low-interest loans or bonds to CDFI entities typically structured over 5-7 years. LP investments in loan funds typically structured over 7- to 10-year hold periods.

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<b>Management Fee:</b> N/A	<b>Carried Interest:</b> N/A	<b>Preferred Return:</b> N/A
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**GP Commitment:** All operational expenses, loan loss reserves

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**Investment Period:** N/A—capital constantly recycling

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**Fund Life:** Ongoing/perpetual

## Community Development Venture Capital Funds (CDVCs)

**Average Fund Size:** In 2019 the average CDVC fund had assets of roughly \$25M.

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**Subscription Amount:** CDVC funds typically have a minimum LP commitment around \$100K.

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**Subscription Period:** 7-10 years on average

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**Management Fee:** Similar to VC industry average, typically around 2%

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**Carried Interest:** Similar to Private Equity industry average, typically around 20%

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**Preferred Return:** Similar to Private Equity industry average, typically around 8%

**GP Commitment:** All operating expenses, CDFI certification, and compliance.

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**Investment Period:** For CDVC funds providing solely equity investments, investing takes place from first fundraising close to years three to five. For CDVC funds providing debt with equity features, lending can take place for the entire lifetime of the fund.

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**Fund Life:** 7-10 years

## FAQs

### What are the reporting requirements for a CDFI?

All CDFIs are required to complete an annual certification report to keep their CDFI certification. This report must be submitted within 90 days of the end of the organization's fiscal year, and may use unaudited financials.

### Does registering as a CDFI come with guaranteed funding?

No. CDFI certification simply enables an organization to participate in programming and apply for grants from the CDFI Fund. It also typically helps fundraising efforts, especially with organizations whose investments are guided by Community Reinvestment Act obligations.

### How many CDFIs are currently certified?

According to the CDFI Fund, there are currently 1,200+ registered CDFI entities.

### What kind of activities do CDFIs engage in (besides lending)?

CDFIs also frequently provide some form of technical assistance to small businesses in the communities in which they operate. This assistance can range from general networking and informal community events to specific training programs and direct consulting engagements with small businesses.

## How can I find a CDFI near me?

Opportunity Finance Network (OFN), an industry trade group for CDFIs, maintains a searchable database [here](#). Entrepreneurs can also use the [Connect2Capital Marketplace](#) to be matched with an eligible CDFI lender based on business funding needs and location.

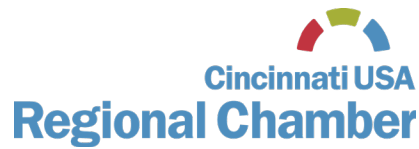
## | Opportunities to Build & Improve

**FinTech innovation:** CDFI Loan Funds are increasingly competing with well-funded, direct-to-consumer Silicon Valley financial technology companies like Square, Toast, Kabbage, and more. These companies leverage data and technology to bring capital products to entrepreneurs—often at rates much higher than CDFIs are offering. CDFIs must adopt technology and marketing best practices if they wish to educate entrepreneurs, compete for business, and be seen as legitimate options in the ever-changing capital marketplace.

**CDVC attention:** While CDLFs have enjoyed a recent rise to prominence in conversations around community economic development and equitable access to capital, CDVC funds remain conspicuously absent from many of these discussions. A national trade association for CDVC funds, the [Certified Development Venture Capital Alliance](#) (CDVCA), is working on increasing access and visibility for CDVCs across the US.



# CDFI Fund Case Study



## Overview

The Cincinnati Minority Business Accelerator’s inaugural investment fund, “MBA Fund 1” was launched in 2022 and is planned to soon be certified as a CDVC fund. Because of this forthcoming certification, MBA Fund 1 has been able to raise nearly \$50M from regional and national banks due to their motivations to satisfy Community Reinvestment Act requirements. MBA Fund 1’s unique approach to investing in and creating Black-owned businesses in Cincinnati means that the fund will deploy the majority of its capital to underserved entrepreneurs, making it a safe fund-level investment from a CRA standpoint.

The process of certifying as a CDVC is not entirely straightforward, which has led the MBA Fund 1 team to devise a careful strategy for approaching the process. The CDFI Fund will not certify an entity without any existing investments, so the MBA Fund must accept some investments, hold a “first close” for their fundraising, and make at least one investment in a CDFI eligible business before submitting their application to the Treasury. Then, once the entity is certified as a CDFI, the remainder of the fund investors who required certification before investing will complete their investments, and the fund will close with a hopeful \$100M of capital to invest in the community.

## Investment Strategy

MBA Fund 1 will invest over a 10-year period in private businesses—at least 75% of which will be in and around the Cincinnati area. The fund will make use of an innovative, multimodal investment approach, offering the following capital products:

- Traditional equity investments
- Revenue-based investments
- Traditional term loans
- Ownership acquisition financing & private equity investments



## Fund Structure

**Management Company:** The Cincinnati Minority Business Accelerator, a subsidiary of the Cincinnati Area Chamber of Commerce

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**Fund:** MBA Fund 1, LLC

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**GP:** MBA Fund 1 Management, LLC

## Fund Terms

**Fund Size:** \$100M

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**GP Commitment:** TBD

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**Investment Period:** 5 years

**Fund Life:** 10 years

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**Management Fee:** 2% of committed capital

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**Carried Interest:** 20%

**Preferred Return:** 8%

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**Key Person:** Darrin Redus

# Donor Advised Funds



## TL;DR

A donor advised fund (DAF) is a philanthropic giving vehicle with the flexibility to invest in a variety of asset types.

## What is a DAF?

DAFs started in the US during the 1930s as philanthropic giving vehicles that enabled donors—individuals, families, companies, or institutions—to invest in a variety of asset types while receiving immediate tax benefits. Following a DAF contribution, a donor maintains control over the timing of grant distributions to charitable organizations from that DAF, but they also receive tax benefits for charitable contributions based on the timing of contributions to the DAF.

DAFs are created and administered by a sponsor such as community foundations (e.g., Silicon Valley Community Foundation), national charities (e.g., ImpactAssets and Fidelity Charitable), and single-issue charities (e.g., universities and faith-based charities). As of 2021, DAF sponsors held \$160B+ in assets under management (AUM).

**Here are four proven mechanisms for investors leveraging DAFs to support underrepresented entrepreneurs and fund managers:**

1. Make a grant from DAF to a nonprofit intermediary that supports underrepresented entrepreneurs or fund managers.

2. Make a debt investment from DAF to a nonprofit intermediary that supports underrepresented entrepreneurs or fund managers.
3. Make a grant from DAF to a for-profit organization that qualifies as charitable.
4. Make an equity or debt investment from DAF to a for-profit organization or for-profit intermediary (e.g., Capital Access Lab, MIT Solve Innovation Future, and PRIME Coalition).

## Fund Criteria

### When is a DAF a good fit for capital providers?

**Cheaper & Faster Launch:** Compared to a traditional GP/LP fund structure, a DAF is easier and faster to set up and launch for investors.

**Tax Efficiency:** Taxable investors, including individuals and families, can receive immediate tax benefits and postpone charitable giving by contributing to a DAF.

**Access to Philanthropic Capital:** Many donors leverage DAFs as a way to offset their high income years with flexible charitable giving. DAFs allow donors to have more time to decide when and how they will make distribution to charities. Investors can either launch their own DAF vehicles to attract philanthropic capital or market their funds to DAF platforms.

**Flexible Investment Options:** DAFs have the flexibility to invest in a wide variety of assets, including startups, small businesses, real assets, and fund managers. Additionally, DAF managers have the flexibility to make equity, debt, and innovative investments or grants.

### When is a DAF not a fit for capital providers?

**Raising Capital beyond Donors:** The DAF vehicle allows investors to raise philanthropic capital, but it does not allow investors to raise other types of “LP” capital. Investors need to set up investment vehicles beyond DAFs, such as 506(b) or 506(c) funds, to accept other sources of LP capital.

**Investments outside of Charitable Purpose:** DAF managers need to align their impact investments with the donors’ charitable purpose. Otherwise, the DAF managers and sponsors are subject to excise taxes for investments outside of their charitable purpose.

## What should capital providers look out for with DAFs?

**Philanthropic Signal:** DAFs can be a powerful financing tool for early-stage entrepreneurs and fund managers; however, potential coinvestors and follow-on investors may view DAF capital as a signal for concessionary returns.

**Potential Tax Shelter:** DAFs can be used as a tax shelter for donors, as their contributions sit in DAFs for years before they decide to grant them to charities. Donors do not need to invest their DAF contributions in mission-driven organizations or assets. A small percentage of the \$110B+ in DAF capital across the US was invested for impact.

## Fund Pricing & Terms

### What do DAF sponsors typically charge for DAFs?

**Administrative Fee:** tiered fee levels based on AUM

- First \$100K: 1.00% annual fee
- Next \$400K: 0.75%
- Next \$500K: 0.50%
- Next \$9M: 0.25%
- \$10M+: 0.125%

**Investment Administrative Fee:** additional fees per investment the DAF makes

- First \$100K: 0.80%
- Next \$100K: 0.60%
- \$200K+: 0.40%

# FAQs

## Can a DAF make direct investments or fund investments?

Yes, a DAF can make both direct and fund investments.

## What tax liabilities might occur when making investments or distributions from a DAF?

Donors and DAF sponsors might have to pay excise taxes if the DAF investments or distributions do not align with the donors' charitable purpose.

## What are the potential tax benefits associated with DAFs for donors?

Tax benefits for donors include avoiding capital gains taxes and receiving a federal income tax deduction of up to 50% of adjusted gross income (AGI) for cash contributions. More tax advantages are listed below.

	DONOR ADVISED FUND	PRIVATE FOUNDATION
TAX DEDUCTIONS - CASH	60% of AGI/year	30% of AGI/year
TAX DEDUCTIONS - SECURITIES & REAL PROPERTY	30% of AGI/year	20% of AGI/year
GRANT REQUIREMENTS	5% annually suggested	5% annually required
EXCISE TAX ON INVESTMENT INCOME	None	Up to 2% of income
ANONYMITY	Upon request	Taxes - grants are public
SEPERATE TAX RETURN REQUIRED	None	Yes - Form 990
ANNUAL ADMINISTRATIVE COSTS	.125%-1% (for the ImpactAssets Donor Advised Fund)	Variable/High

Source: ImpactAssets

## Can donors make noncash contributions to DAFs?

Yes, donors can contribute noncash assets like real estate, stock, and crypto to DAFs and receive immediate tax benefits.



# Donor Advised Fund Case Studies

**Capital Access Lab | 159**

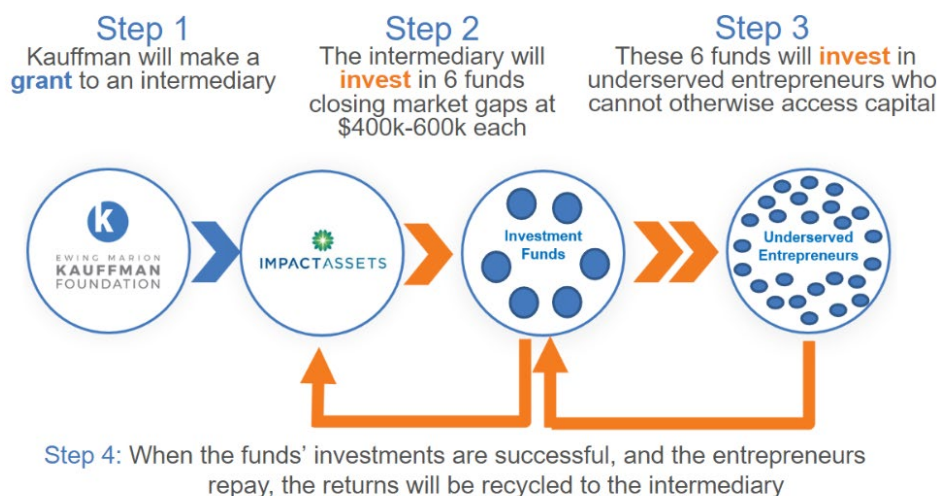
**MIT Solve | 162**



## Overview

Launched in 2019, the [Capital Access Lab](#) is a national pilot initiative that aims to find, promote, and scale innovative fund managers, providing new kinds of capital to the 83%+ of underserved entrepreneurs and communities in the United States.

The Ewing Marion Kauffman Foundation (Kauffman Foundation) committed \$3M to seed this new initiative with follow-on funding of \$500K from the Rockefeller Foundation. CAL was structured as a DAF under the sponsorship of public charity ImpactAssets.



Source: Capital Access Lab

## Investment Strategy

CAL used a fund-of-funds (FoF) approach to seed innovative fund models that do not resemble traditional VC or lending. The FoF aims to spur the formation of new capital products, such as revenue-based loans and redeemable equity, which increase investment to underserved entrepreneurs who have been historically left behind due to their race, ethnicity, gender, socioeconomic class, and/or geographic location. CAL primarily makes anchor LP investments of \$400K to \$600K into emerging fund managers that make direct

investments to underserved entrepreneurs across the US. CAL's pipeline included 120+ funds across 38 states, 60% of which were led by women and 45% of which were led by people of color.

## Track Record

**Capital Access Lab (2019, \$3.5M):** As of June 2022, CAL has invested \$3.4M in six funds, catalyzing an additional \$166M+ in investments for the funds.

### CAL's portfolio funds include:

[Anzu Partners](#) (DC) is an early-stage investment firm that backs industrial and life science technology companies in manufacturing, materials, modeling, and measurement. Anzu launched a revenue-based fund to expand its product offerings beyond traditional VC.

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[1863 Ventures](#) (DC) is a \$10M revenue-based financing fund for New Majority entrepreneurs.

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[Capacity Capital](#) (Chattanooga, TN) is a \$2M place-based fund providing redeemable equity for local small businesses in Chattanooga.

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[Collab Capital](#) (Atlanta) is a \$52M early-stage fund that uses an innovative profit share model for Black founders in the US.

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[Indie.vc](#) (Salt Lake City, UT) provides seed-stage funding for overlooked startups that do not scale big enough or fast enough for traditional VC.

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[Founders First Capital Partners](#) (San Diego, CA) provides revenue-based funding and business acceleration support to service-based small businesses led by underrepresented founders outside of major capital markets.

## Why was a DAF a good fit for CAL?

The DAF structure was a good fit for CAL because it unlocked grant funding from the Kauffman Foundation and Rockefeller Foundation to make market-rate LP investments in first-time and emerging fund managers with innovative models. The DAF served as a flexible investment vehicle for CAL to launch quickly and enable the team to get creative with the investment strategy. If CAL launched a traditional FoF structure, it would have cost significantly more, taken several years to raise LP capital, and delayed capital flowing to innovative capital models and, ultimately, underserved entrepreneurs across the US.



## Fund Structure

**Donor:** Ewing Marion Kauffman Foundation

**Donor Advisor:** Capital Access Lab

**DAF Sponsor:** ImpactAssets, Inc.

**Fund:** Kauffman Capital Access Fund

**Fund Type:** DAF

**Capital Products:** LP commitments and GP investments

**Launch Date:** December 2018

**Grant Amount:** \$3M

## DAF Fees

**Total Annual Fees:** 0.90%

**Annual Administrative Fee (blended):** 0.38%

**Annual Investment Administrative Fee (blended):** 0.52%

## More Reading & Listening

[Access to Capital for Entrepreneurs: Removing Barriers](#)

[Access to Capital for Entrepreneurs: Removing Barriers Report \(2021 Update\)](#)

<https://www.kauffman.org/capital-access-lab/news/>

**For more tools and resources, visit [innovative.finance/resources](https://www.innovative.finance/resources).**

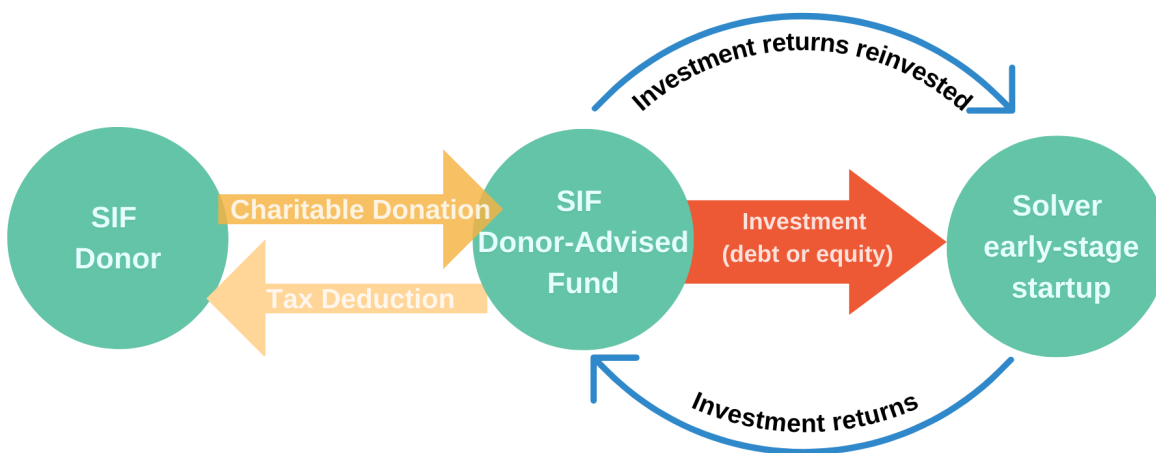


## Overview

[MIT Solve](#) is a global initiative of the Massachusetts Institute of Technology (MIT) in Cambridge, Massachusetts, with a mission to solve world challenges. Launched in 2016, MIT Solve is a tech incubator and marketplace for social impact innovation. In 2019, MIT Solve launched the [Solve Innovation Future](#) venture fund to provide flexible, early-stage capital for social entrepreneurs through its open innovation Global Challenges that focus on sustainability, health, economics, and education.

Solve Innovation Future was set up as a DAF under the sponsorship of US public charity ImpactAssets. The fund is led by Principal Casey van der Stricht and is targeting \$30M from donors through tax-deductible gifts to MIT. The DAF received up to \$3M in anchor funding from Founder and CEO Noubar Afeyan of Flagship Pioneering.

Powered by philanthropic capital, Solve Innovation Future (SIF) is an evergreen venture vehicle: driving impactful investing in game-changing innovations and fueling the future of philanthropy.



Source: MIT Solve

## Investment Strategy

Solve Innovation Future makes seed- and early-stage investments in social entrepreneurs with a mix of equity, debt, and innovative capital. The DAF will make \$100K to \$250K investments for five or more companies annually that participate in their global “Solver” events. The evergreen-like philanthropic vehicle allows the Solve team to reinvest proceeds from the DAF into the next generation of social entrepreneurs.

## Track Record

**Solve Innovation Future (2019, \$30M target):** As of June 2022, Solve Innovation Future has catalyzed nearly 4x its investment in additional investment capital toward its Solver teams.

### Its portfolio includes:

[Access Afya](#) (Nairobi) is a social enterprise that provides high quality, affordable primary healthcare in Nairobi's informal settlements.

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[Algramo](#) (Santiago, Chile) is building a high-tech reusable packaging system to counter plastic waste.

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[CENTURY Tech](#) (London) is an AI-powered platform that personalizes education and improves learning outcomes.

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[eggXYt](#) (Jerusalem) is developing the ultrasound technology for eggs to enable a sustainable future in the livestock industry.

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[Kinedu](#) (Monterrey, Mexico) is on a mission to improve the beginning of every small child's story by fostering quality learning experiences at home, at school, and everywhere in between.

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[Queen of Raw](#) (NYC) enables fashion brands and retailers to buy and sell unused textiles with its global network, providing businesses a quick and easy way to secure discounted materials based on real-time location and availability while generating revenue and offloading excess stock.

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[Someone Somewhere](#) (Mexico City) is a digitally native brand on a mission to lift millions of artisans out of poverty.

Here are more details on its [portfolio companies](#).

## Fund Structure

**Donors:** Various individuals & institutions

<b>Donor Advisor:</b> MIT Solve	<b>DAF Sponsor:</b> ImpactAssets, Inc.
<b>Fund:</b> Solve Innovation Future	<b>Fund Type:</b> DAF

**Capital Products:** SAFE, convertible notes, equity, loans, redeemable equity, and revenue-based loans

**Launch Date:** May 2019

**Target Size:** \$30M

# Small Business Investment Companies



## TL;DR

Small Business Investment Companies (SBICs) are privately owned investment funds, licensed and regulated by the Small Business Administration (SBA).

## Background

Congress established the Small Business Investment Company program in 1958 to create another pathway for long-term capital to be made accessible to small businesses. After an SBIC is licensed and approved, the SBA makes a commitment to provide a set amount of leverage over several years. The application process to become a registered SBIC is rigorous, but once registered, fund managers have the ability to leverage federal money to capitalize their investment funds at a matching rate of 2:1 for every dollar of private capital raised. This uniquely subsidized capitalization structure, paired with the stringent fund requirements, ensures that SBICs can provide small businesses with various capital products that are often more favorable than traditional bank loans or venture capital investments.

Since its inception, the SBIC program has provided over \$100B in capital to entrepreneurs across the country. These funds have helped transform small firms into powerhouse job-creators. Early-stage small businesses that received SBIC investments include Apple, Costco, FedEx, and Intel. In fiscal year 2020, SBICs financed 1,063 small businesses, with an average amount of just under \$2M. These funds helped entrepreneurs acquire new companies, refinance debt, conduct R&D, purchase equipment, and generally operate their enterprise. In 2020, the SBA licensed 26 new SBICs, up from 18 in 2019. And, in 2021, they broke the record again, licensing 32 new SBICs.

One common and important criticism of the SBIC program is its lack of demographic diversity—both among fund manager participants and small businesses funded. In 2007, the SBA formally acknowledged that women and minorities participated in the program at low rates. Today, the diversity numbers haven't budged; for example, in 2020, SBICs only made up around 5% of their total financing to minority-owned small businesses. The numbers were even worse for businesses owned by women and veterans.

## What is an SBIC?

SBICs are licensed private fund managers who receive low-cost, government-backed capital from the SBA to invest in US small businesses. Roughly 300 exist currently, and a full list of all current SBICs can be found on the Small Business Administration's website.

### SBIC Funds can offer the following types of capital for small businesses:

- **Debt:** A typical SBIC loan ranges from \$250K to \$10M, with an interest rate between 9% and 16%.
- **Equity:** SBICs invest in a business in exchange for a share of ownership in the company. Typical investment amounts range from \$100K to \$5M.
- **Debt/Equity Hybrid:** Financing includes a combination of loans and ownership shares. Loan interest rates are typically between 10% and 14%. Investments range from \$250K to \$10M.

### Key features of SBICs:

- Under the most common and broadest “standard” SBIC license, SBA provides up to 2x leverage to private LP capital in a fund, up to \$175M max fund size.
- SBICs may invest in companies using debt, equity, or “debt with equity features.” SBICs may control a small business for up to seven years (or longer with SBA approval).
- At least two managing members of the SBIC must have 10+ years of experience investing in or supporting small businesses.

- Application to register as an SBIC is highly competitive and lasts at least 1 year. Further application FAQs can be found on the Small Business Administration's SBIC web page.
- Benefits for "Impact SBICs" include a potentially accelerated application process and additional support.
- SBICs are typically not permitted to invest in project finance, real estate, or passive entities such as a nonbusiness partnership or trust. Proceeds from the SBA's capital match "debenture" can only be used to invest in small businesses per the regulations and parameters defined by the SBA's Office of Size and Standards.

### Benefits of forming a SBIC:

In addition to having a positive impact on small businesses and the economy, the SBIC program offers multiple benefits to fund managers:

- **Rapid Fund Deployment:** The potential to capitalize as much as two-thirds of a fund with SBA leverage means managers spend less time fundraising and more time investing.
- **Flexible Terms:** The duration of SBA's financing instruments can easily be matched up with short- or long-term investments.
- **Exempt from SEC Registration:** SBICs are exempt from SEC registration, yet LPs benefit from SBA's careful monitoring of each fund's performance and regulatory compliance.
- **Exempt from Volcker Rule:** SBICs are exempt from the bank investment limitations set forth in the Volcker Rule as part of the Dodd-Frank Wall Street Reform and Consumer Protection Act.
- **Increased Financial Scale:** SBA leverage allows funds to scale up their strategies and extend their financings to more businesses.
- **Enhanced Returns Potential:** SBA-guaranteed capital is low cost and does not participate in profit.
- **CRA Credit:** Investments in SBICs are presumed to be a "qualified investment" for Community Reinvestment Act credit.

## **SBIC Benefits to Investors:**

For more than a decade, SBICs have delivered returns to their investors that are in line with those available from other private equity funds in the market. Since 1998, SBICs that benchmark in the top half of private equity have delivered a 5- to 10-point boost in the IRR delivered to LPs as a result of SBA leverage.

## **Costs of forming a SBIC:**

- The accounting, bookkeeping, and back-office rigor required to establish and maintain an SBIC fund is greater than that associated with a typical private investment fund. Therefore, an SBIC fund typically requires a more significant investment in the organizational entity itself, especially in staff time and outsourced legal and accounting.
- The timeline to establish and formally register an SBIC from idea to completion typically takes 12 to 24 months. For opportunistic investors, this timeline often is the major constraint that inhibits use of the program.





# Small Business Investment Company Case Study



STONEHENGE  
— CAPITAL —

## Overview

[Stonehenge Capital](#) is a nationally focused investment company, managing funds of various types in geographies across the US. Established in 1999, Stonehenge makes high impact investments in areas targeted for economic revitalization, primarily using federal and state tax incentive programs. To date, the firm has managed more than \$1.1B in federal and state New Markets Tax Credit allocations, including several loan funds with place-based strategies designed to address the capital needs of small businesses in underserved communities. Stonehenge also manages one Small Business Investment Company (SBIC) fund, called Stonehenge Community Impact Fund LP.

This SBIC fund builds on Stonehenge's existing experience deploying capital to businesses within economically distressed or disadvantaged communities. The criteria for the Stonehenge Community Impact Fund is similar in many regards to the firm's other investment funds: targeting lower-income census tracts, HUB Zones, and minority entrepreneurs.

The fund holds roughly \$225M in total assets, and thanks to the unique and highly valuable incentive structure provided by the SBA, the Stonehenge team only had to raise roughly \$75M in private capital for the fund, which was then matched 2:1 by federal government debentures.

The lion's share of the Stonehenge SBIC fund's Limited Partner (LP) investors are banks and financial institutions—for whom an investment in this fund both satisfies their institution's motivation to generate profits, and also in many cases allows the banks to count this investment toward their total Community Reinvestment Act (CRA) obligations.

Investment in the Stonehenge Community Impact Fund works much like any other private investment fund. For instance, the fund adheres to the following, traditional criteria:

- 7- to 10-year hold period of private capital before returns to investors
- Standard fund-level "economics" including a 2% management fee charged by the General Partnership, and a nondisclosed but traditional "waterfall" structure for distributing carried interest

## Investment Strategy:

**Typical check size:** \$5M - \$15M

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**Terms:** Senior secured, senior-stretch, and unitranche debt—often including equity kickers or warrants

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**Target firm size:** Revenue of \$5M - \$75M and EBITDA of \$1M - \$10M

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**Business use(s) of funds:** General growth capital, equipment purchases, facility acquisitions or expansions, management buyouts, company acquisitions, generational transfers. Various uses of funds that banks typically are less likely to approve for secured debt.

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**Specific Focus on Low-to-Moderate Income (LMI) Communities:** Qualified locations may include but are not limited to Opportunity Zones, NMTC-eligible census tracts, rural communities, and other locations targeted for economic development.

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**Cost of Capital:** High single-digit APRs for entrepreneurs (8-10%)

## Track Record:

As of July 2022, Stonehenge SBIC has deployed \$45M of its \$225M in capital into four deals.

## Case Study: PosiGen Solar - Portfolio Company



PosiGen is a residential solar contractor focused on low- to moderate-income communities, based in New Orleans, Louisiana. The company also provides energy-efficient solutions to homeowners. Not only was PosiGen based in the appropriate geographic location for the Stonehenge SBIC fund to invest, but the business also creates a positive social and environmental impact in the community, making the deal attractive from an impact standpoint.

PosiGen needed a total of \$24M for working capital to grow the business, plus debt-refinance funding to decrease monthly debt expense and improve margins. The Stonehenge SBIC fund provided \$8M in a senior working capital facility and specifically took a risk by refinancing the company's debt for a work in progress, which allowed the company to grow more quickly without having to wait for project completion to refinance.



# Landscape Your City

# Understanding Local Capital Needs

Before developing and deploying new innovative financial products, funders and investors first need a deep understanding of their community's capital landscape and capital gaps.

Below, we've identified resources and developed step-by-step processes to help communities assess local capital needs and systematically identify new products that could be of the greatest use within their current entrepreneurial ecosystem. While this list is neither exhaustive nor comprehensive, it aims to serve as a starting point for communities that are interested in understanding where capital is flowing and where capital gaps exist.

## Comparative Approach

Given significant data limitations, landscaping efforts can benefit from a comparative frame—finding similar metros areas and comparing estimates across key sources of capital and then measuring and comparing entrepreneurial activity and success within and across given communities across demographic groups and sectors.<sup>16</sup>

**Example within the EDA Innovative Finance cohort:** *In San Antonio, the ratio of Latino/a-owned businesses ready to hire employees ("employer firms") to those doing businesses as sole proprietors ("nonemployer firms") is far lower than the ratio among Latino/a-owned firms in the Seattle MSA, 13:1 versus 5:1, let alone compared to Seattle's white-owned firms, at 3:1. As a corollary, Seattle has nearly three-times the SBA 7(a) lending volume, despite only having a 57% larger population than San Antonio. These comparisons convey current successes, inequities in entrepreneurship, and possible focus areas for improvement.*

### Data limitations:

While the primary goal is to evaluate capital demand and supply within a given community to create a picture of capital gaps, absolute levels of capital demand and supply are difficult to estimate for several reasons, including:

1. Current data provide only rough approximations of the whole access to capital picture, with rise of merchant cash advances, FinTech, and other alternatives.
2. Data releases, particularly government surveys, usually have at least a two- or three-year reporting lag.
3. Reporting varies in the geographic units used; some are by county or MSA, while other sources provide data at only state or national levels.

# The Data

## 1. Debt and Equity Capital Landscape

Capital metrics tend to focus primarily on debt products, traditionally the most widely used financial products (and most consistent, government-supported data) among current forms of startup and small business capital. These measures provide insight into an area's economic activity and, when compared across geographies, the relative availability and connections to capital for entrepreneurs.

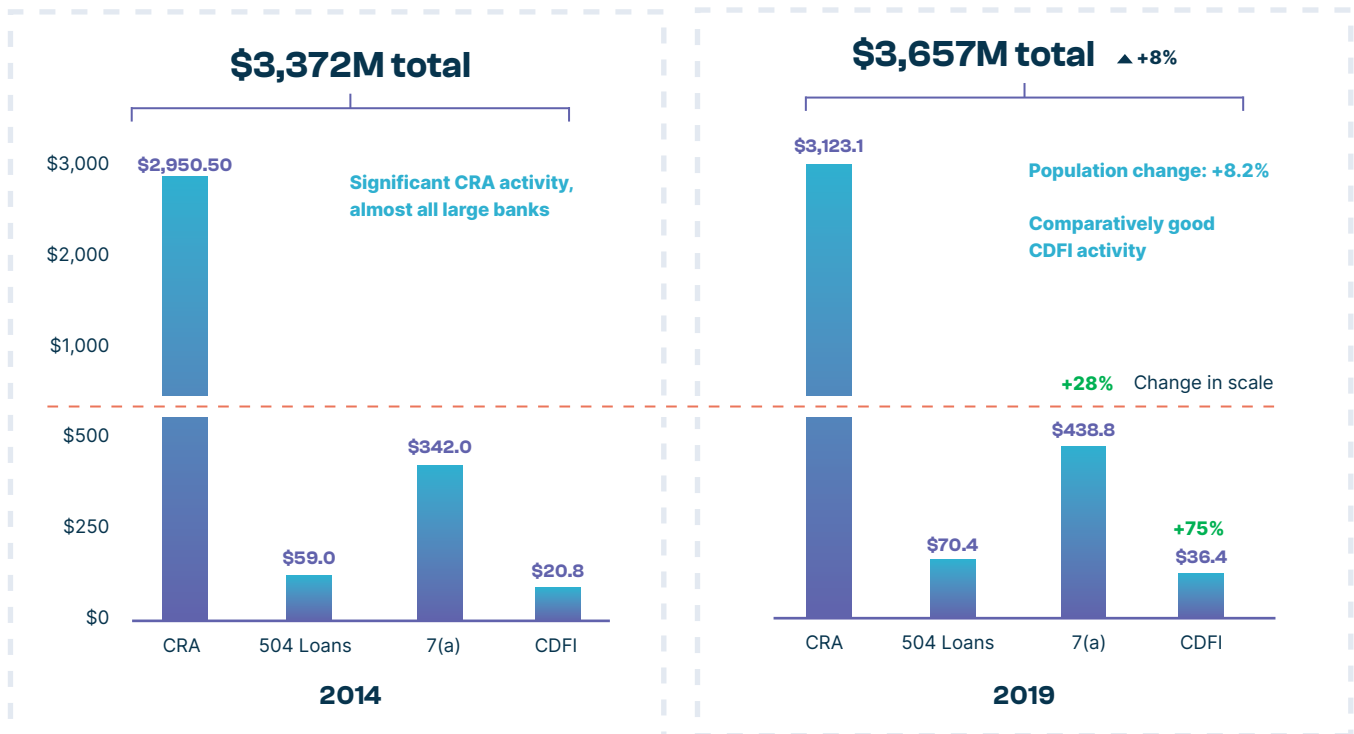
**Debt Capital Metrics:** The federal government supports and consequently tracks several debt products, though this data is not comprehensive, for multiple reasons. Debt product data do not cover all of private sector activity, for one; government reports and national data are also at times self-reported, limited to certain institutions, or too broad in their coverage, including real estate or credit card activity.

- **CRA Small Business Loans.** This includes non-SBA guaranteed bank lending eligible for Community Reinvestment Act (CRA) credit, reported by the Federal Financial Institutions Examination Council (FFIEC). Only banks above a certain asset threshold and insured by the FDIC are required to report CRA activity. CRA defines lending to small businesses generally as CRA transactions below \$1M, and reports lending by subsets of loan amounts (below \$100K, for instance) and microloans to small businesses, i.e., firms with gross annual revenues equal to or less than \$1M.<sup>17</sup>
  - **Data Limitations:** CRA allows banks to count the full lines of credit on business credit cards issued to CRA-eligible businesses (vs. actual amount drawn). This increases the volume and lowers the average “loan” amount for banks that are also large credit card issuers, such as Citi, American Express, Capital One, with products that usually come at a high-interest cost of capital.<sup>18</sup>
- **SBA 504 Loans.** Through its 504 loan program, SBA supports long-term, fixed-rate financing for major fixed assets that promote business growth and job creation (e.g., existing buildings or land, new facilities, and long-term machinery and equipment). 504 loans are primarily used for real estate or large equipment purchases, typically have a lower interest rate and down payment, and do not require additional collateral.<sup>19</sup>
- **SBA 7(a) Loans.** SBA's most common loan program—7(a) loans—help small businesses access working capital, up to \$5M, and are generally considered higher-risk loans, thus requiring a lower down payment and having a variable interest rate.<sup>20</sup>
  - The SBA provides all transaction data for 504 and 7(a) loans online—relatively up-to-date for download through SBA.gov.<sup>21</sup>

- CDFIs Loans.** CDFIs are certified by the US Department of the Treasury and dedicated to delivering responsible, affordable lending to help low-income, low-wealth, and other disadvantaged people—helping communities access capital for small businesses, housing and other construction, and personal banking needs. Compiled by PolicyMap from Community Investment Impact System, communities can identify total dollar amount of CDFI loans to business borrowers.<sup>22</sup> CDFI business lending data can also be disaggregated to show microlending to firms with five or fewer employees, including sole proprietors, i.e., nonemployer firms.

- Data Limitations:** CDFI loan data is among the noisiest used as it is self-reported by CDFIs, underreporting lending, and appears to sometimes include larger real estate transactions, overinflating lending totals, and at least some areas' average loan sizes.

### Small Business Debt Landscape Example: Seattle MSA



The above example from our Seattle MSA landscape analysis shows snapshots for 2014 and 2019 small business lending. Despite limitations in the data, and compared to other cohort members, the Seattle MSA shows strong commercial lending activity through large CRA numbers, robust 7(a) activity, and a substantial increase in CDFI business lending.



**Equity Capital Metrics:** Equity and other private investment data is harder to come by, but there are some sources that can be helpful to gain high-level insight into equity activity in your community:

- **PitchBook, Crunchbase, and other proprietary data:** Pitchbook and other third parties, such as PwC, track and compile data, though often on a one-off and self-reported. Still, funders may find it useful in analyzing their capital landscape.<sup>23</sup>
- **The National Venture Capital Association:** This group breaks down and publishes PitchBook VC activity data by state, a useful tool for VC data that is both granular (by geography) and compiled (versus deal-by-deal data).<sup>24</sup>
- **The 2018 Rise of the Global StartUp City report by Richard Florida and Ian Hathaway:** This report provides further publicly available analysis of PitchBook data to show VC investment by number of deals and total investment dollars by metro area.<sup>25</sup> The report covers more than 100 US metros and investment data from 60 countries. Punto Lab systematized the data in an online spreadsheet available for analysis.<sup>26</sup>

**Other Sources:** Alternative sources of data that could serve further analysis covering developments in FinTech and providing more up-to-date, national data include:

- **The Kabbage Small Business Index:** This index provides state-level data, compiled from its clients up until December 2020.<sup>27</sup>
- **Point-of-sale merchant cash advances:** Some are required to disclose loan amounts and numbers in their filings with the US Securities and Exchange Commission.<sup>28</sup>
- **US Census Bureau's Small Business Pulse Survey:** This survey (also offered at the state level) is based on a high-frequency questionnaire of small businesses on overall effect of the COVID-19, trends in revenues, whether they are open or closed, staffing, and other useful information.<sup>29</sup>
- **The Financial Health Network:** Many FinTech companies are part of this industry group, which is required to share data.<sup>30</sup>
- **Local sources:** Local sources, such as business chambers, local governments, your area's Federal Reserve Bank, or other sources may have data specific to your geography.<sup>31</sup>

## 2. Firm Demographics and Industry Landscape

### Size, Sector, Number of Firms by Demographic Group

Understanding the demographic makeup of business owners and leadership in your community is key to understanding the capital gaps that may exist. The US Census Bureau's Annual Business survey data allow analysis of the **number**, **size**, and **sector** by demographics of business ownership by various geographies.

The Number, Size, and Sector framework was introduced in the Nowak Metro Finance Lab's Small Business Equity Toolkit, to compare business ownership across demographic groups across the United States' 100-largest cities and metros and highlight opportunities through supplier diversity in what the Lab has coined the Procurement Economy, to unlock B2B and B2G contracts for local and diverse suppliers. From this analysis and compared to traditionally well-resourced and -represented entrepreneurs, landscaping shows overall strengths and growth opportunities within an entrepreneurial ecosystem, and "tip of the iceberg" outcomes that could denote underlying capital access and technical capacity gaps decision makers could address.

**Size, Sector, Number Example:** In Seattle, growth opportunities include its large Asian-American and Black communities, as well as support for women entrepreneurs:

- **Number:**
  - Woman-owned businesses lag behind their male counterparts in relative number.
  - Asian-American-owned businesses keep pace with their white counterparts.
  - Firm ownership is lowest among Black Seattleites, as measured on a per resident basis.
- **Size:**
  - Despite their relatively high concentration, Asian-American-owned firms in Seattle fall far behind white business owners in terms of average annual sales.
  - Average sales for women-owned businesses are one-third the amount of men's.
  - Average sales is also lowest among Black-owned businesses in Seattle.
- **Sector:**
  - Asian-American-owned business in Seattle are highly concentrated in low-wage industries, constituting more than half of all Asian-American-owned firms.
  - Women-owned businesses are 50% more likely to be in a low-wage sector compared to their male counterparts.
  - Black-owned businesses are less represented in low-wage sectors, though this
  - may be a feature of very low representation and high margin of error in the Black business ownership.

### Seattle Asian-Owned Business Baseline

Number of Businesses		Business Size		Business Sector*	
22.5	Asian-Owned Businesses per 1,000 Asian Residents	\$1.3M	Avg. Annual Sales from Asian-Owned Businesses	51%	Asian-Owned Businesses in Low-Wage Industries
24.1	White-Owned Businesses per 1,000 White Residents	\$2.6M	Avg. Annual Sales from White-Owned Businesses	43%	White-Owned Businesses in Low-Wage Industries

### Seattle Woman-Owned Business Baseline

Number of Businesses		Business Size		Business Sector*	
9.2	Woman-Owned Businesses per 1,000 Woman Residents	\$1.1M	Avg. Annual Sales from Woman-Owned Businesses	34%	Woman-Owned Businesses in Low-Wage Industries
22.3	Male-Owned Businesses per 1,000 Male Residents	\$3.3M	Avg. Annual Sales from Male-Owned Businesses	22%	Male-Owned Businesses in Low-Wage Industries

### Seattle Black-Owned Business Baseline

Number of Businesses		Business Size		Business Sector*	
4.8	Black-Owned Businesses per 1,000 Black Residents	\$1.0M	Avg. Annual Sales from Black-Owned Businesses	16%	Black-Owned Businesses in Low-Wage Industries
24.1	White-Owned Businesses per 1,000 White Residents	\$2.6M	Avg. Annual Sales from White-Owned Businesses	43%	White-Owned Businesses in Low-Wage Industries

## High Wage, Low Wage, and Industry Metrics

Once you have a picture of the breakdown of firm ownership by demographic, it is important to look at those firms in the context of high wage firms, low wage firms, and general industry.

**“High-wage” industries:** represents the percentage of firms in the professional and technical services sector, among the highest-paid sectors nationally and with consistent data availability

- **Data:** Census Bureau’s Annual Business Survey and American Community Survey

**“Low-wage” industries:** represents the percentage of firms in the four sectors with the lowest average wages in a given MSA.

- **Data:** Census Bureau’s Annual Business Survey and American Community Survey

This level of data analysis can inform both short- and long-term strategies for bringing capital products to larger swaths of underrepresented entrepreneurs. Short-term, we can aim to buoy sectors where there is currently strong representation of underrepresented founders. Long-term, we can target specific, strategic industries with high-wage growth potential where the ecosystem could foster more underrepresented founders.

**Example:** In Seattle, decision makers could tailor longer-term strategies that grow MWBE representation in high-wage industries, either growing upon existing success (for instance, strong woman and Black representation in Seattle’s professional, scientific, and technical services sectors) or an area where MWBEs could improve (e.g., increasing Asian-American business ownership in any of Seattle’s high-wage industries, where they currently lack representation).

### Top 3 Industries by Demographic Ownership Group by Average Wage, 2019

Black	Asian American	Women	Men	Non-minority
Health Care & Social Assistance (21%)	Accommodation & Food Services (24%)	Professional, Scientific, & Technical Services (28%)	Construction (19%)	Professional, Scientific, & Technical Services (18%)
Professional, Scientific, & Technical Services (17%)	Health Care & Social Assistance (16%)	Health Care & Social Assistance (28%)	Professional, Scientific, & Technical Services (18%)	Construction (17%)
Construction (14%)	Retail Trade (14%)	Other Services (17%)	Health Care & Social Assistance (8%)	Health Care & Social Assistance (10%)

Avg. Wages < \$40,000

Avg. Wages >\$80,000

- Asian American-owned businesses concentrated in low-wage sectors
- Strong high-wage representation for Black businesses (Seattle ranks 12th)
- Woman-owned businesses’ sales lag (96th on parity metric)

2018 Annual Business Survey (2018 ABS) and 2019 American Community Survey (2017 ACS)

### 3. Nonemployer firms, employer firms, and opportunities to build wealth

A telling piece of data is the ratio of nonemployer to employer firms by demographic group and how widely they vary across metro areas, sourced from the National Nonemployer Statistics.<sup>31</sup> This ratio underscores the share of entrepreneurs with firms ready to officially hire employees and able to scale. Nonemployer businesses are sole proprietors, ranging from individuals with additional income from a side hustle (e.g., driving for a rideshare app, woodworking for family friends) to businesses that haven’t yet officially hired on employees and instead issue 1099s. Moving from growing into an employer firm is a key path to fully fledged entrepreneurship and stable source of income and wealth, let alone becoming capital-ready.<sup>32</sup>

Ratios of nonemployer to employer firms indeed vary significantly. In Seattle, for example, there are three white-owned nonemployer firms for every one white-owned employer firm; on the other hand, there are 19 nonemployer businesses owned by Black Seattleites for every one Black employer firm—the lowest of any demographic. This ratio is striking, but in line with national numbers of 95% of all Black businesses being nonemployer firms—a huge opportunity to grow Black wealth.<sup>33</sup>

#### 4. Conclusion of capital gaps based on "data steps" above

By collecting and comparing 1) available resources surveying the local availability and utilization, and 2) firm attributes by owner demographics and industry, and 3) current levels and types of entrepreneurial activity of nonemployer vs. employer firms, local leaders can evaluate their capital needs, strengths, and opportunities to grow. This inventory of data available underscores a need for more comprehensive reporting, especially for equity investment.

## Comprehensive Economic Development Strategies (CEDS)

In every community, an important resource for understanding the local capital landscape and regional priorities are the local or regional [Comprehensive Economic Development Strategies](#). CEDS, or a CEDS-equivalent document, are collective roadmaps for regional economic development, prerequisites for communities creating Economic Development Districts (EDDs), multi-jurisdictional entities that convene decision makers and stakeholders around identifying and achieving shared economic development goals.<sup>34</sup> As you landscape your community and understand local opportunities for innovative capital, the CEDS are a useful tool to understand regional entrepreneurial and equity objectives.

#### Examples:

**San Antonio / Alamo Area Council of Governments:** Two core objectives of the San Antonio CEDS are 1) growing businesses in key economic clusters and 2) expanding access to resources, specifically capital, for under-resourced entrepreneurs.

- Alamo Angels, a local angel group, is considering adopting revenue-based financing in their strategy. In doing so, they would be able to both diversify their investments to newly reach Main Street, underserved, often Latino/a businesses, and provide short-term returns and liquidity for investors whose investments are typically tied up in company equity for several years.

**Seattle / Puget Sound Regional Council:** A strategic focus of Seattle’s CEDS is to “expand support for small and medium sized businesses and businesses owned by marginalized communities.”<sup>35</sup>

- A national CDFI, National Development Council, is exploring the implementation of an innovative product in their Seattle-based office: offering revenue-based loans to allow their debt products to reach new businesses with strong cash flow and growth potential but few assets to offer as collateral for a traditional loan.

## A Full Continuum of Capital

Innovative financial products are situated to expand capital access and fill the capital gaps that exist in many communities. The continuum of traditional and innovative capital products covers a large portion of all business types that might exist within a local entrepreneurial ecosystem.

A helpful framework for business categorization is the Delgado and Mills Typology: Dr. Mercedes Delgado and former SBA Administrator Karen Mills collaborated on a 2020 paper presenting a new—and very illustrative—typology of businesses by sector.<sup>36</sup> These categories denote significant differences in the supply chain (business-to-business and -government; B2B and B2G) and direct-to-consumer (B2C) parts of the modern economy.

The seven categories they created relate to businesses with very different average wages, potential for wage growth, current employment, and potential for employment growth within the economy—and they roughly correspond to different innovative financial products.

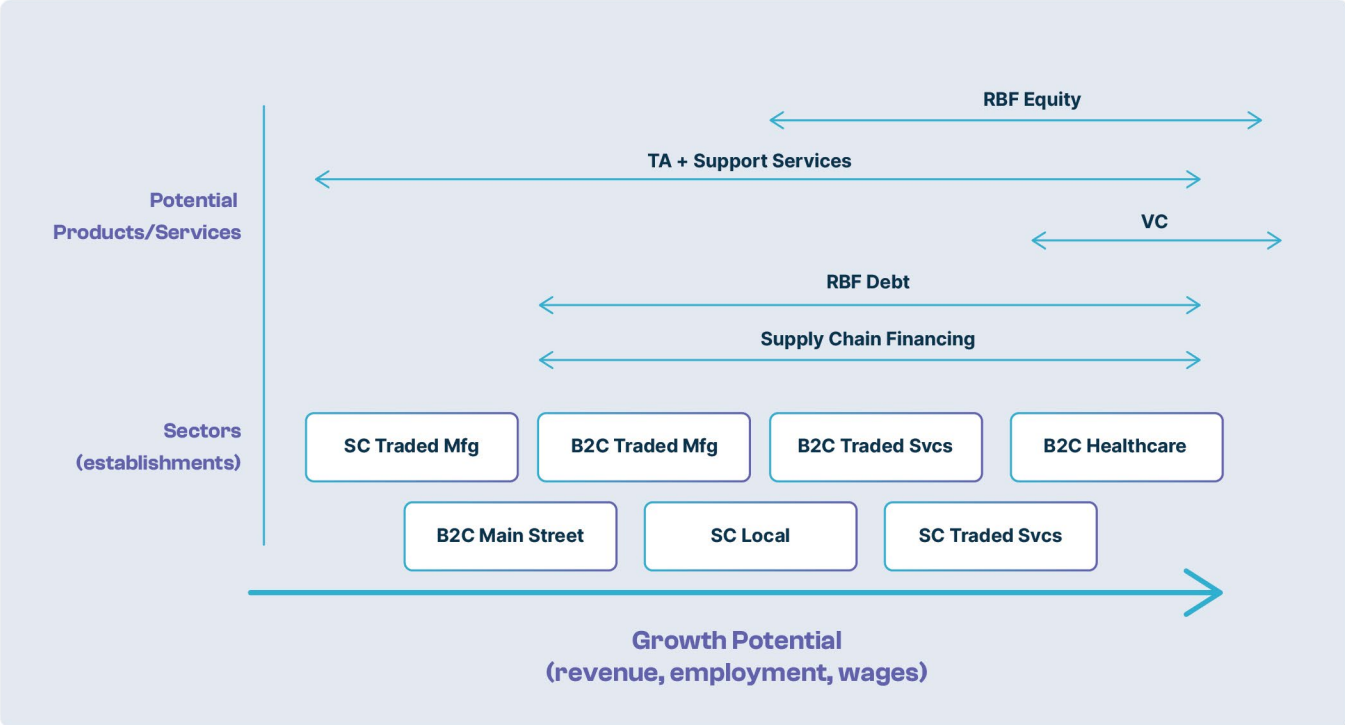
### Examples for Delgado and Mills’s Categories of Firms

- Supply Chain (SC) Traded – Services: engineering services
- Supply Chain (SC) Traded – Manufacturing: semiconductor manufacturing
- Business to Consumer (B2C) Local – Main Street: full-service restaurant
- Business to Consumer (B2C) Local – Health Care: hospital
- Business to Consumer (B2C) Traded – Services: computer training
- Business to Consumer (B2C) Traded – Manufacturing: food processing
- Supply Chain (SC) Local: security guard, janitorial services

For example, RBF reaches across the continuum of enterprises from modest growth B2C Main Street businesses to tech-enabled startups in the Supply Chain Traded industry. Redeemable Equity, meanwhile, reaches a smaller segment of firms but gives access to mission-aligned, growth capital to more firms, with a preference for higher-growth potential businesses so investors can share in large growth prospects, much like traditional venture capital. Similar to RBF Debt, Supply Chain Finance can reach a range of firms, helping them meet short-term cash flow needs, from construction firms (Supply Chain Local), to architecture services (Supply Chain Traded), to even restaurants fulfilling government contracts (B2C Main Street).

Across industries, firms need liquidity to meet accounts receivable and larger business opportunities to grow profits and scale. Communities and mission-aligned capital can provide supply chain financing alternatives that systematize new evaluations of creditworthiness and emphasize historically excluded entrepreneurs to expand financing and growth opportunities.<sup>37</sup>

**Potential for Innovative Finance**



# Resources

## Endnotes

- <sup>16</sup> Small Business Equity Toolkit. (n.d.). [www.smallbusinessequitytoolkit.com](http://www.smallbusinessequitytoolkit.com).
- <sup>17</sup> Federal Financial Institutions Examination Council. (n.d.). Community reinvestment act: Aggregate report search by state. [www.ffiec.gov/craadweb/aggregate.aspx](http://www.ffiec.gov/craadweb/aggregate.aspx); CRA definition of small business lending: [https://www.ffiec.gov/cra/pdf/2015\\_CRA\\_Guide.pdf](https://www.ffiec.gov/cra/pdf/2015_CRA_Guide.pdf).
- <sup>18</sup> <https://www.urban.org/urban-wire/small-business-and-community-development-lending-are-key-cra-compliance-most-banks>
- <sup>19</sup> <https://cdcloans.com/504-vs-7a/>
- <sup>20</sup> <https://www.sba.gov/partners/lenders/7a-loan-program/types-7a-loans>
- <sup>21</sup> U.S. Small Business Administration. (n.d.). 7(a) & 504 FOIA. data. [sba.gov/dataset/7-a-504-foia](http://sba.gov/dataset/7-a-504-foia).
- <sup>22</sup> [https://www.policymap.com/data/our-data-dictionary/#CDFI%20\(Community%20Development%20Financial%20Institutions\)%20Fund%20CDFI%20Program](https://www.policymap.com/data/our-data-dictionary/#CDFI%20(Community%20Development%20Financial%20Institutions)%20Fund%20CDFI%20Program)
- <sup>23</sup> In Q1 of 2021, PwC discontinued the publication of its MoneyTree Report, which segmented Venture Capital investment by metro area and state: <https://www.pwc.com/us/en/industries/tmt/technology/moneytree.html>; PitchBook compiles data on private equity and venture capital investment by firm: <https://pitchbook.com/>.
- <sup>24</sup> <https://nvca.org/research/regional-data/>
- <sup>25</sup> <https://startupsusa.org/global-startup-cities/#data>
- <sup>26</sup> <https://docs.google.com/spreadsheets/d/1kCEJW6uRE2n4iO-ZEkaVulUsYEvDrG22/edit#gid=1388615308>
- <sup>27</sup> <https://www.kabbage.com/small-business-revenue-index/>
- <sup>28</sup> <https://ncrc.org/fact-sheet-on-section-1071-small-business-loan-data/>
- <sup>29</sup> <https://portal.census.gov/pulse/data/>
- <sup>30</sup> <https://finhealthnetwork.org/>
- <sup>31</sup> <https://www.census.gov/programs-surveys/nonemployer-statistics.html#:~:text=NES%20is%20an%20annual%20series,and%20total%20receipts%20by%20industry>
- <sup>32</sup> [https://www.nlc.org/resource/future-of-cities-a-roadmap-to-inclusive-entrepreneurship/?utm\\_campaign=Meetings-Events&utm\\_medium=email&utm\\_source=informz&utm\\_content=inclusive-entrepreneurship-day-of-20220110&utm\\_term=teaxt-read-guide&\\_zs=Di8Jd&\\_zl=6Xxt2](https://www.nlc.org/resource/future-of-cities-a-roadmap-to-inclusive-entrepreneurship/?utm_campaign=Meetings-Events&utm_medium=email&utm_source=informz&utm_content=inclusive-entrepreneurship-day-of-20220110&utm_term=teaxt-read-guide&_zs=Di8Jd&_zl=6Xxt2)
- <sup>33</sup> [https://www.responsiblelending.org/sites/default/files/nodes/files/research-publication/crl-cares-act2-smallbusiness-apr2020.pdf?mod=article\\_inline](https://www.responsiblelending.org/sites/default/files/nodes/files/research-publication/crl-cares-act2-smallbusiness-apr2020.pdf?mod=article_inline)
- <sup>34</sup> <https://eda.gov/edd/>
- <sup>35</sup> [https://www.psrc.org/sites/default/files/2022-2026\\_ceds\\_central\\_puget\\_sound\\_region\\_-\\_final\\_adopted.pdf](https://www.psrc.org/sites/default/files/2022-2026_ceds_central_puget_sound_region_-_final_adopted.pdf)
- <sup>36</sup> Delgado, M., & Mills, K.G. (2020). The supply chain economy: A new industry categorization for understanding innovation in services. Res Pol, 49(8). [doi.org/10.1016/j.respol.2020.104039](https://doi.org/10.1016/j.respol.2020.104039).
- <sup>37</sup> <https://www.thenewlocalism.com/newsletter/supply-chain-finance-innovations-for-supporting-inclusive-entrepreneurship/>

For more tools and resources, visit [innovative.finance/resources](https://innovative.finance/resources).





# Capital Formation & Implementation

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**Federal Sources of Funding | 196**

**Philanthropy | 204**

**Fund Infrastructure | 209**

## Overview

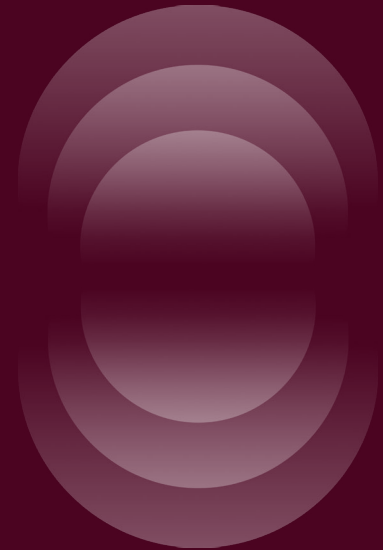
Deciding to utilize an innovative capital product or fund structure is just the first step towards actually raising a fund and investing capital. Fundraising for traditional products is already a challenging task, and finding investors who are willing to back innovative investment products can be even more difficult before they are more commonly used and understood by capital markets.

From private capital, to federal sources of funding, and how to build a tech stack for your fund, we have included some important resources related to fundraising and fund development and implementation. We did so with a specific focus on innovative products and first-time and emerging fund managers with the goal of lowering the barriers to entry for aspiring investors in hopes of seeing more underrepresented and innovative fund managers successfully capitalize and deploy their funds.

To explore our database of tools and resources for innovative financing, visit [innovative.finance/resources](https://innovative.finance/resources) or scan here:



# LP Readiness & Landscape



## TL;DR

The world of Limited Partners (LPs) and other investors backing fund managers can be ambiguous and difficult to navigate, especially for first-time fund managers and innovative fund models. Below is a breakdown to help capital providers understand how to prepare for engaging with LPs.

## What are the different types of investors?

### What is an LP?

LP stands for a Limited Partner that invests in a fund. Limited Partners have no control over the management of the fund, and their liability is limited to their specific personal investment.

### What is an institutional LP?

Essentially, any type of large LP with \$100M+ in AUM beyond High Net Worth Individuals (HNWIs) and family offices. This includes foundations, endowments, pensions, corporates, and banks.

## What is an accredited investor?

An accredited investor is a person or entity that is allowed to invest in alternative assets like hedge funds, private equity funds, venture capital funds, etc. Nonaccredited investors are not allowed to invest in these funds.

**The SEC defines an accredited investor as someone who meets one of following three requirements:**

1. **Income:** annual income of at least \$200K, or \$300K if combined with a spouse's income, for the past two years. This level of income should be sustained for the next two years.
2. **Knowledgeable Employee:** "knowledgeable employee" of certain investment funds or holds a valid Series 7, 65 or 82 license.
3. **Net Worth:** net worth of \$1M or more, either individually or together with a spouse, but excluding the value of their primary residence.

## What types of LPs are out there?

- High Net Worth Individuals (HNWIs)
- Family Offices
- Foundations
- Endowments
- Pensions
- Corporates
- Banks
- Fund of Funds (FoF)
- Investment Firms (e.g., VC and PE)

## How do I access LPs?

The LP world can be challenging to navigate and hard to access for first-time fund managers. The first step for a fundraising strategy is to understand the different LP types and LP landscape to figure out "product (fund)—market (LPs) fit." There is no standardized or perfect solution to accessing LPs, but first-time fund managers can reduce wasted time by prioritizing meetings with LPs that have actually made investments in pilot or emerging funds.

**HNWIs** typically outsource their investment portfolios and wealth management to private wealth groups—such as Goldman Sachs, Morgan Stanley, and UBS—and registered investment advisors (RIAs). These private wealth groups have approved investment product lists by asset class, including their bank’s own investment products. Fund managers need to get on those “lists” that wealth advisors use to make recommendations or invest on behalf of their HNWI clients. Large banks have their own asset management and private investment research teams that lead the fund diligence and approve which funds or products go on these lists. Emerging fund managers need to make sure they get in front of the right research group focused on their asset class.

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**Family Offices** often outsource their investment portfolios and/or wealth management to either private wealth groups or investment consultants such as Cambridge Associates, Hewitt EnnisKnupp, Mercer, Russell Investments, and Towers Watson. Some Family Offices have an in-house investment team, and when that is the case, it can be a good opportunity for emerging fund managers to connect.

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**Foundations** typically outsource their investment portfolios to investment consultants. Larger foundations may have in-house investment staff to lead diligence on funds.

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**Endowments** typically outsource their investment portfolios to investment consultants. Larger endowments may have in-house investment staff to lead diligence on funds.

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**Pensions** typically outsource their investment portfolios to investment consultants.

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**Corporates** typically do not outsource their investment portfolios and will build in-house teams to lead fund manager programs.

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**Banks** typically do not outsource their investment portfolios and will build in-house teams to lead fund manager programs.

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**FoFs** manage their own investment portfolios but need to raise capital from their own LPs.

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**Investment Firms (e.g, VC and PE)** opportunistically will make fund investments in emerging fund managers as a source of deal flow and/or angel investment from one of the partners.

## Where to start: who's actually investing in innovative fund models and/or first-time fund managers?

1. **HNWIs**, including angel investors, former entrepreneurs, and GPs at established VC and PE firms
2. **Family offices**
3. **Banks** leveraging their balance sheets and/or CRA programs
4. **Corporations**, including Fortune 1000 technology and insurance companies
5. **Foundations** leveraging their grantmaking program and endowment to make Program Related Investments (PRIs) and Mission Related Investments (MRIs), respectively
6. **Fund of Funds**
7. **VCs** interested in backing earlier-stage "scout funds" primarily as a deal flow source

## LP Landscape

LP data has always been mysterious and hard to track down because the majority of institutional and accredited investors do not disclose their names. However, more LPs are starting to disclose their commitments to emerging fund managers and have provided some insight into the LP landscape.

**Here is a list of some of the most active LPs for first-time fund managers in the US (in no particular order):**

**Banks:** Bank of America, Goldman Sachs, Truist

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**Corporations:** PayPal, Carta, MassMutual, Consumer Technology Association, Alphabet / CapitalG, Foot Locker

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**Family Offices:** Pivotal Ventures, Spring Point Partners

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**Foundations:** Living Cities, Ford Foundation, Surdna Foundation

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**FoFs:** First Close Partners, Screendoor Partners, Bain Capital Ventures, Plexo Capital, Equity Alliance, Capricorn Investment Group, Cendana Capital, Foundry Group, Next Play Capital

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**VCs:** Motley Fool Ventures, Insight Partners, Alpaca VC

## LP Call to Action:

Corporations filling part of the major capital gap for emerging fund managers is a start, but they typically do not have an intentional, long-term strategy. Institutional LPs with large AUMs and patient investment capital, especially foundations and endowments, should leverage part of their annual grant budgets to permanently seed the next generation of fund managers through PRI and MRI programs.

# Resources

## Articles & Research

[OpenLP](#)

[Signature Block](#)

[Silicon Valley Bank](#)

## Fund Manager Programs

[Boston Impact Initiative](#)

[Confluence Philanthropy](#)

[Catalyze](#)

[Coolwater Capital \(previously Oper8r\)](#)

[Left Tackle Capital](#)

[NAIC](#)

[Plexo Capital GPx](#)

[Purpose Foundation](#)

[Recast Capital](#)

[Sutton Capital](#)

[VC Include](#)

[VC Lab](#)

For more tools and resources, visit [innovative.finance/resources](https://www.innovative.finance/resources).

# Community Reinvestment Act (CRA) Motivated Capital



## TL;DR

The Community Reinvestment Act (CRA) requires regulated financial institutions to help meet the credit needs of all communities in the service area they are chartered to operate. In turn, financial institutions often invest in intermediaries (such as CDFIs) serving low- and moderate-income communities and can be a promising potential capital source for innovative funds.

## How does the CRA work?

The Community Reinvestment Act was enacted in 1977 to help verify that federally insured banks meet the credit needs of the communities in which they are located, consistent with safe and sound banking practices. The CRA was one of several laws passed during the 1960s and 1970s to expand access to credit in response to the federally endorsed practice of “redlining” and other institutions of systematic discrimination.

Three federal regulators—the Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation (FDIC), and the Federal Reserve Board—share oversight of the CRA. Neither the CRA nor its implementing regulations prescribe ratios or benchmarks that regulators must use in the evaluation or application processes. Instead, the CRA encourages banks to help rebuild and revitalize communities through sound lending and good business judgment that benefit both banks and the communities they serve.



The CRA provides a framework for depository institutions and community organizations to work together to promote the availability of credit and other banking services in low- and moderate-income communities and for low- and moderate-income individuals. Besides directly funding credit-challenged communities, banks can also satisfy their CRA obligations by funding third-party financial institutions, often including (but not limited to) CDFI loan funds, CDVC funds, state and local governments, community development organizations, and even private, impact-oriented investment funds.

On May 5, 2022, 45 years after its creation, the three federal agencies tasked with managing the CRA announced a plan to strengthen and modernize the Community Reinvestment Act. Forthcoming changes to the CRA likely include [several key elements](#), which should improve the outlook for nontraditional capital providers seeking to capitalize funds with CRA-motivated bank partners.

## How can capital providers prepare to raise capital from CRA-motivated financial institutions?

1. Focus on elements of your fund or capital product(s) that are:
  - Innovative
  - Complex
  - Responsive
2. Identify FDIC, OCC, and Federal Reserve geographic areas relevant to your efforts on the [FDIC website](#).
3. For OCC-regulated banks, CRA compliant investments must be “Public Welfare Investments,” i.e., investments that have an impact on low-moderate income geographies or demographic groups.
4. Sign up for newsletters from local [OCC](#), [FDIC](#), and [Federal Reserve](#) offices to keep an eye on trends in local CRA capital markets.
5. Sometimes a bank’s CRA department is housed under compliance—there isn’t always a dedicated CRA department or manager.
6. Fund managers should consider pitching their funds as nonconcessionary to banks’ CRA officers or CFOs. Woodforest Bank, for example, saw Blueprint Local Opportunity Zone Fund as an investment to not only achieve CRA-qualified impact outcomes but also achieve competitive returns.

7. CRA investors are geographically specific. A good way to find local CRA capital is on the [FFIEC](#) website, by searching for the geography in which you're located and determining which banks have deposits in your region. Banks are required by law to deploy CRA capital in every area where they receive deposits. As an example, Woodforest had a side letter with Blueprint Local, asking for best efforts to deploy capital within certain geographies where the bank had deposits.
8. Timing is everything when talking to a bank. Their interest has everything to do with where they are in their exam cycle—which ranges from 3 to 5 years. Near the end of the cycle, the team is getting exam ready and focusing on reporting; at earlier stages in the cycle the CRA team might be more willing to invest. Often if the answer is no, this may be a sign to revisit the conversation a year later.
9. Banks are risk-averse. If you're a new fund, focus on the qualifications of your individual team members and your unique track records to compensate for the fund's lack of experience.
10. Prospecting for CRA capital might go better with banks that have recently received a poor compliance rating and, therefore, might be open to investing in a high-impact fund in order to bolster their rating for their next exam cycle.

#### MINI CASE STUDY

### Woodforest National Bank - Blueprint Local Fund Investment

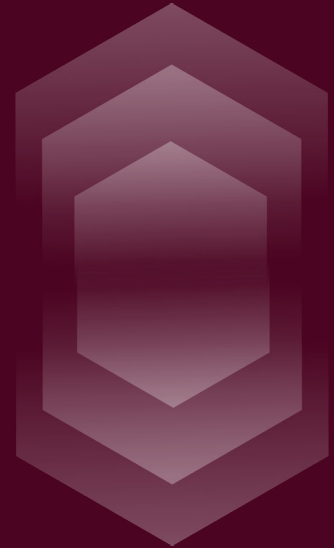
Woodforest National Bank is a privately held, OCC-regulated bank headquartered in The Woodlands, Texas. The bank has nearly 800 branches across 17 states, and readers may recognize Woodforest as Walmart and Sam's Club's largest retail partner. Woodforest National Bank's Community Reinvestment Act (CRA) team is widely recognized as a leading institution among banking and community development practitioners for their innovative approaches to funding impactful and fiscally sound projects in a way that simultaneously satisfies the banks' CRA obligations. One such example of Woodforest's achievements in this arena includes several investments into private investment funds managed by Blueprint Local.

While it is uncommon, banks like Woodforest are able to satisfy their CRA requirements by making a traditional LP (limited partner) investment in an impact-motivated, for-profit investment fund. Blueprint Local, an impact investment fund manager focused on investing in federally designated Opportunity Zones, has received several significant contributions to

its regionally focused Qualified Opportunity Funds from Woodforest National Bank. These contributions from Woodforest take the same form as an investment from any other limited partner investor; yet for Woodforest, the nature of the investment funds' commitments to investing exclusively in Opportunity Zones allows these investments to count toward the bank's CRA obligations. In this way, Woodforest not only expands the capacity of a unique private investment fund manager to create greater impact in communities, but also participates in the positive financial returns of this fund, therefore enabling the bank to make further investments of this type in the future.

As a form of risk mitigation, Woodforest requested that Blueprint Local sign an independent contractual agreement, often referred to as a "side-letter," to ensure that, to the best of the fund manager's ability, Woodforest National Bank's capital would be invested exclusively in high-impact projects in low-to-moderate income census tracts (which frequently overlap with Opportunity Zone tracts).

# Federal Sources of Funding



## TL;DR

The US federal government has dozens of unique funding sources available to various sorts of capital providers, often with flexible and competitive terms that are beneficial for fund managers.

## What sources of funding from the federal government are available?

All investment fund managers and providers of innovative financial products for small businesses share a universal challenge: finding well-suited sources of capital to pass along to entrepreneurs and cover the costs of their business operations. Fortunately, the US federal government has dozens of unique funding sources available to various sorts of capital providers, often with terms that are beneficial for fund managers. Grouped below by the federal agency that manages them, the following programs provide direct funding for capital allocators to pass along to entrepreneurs.

# Small Business Administration (SBA) Programs:

## Guarantee Programs

Among the most widely recognized governmental capital access programs are the SBA loan guarantee programs—aimed at established small business lending institutions of various types, ranging from CDFIs to community banks. Each program is intended to decrease the risk of an approved debt provider in extending credit to business borrowers who otherwise might not access loan capital for their business.

### 7(a) Loan Guarantees

7(a) loans can be used for real estate purchases, short- and long-term business capital, refinancing current business debt, and purchase of furniture, fixtures, and supplies. Eligible small businesses must be for-profit, doing business in the United States, have reasonable invested equity, and not be delinquent on any debt obligations to the US government. Some for-profit businesses are ineligible, including real estate investment firms when the real property is held for investment purposes, and firms involved in lending activities. The maximum loan amount is \$5M for standard 7(a) loans and \$350K for the small loan 7(a) program.

- SBA Express

An accelerated loan program where the SBA will respond to an application in 36 hours. The maximum loan amount is \$500K.

- Community Advantage

A pilot loan program to assist small businesses in underserved markets. This includes businesses located in certain underserved communities, new businesses, veteran-owned businesses, and businesses where more than 50% of the full-time workforce is low-income or resides in low-income census tracts. The maximum loan amount is \$350K.

- Other 7(a) subtypes

- Export Express

- An accelerated loan program for businesses selling to international markets and to enhance a company's export development. The maximum loan amount is \$500K.

### [Export Working Capital](#)

A loan program for businesses that can generate export sales and needs additional working capital to support these sales. The maximum loan amount is \$5M.

### [International Trade](#)

A program to provide long-term financing for business expansion or modernization because of growing export sales or to counter the adverse effects of foreign competition. The maximum loan amount is \$5M.

### [504/Certified Development Company Loan Guarantees](#)

504 loans can provide long-term, fixed-rate financing for major fixed assets that promote business growth and job creation, including the construction and purchases of facilities, land, and machinery and equipment, or the modernization or improvement of existing facilities. 504 loans are not for working capital, inventory, debt consolidation, repayment or refinancing, or passive or speculative activities. Eligible businesses must operate for profit within the United States, have a tangible net worth of less than \$15M, and have an average income of less than \$5M for the past two years (after federal income taxes). The maximum loan amount is \$5M.

## **Direct Investment Programs**

In addition to providing guarantees to lenders who offer debt capital to business borrowers, the SBA also injects funds into the small business capital marketplace via several additional programs:

### [Microloan Program](#)

The microloan program provides very small loans to startups, newly established, or growing small businesses. The loans are made through nonprofit community-based lenders. The maximum loan amount is \$50K. With microloans, the SBA loans capital directly to intermediaries, up to \$5M in total.

### [Small Business Investment Companies \(SBICs\)](#)

SBICs typically invest in small, mature, and profitable businesses through debt and equity. Eligibility varies by SBIC, but all businesses must qualify as small businesses, be a US-based business, and be in an approved industry (farmland, real estate, financing, and certain other industries do not qualify). Loans typically range from \$250K to \$10M. Equity investments typically range from \$100K to \$5M. Once certified, qualified SBIC fund managers can leverage a private-public partnership investment model, where every \$1 of private money raised by the SBIC (e.g., from banks, high net worth individuals, other institutional investors) is [matched with \\$2 of government-guaranteed SBA debt](#), up to \$175M.

## Small Business Innovation Research (SBIR) and Small Business Technology Transfer (STTR)

The SBIR and STTR programs are competitive grants for small businesses engaged in research and development with the potential for commercialization. Eligible small businesses must be for-profit and US-based with no more than 500 employees. STTR awards require a partnering nonprofit research institution. SBIR/STTR awards range based on phase from \$50K to \$750K.

## Department of Commerce Programs

### Economic Development Administration (EDA)

- **Revolving Loan Funds (RLFs), under Economic Adjustment Assistance Program**  
EDA grant-supported RLFs are established by governments, higher education institutions, and public or nonprofit organizations, matched with local funds. RLFs provide loans that typically focus on working capital for operating expenses for both for-profit and nonprofit businesses where credit is otherwise unavailable. Loan amounts and eligibility varies by RLF but often target specific industries, geographic areas, or distressed communities. After seven years and program terms are met, RLFs become “de-federalized” with added flexibility for local lending and investment activity.
- **Build to Scale (B2S)**  
The B2S Program can provide grants to governments and organizations with state or locality support, focused on improving science, technology, innovation, or entrepreneurship (including institutions of higher education and public-private partnerships) to assist in building regional economies that foster technology-driven business growth.

#### **Venture Challenge**

The Venture Challenge provides grants to help communities build enterprise ecosystems and scale commercialization and startup acceleration. “Build” applicants may request up to \$750K, and “scale” applicants may request \$750K to \$2M.

#### **Capital Challenge**

The Capital Challenge provides grants to form investment programs and networks to aggregate and deploy equity-based capital to companies. “Form” applicants may request up to \$300K and “deploy” applicants may request between \$300K and \$750K.

## National Oceanic and Atmospheric Administration

- [Fisheries Finance Program \(FFP\)](#)

The FFP is a direct government loan program that provides US fishermen and aquaculture operators with long-term fixed-rate financing for vessels, facilities, harvesting privileges, fishing quotas, and debt incurred for these purposes. Maximum loan amounts vary by year.

## Department of the Treasury Programs

### CDFI Fund [awards](#)

- [CDFI Bond Guarantee Program](#)

The Bond Guarantee Program is a federal credit subsidy program that allows qualified CDFIs (or their designees) to issue bonds that are sold to the Federal Financing Bank. This provides CDFIs with long-term credit at below-market interest rates. CDFIs may use the capital to extend credit to other community development borrowers or to refinance existing loans. Bonds must be worth a minimum of \$100M, with the Federal Financing Bank providing a 100% guarantee on the bonds up to \$1B per year.

- [CDFI Program Financial Assistance Awards](#)

The CDFI Program provides financial awards of up to \$2M in the forms of grants, loans, equity investments, deposits, and credit union shares to certified CDFIs. These funds must be matched by CDFIs with nonfederal sources. Financial Assistance awards can be used for lending capital, loan loss reserves, capital reserves, operations, and development services.

- [Native Initiatives Financial Assistance Awards](#)

The Native Initiatives program provides financial assistance awards to certified CDFIs with at least 50% of activities serving Native American, Alaska Native, or Native Hawaiian communities. The awards come in the form of loans, grants, equity investments, deposits, and credit union shares.

- [New Markets Tax Credits](#)

New Market Tax Credits attract private capital into low-income communities by permitting individuals and corporate investors to receive a 39% federal income tax credit on the original investment amount over seven years in exchange for making equity investments, in Community Development Entities (CDEs). CDEs provide loans, investments, or financial counseling in low-income communities, and must be certified by the CDFI Fund.



### **State Small Business Credit Initiative (SSBCI)**

SSBCI provides a combined \$10B to states, territories, and tribal governments to expand access to capital for small businesses. The SSBCI provides funding for states to create and fund debt and equity investment programs for small businesses and startups, matched 10:1 by private capital investment over a 10-year horizon. Programs can include venture capital, loan participation, loan guarantee, collateral support, and capital access programs.

### **Small Business Lending Fund (SBLF)**

The SBLF provides capital to qualified community banks and community development loan funds (CDLFs), i.e., depository institutions with assets under \$10B. The more a lender increases small business lending, the lower rate the lender will pay for SBLF funding. Loans up to \$10M to businesses with up to \$5M in annual revenue can qualify as small business lending.

### **Opportunity Zones (Internal Revenue Service)**

Opportunity Zones provide tax benefits to investors who elect to temporarily defer their capital gains taxes if they invest those gains into a Qualified Opportunity Fund (QOF). QOFs are investment vehicles that must hold 90% of assets in qualified properties within US Treasury-designated Opportunity Zones; investments can directly benefit operating businesses. The tax benefit is determined by the length of time the taxpayer holds the QOF investment.

## **Department of Housing and Urban Development Programs**

### **Appalachia Economic Development Initiative (AEDI)**

The AEDI provides grants to state, community, or economic development agencies that apply on behalf of a nonprofit organization or community development corporation focused on small business development that benefits the Appalachia Region. Some eligible activities include loan or investment capital, loan loss reserves, program staff costs, information systems, marketing studies, portfolio analyses, and business planning. The maximum grant amount is \$1M.

### **Community Development Block Grants (CDBG)**

CDBG provides annual formula-funded grants to states, certain metropolitan cities, and certain urban counties to develop housing and expand economic opportunities for low- and moderate-income persons. Funds can be used to acquire real estate, relocation and demolition, rehabilitation of structures, construction of public facilities, public services, energy conservation and renewable energy programs, and assistance to for-profit businesses to carry out economic development and job creation or retention activities. Funds cannot be used for government buildings, political activities, certain income payments, or the construction of most new housing.

## Department of Agriculture Programs

### Rural Development Business Programs

- **Business & Industry Loan Guarantees**

Provides guarantees to rural lenders for loans to for-profit and nonprofit business, cooperatives, federally recognized Tribes, public bodies, and individuals. Some eligible loan uses are business development, the purchases of land, buildings, infrastructure, machinery, supplies, equipment, or inventory, and debt refinancing that improves cash flow or the number of jobs.

- **Rural Business Investment Program**

USDA licenses Rural Business Investment Companies (RBICs) to make venture and equity capital investments in smaller enterprises in rural areas and leverage investment from larger banks and institutional investors. RBICs must be qualified newly formed for-profit entities or subsidiaries, raise at least \$10M, have relevant experience in venture capital or community development financing, and invest at least 75% of investments (dollar and number) in rural areas.

- **Rural Economic Development Loan & Grant Program**

The USDA offers zero-interest loans and grants to local utilities. Loans are passed through to local businesses to create and retain employment in rural areas. Grants are awarded to establish revolving loan funds (RLFs). Funds can be used for business incubators, community development assistance, education, training, medical care facilities and equipment, startup venture costs, business expansion, and technical assistance. Intermediaries can request up to \$300K for RLF establishment grants and up to \$1.5M in loans.

- **Rural Microentrepreneur Assistance Program**

The USDA offers loans and grants to Microenterprise Development Organizations (MDOs) to provide microloans to startups, establish Rural microloan revolving funds, and provide training and technical assistance. Grants amount reach up to \$205K annually, and total aggregate debt from lending cannot exceed \$2.5M in aggregate. Nonprofits, federally recognized Tribes, and institutions of higher education may qualify as MDOs. Ultimate loan recipients must be located in eligible rural areas and have 10 or fewer full-time employees. Ultimate loan recipients can receive up to \$50K and use funds for expenses including working capital, equipment, debt refinancing, and improving real estate.

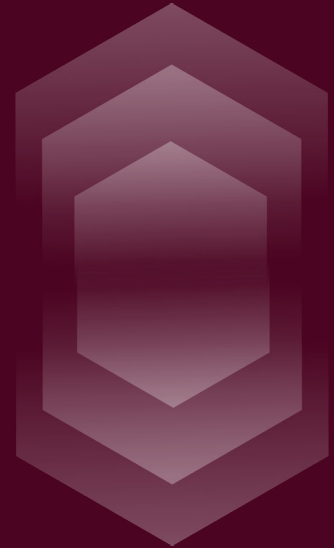
- **[Food Supply Chain Guaranteed Loan Program](#)**  
Entities may qualify for loan guarantees if involved in the aggregation, processing, manufacturing, storage, transportation, wholesale, or distribution of food. Eligibility and uses of funds are similar to the Business & Industry Loan Guarantee Program. Projects can be in rural or urban areas.
- **[Intermediary Relending Program](#)**  
The USDA provides low-interest (1%) loans to local lenders who then lend to businesses that can help improve economic conditions and create jobs in rural areas. Qualified nonprofits, federally recognized Tribes, public agencies, and cooperatives may apply as intermediary lenders. Ultimate loan recipients can include qualified individuals, public or private organizations, or other entities. The project must be located in a rural area, and funds can be used to promote community development; establish or expand a business; buy, build, expand, or renovate facilities; buy equipment, machinery or supplies; or other uses. The ultimate loan recipient can receive up to the lesser of \$400K or 50% of the loan to the intermediary lender.
- Other specific small business programs listed on site (e.g., [Renewable Energy Systems](#), [Co-ops](#), [Meat and Poultry](#)... so on)

## Department of the Interior Programs

### Bureau of Indian Affairs

- **[Indian Loan Guaranty, Insurance, and Interest Subsidy Program](#)**  
The BIA offers loan guarantees to lenders for Indian-owned businesses to receive financing for their projects. The borrower must be a federally recognized Tribe, a member of such Tribe, or an entity that is at least 51% owned by members of such Tribe. The borrower must have at least 20% equity in the project and the project must serve a reservation or tribal area. Some loan uses include operating capital, equipment, purchases, acquisition, refinancing, building construction, and lines of credit.

# Philanthropy



## TL;DR

The US federal government has dozens of unique funding sources available to various sorts of capital providers, often with flexible and competitive terms that are beneficial for fund managers.

## How do philanthropic foundations contribute to fund managers?

### Foundations have three major funding tools for fund managers across the capital spectrum:

**Grants** are a financial donation given to an organization. Foundations primarily award the majority of their grants to 501(c)(3) organizations and other tax-exempt organizations. Grants are donations, not investments, and need to meet a specific charitable standard to qualify as a grant. Generally, foundations must follow the “5% payout requirement” and distribute annually—through grants and grant-related expenses—at least 5% of the total market value of net investment assets from the preceding year to avoid paying taxes. This rule forces foundations to distribute money for charitable purposes instead of fully leveraging the tax-exempt status as a tax shelter for wealth generation.

**Program-Related Investments (PRIs)** are mission-driven investments closely related to charitable grants. Unlike MRIs, an investment is required to meet a specific charitable standard to qualify as a PRI. However, a PRI does not need to be a market-rate or “prudent” investment. PRI strategies are still an innovative funding tool used by a small number of foundations. Traditional grantmaking strategies only use grants and avoid PRIs due to the risk-averse nature of foundations, which are hyper-focused on charitability. PRIs create an extra layer of regulatory and underwriting complexity for foundations. Thus, it is easier for a foundation than a fund manager to make a grant to a nonprofit.

**Mission-Related Investments (MRIs)**, also commonly referred to as “impact investments,” further an organization’s mission. Any investment in which the investor intends to generate both a social return and a financial return, such that it is not exclusively about profit, could qualify. There is no legal definition of an MRI and no legal requirements to qualify for, or prohibitions resulting from, this status. An MRI is not a charitable activity. MRIs are made from investment assets rather than program assets, sometimes referred to as the endowment side or the “other 95%” of a foundation’s assets that are not designated for making charitable qualifying distributions. MRIs do not need to meet the charitable standards that a PRI must meet.

		INVESTMENT		PHILANTHROPY*		
		TRADITIONAL INVESTMENT	MISSION-RELATED INVESTMENT (MRI)		PROGRAM-RELATED INVESTMENT (PRI)	GRANTS
FOUNDATION APPROACHES	Seek competitive financial returns regardless of, or with little consideration for, ESG factors.	Investments from a foundation’s endowment that seek to achieve specific goals to advance mission. Generally seek competitive financial returns.			Part of a foundation’s annual payout. PRIs seek to advance the foundation’s mission, with financial return a secondary consideration. Often below-market rate.	Focus on generating specific social or environmental impacts with no expectation of financial return.
	STRATEGIES		RESPONSIBLE**	SUSTAINABLE**	IMPACT**	
		ESG risk management	ESG opportunities	Target social and environmental impact		
		Screen investments for ESG risk factors, excluding those investments with material exposure to those risks. Generally seek competitive financial returns.	Focus on ESG opportunities through active investment selection, portfolio management, and shareholder advocacy. Generally seek competitive returns and alpha generation driven by ESG factors.	Intend to generate specific measurable social and environmental impact alongside a financial return. Financial return expectations may range from below-market to market-rate depending on strategy and specific investment context.		

\*Counts as charitable distribution towards 5% payout.

\*\*Note US SIF now uses the acronym “SRI” to indicate sustainable, responsible, and impact investment (as opposed to its previous definition as socially responsible investment) reflecting the continued evolution of usage and interchangeability of these terms.

Source: Rockefeller Foundation

## Here is quick guide for fund managers to approaching foundations and which funding tool(s) to pursue:

### 1. Grants

- **Research & Background Check:** Check the foundation's website for grant opportunities or Request for Proposals (RFPs) to see if your fund may be a fit for funding. Additionally, most foundations have a public list of their historical grantees and grant amounts available on their website, which is worth reviewing. If they don't list the grantees on their website, then check out a more detailed list available in their 990 forms via Candid, GuideStar, IRS, and ProPublica. The 5% payout requirement can help you estimate how much a foundation needs to make in grants annually by knowing its total assets (multiply Total Assets by 5% to get an estimate for their annual grant budget).
- **Intro Call:** If there is a potential fit, connect with the foundation's program or grantmaking team to ask any RFP-related questions.
  1. Are you considering fund managers or private investment funds for this grant opportunity?
  2. If my fund is not structured as a 501(c)(3) or does not sit within a 501(c)(3), can my fund still be a fit?
  3. Have you ever made a grant to a fund manager?
  4. If yes, what is the typical grant size?
  5. If yes, how was the fund manager allowed to use that grant—operating capital on the management company side and/or investment capital on the LP side?
  6. Does my investment strategy fully align with your foundation's charitable purpose? Which parts make you nervous for charitability?
- **Application:** If you still believe there is a potential fit, then fill out the grant application
- **Uses:** Foundations rarely will make grants outside of their comfort zone of funding nonprofits, but occasionally they will use grants to support fund managers. If they do, then they typically will use grants to support operating capital needs or fund expenses—such as a staff, travel, convening, or capacity building grant—for fund managers. This is a great way for first-time fund managers to offset expensive launch costs and extend the fundraising runway.

## 2. Program Related Investments (PRIs)

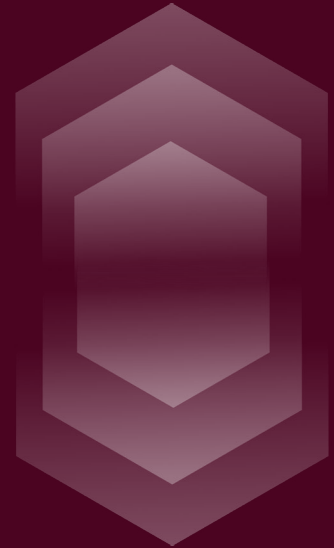
- **Research & Background Check:** Check the foundation’s website for its “impact investing,” “catalytic capital,” or “innovative finance” strategy to see if your fund may be a fit for funding. Most foundations have a public list of their historical grantees and grant amounts available on their website, which is worth reviewing and filtering for PRIs. If they don’t list the grantees on their website, then check out a more detailed list available in their 990 forms via Candid, GuideStar, IRS, and ProPublica. The 5% payout requirement can help you estimate how much a foundation needs to make in grants annually by knowing its total assets (multiply Total Assets by 5% to get an estimate for their annual grant budget).
- **Intro Call:** If there is a potential fit, connect with the foundation’s impact investing team to ask any PRI-related questions.
  1. Are you considering fund managers or private investment funds for your PRI strategy?
  2. Have you ever made a PRI to a fund manager?
  3. If yes, what is the typical PRI size?
  4. If yes, how was the fund manager allowed to use that PRI—operating capital on the management company side and/or investment capital on the LP side?
  5. Does my investment strategy fully align with your foundation’s charitable purpose? Which parts make you nervous for charity?
- **Application:** If you still believe there is a potential fit, then fill out the PRI application.
- **Uses:** Foundations with PRI strategies are more likely to support fund managers than foundations without PRI strategies. They will make PRIs or impact investments in funds or intermediaries to advance their foundation’s philanthropic strategies and programs. Generally, PRIs have more flexibility than grants and can be used to support operating capital needs or investment capital. Fund managers need to determine the best use of PRI capital—whether they can use it on the GP or LP side.

### 3. Mission Related Investments (MRIs)

- **Research & Background Check:** Check the foundation’s website for its “MRI,” “ESG (Environmental, Social, Governance),” “SRI (Socially Responsible Investing),” or “impact investing” strategy to see if your fund may be a fit for funding. Unlike grants or PRIs, foundations do not publicly disclose their MRIs, because they are not legally required to by the IRS. Typically, you can research articles, reports, and other publications by the foundation to learn more about its MRI portfolios.
- **Intro Call:** If there is a potential fit, connect with the foundation’s MRI or endowment team to ask any MRI-related questions.
  1. Have you backed any emerging fund managers in your MRI strategy?
  2. How do you define an “emerging” fund manager?
  3. Have you ever made an MRI to a fund manager with an innovative capital model like RBI, profit sharing, or employee ownership?
  4. What is the smallest fund size you’re willing to back as an LP?
  5. What is the typical MRI size?
  6. Does my investment strategy fully align with your foundation’s mission?
- **Build Relationship & Pitch:** If you still believe there is a potential fit, then continue to build a long-term relationship with the foundation. If your first or second fund does not currently fit their MRI criteria, perhaps your third or future fund will be a good fit.
- **Uses:** Foundations with MRI strategies make LP investments in fund managers and can not provide philanthropic support like they can on the grantmaking side. If you are too early for their PRI program, then most likely you are way too early for their MRI program as a fund manager. Foundations will rarely invest in first-time fund managers or innovative fund models out of their MRI program.



# Fund Infrastructure



## TL;DR

Beyond fundraising, innovative and first-time fund managers need to decide which tools and services they want to prioritize for fundraising and fund operations.

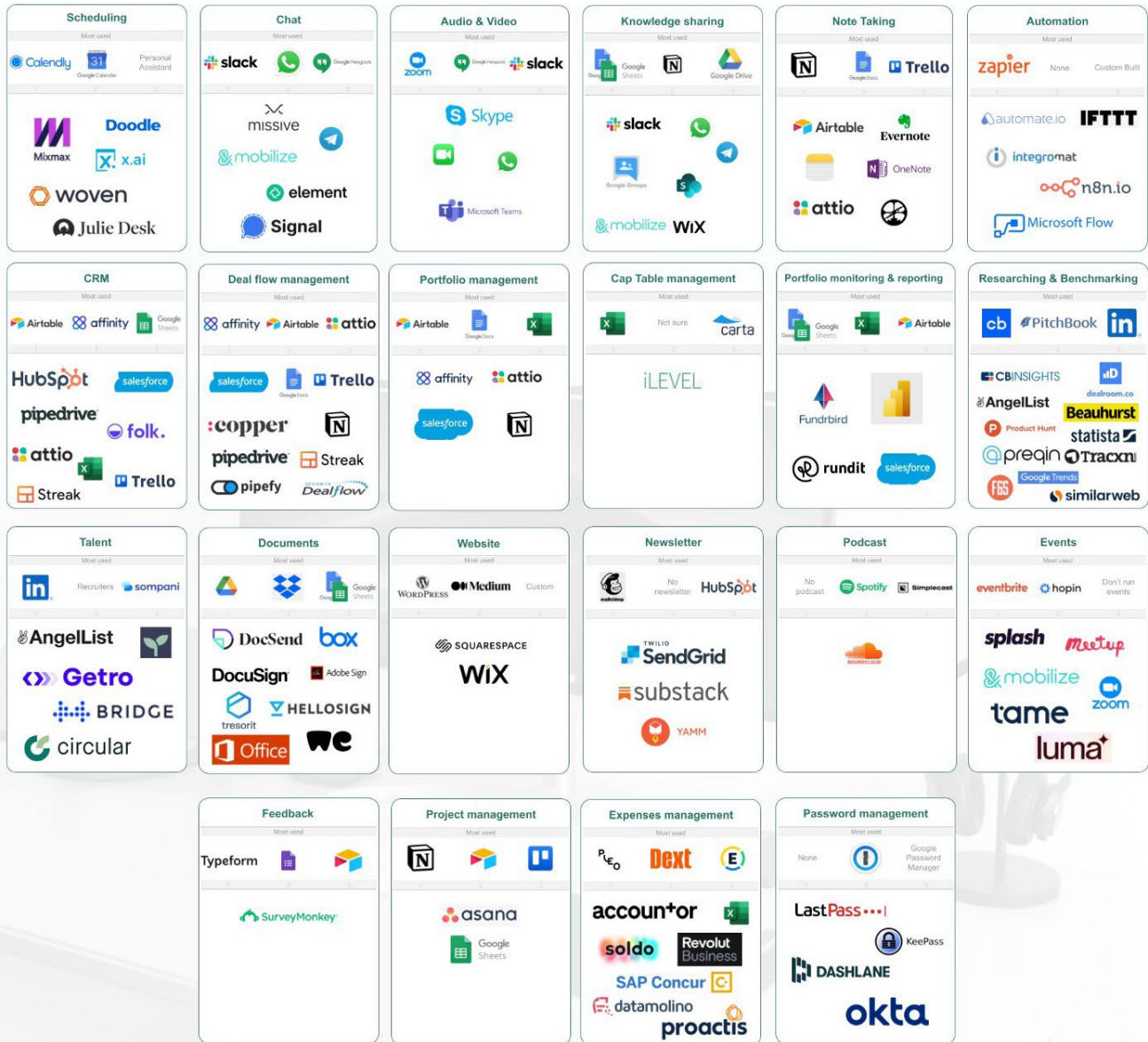
## Overview

There are an overwhelming number of options for fund service providers, especially in categories like CRM, pipeline/deal flow, and administration (as shown). Ultimately, fund managers need to build a tech stack and optimize operations to best serve their customers: founders and LPs.

# VC Tech Stack

May 2021 Edition

by Miguel Pinho - miguel@seedcamp.com - VCTechStack.com



The "most used" tools are sorted but the rest are not - i.e. the logo size and position does not reflect the usage numbers. These are the solutions used by VCs out of the 212 tools listed in the form. This is based on 21 responses from mostly European VCs in early 2021. Some of these solutions might not be "tech solutions" but I wanted to make sure they were included in the list of options as they were still very frequent. Report built by: Miguel Pinho - miguel@seedcamp.com - More at VCTechStack.com

Source: VC Tech Stack Landscape 2021

## What are 10 tools & services that are often considered for fund launch?

### 1. Administration

- Fund
  - Most common service providers: Carta, Aduro (acquired VMS), and Angellist
  - Others common providers: Vector AIS, Standish Management, Ultimus (acquired LeverPoint), and Opus
- SPVs
  - Most common service providers: Carta, Aduro, and Angellist
  - Others common providers: Sydecar, Flow, and Allocations

### 2. Legal

- Most common service providers: Cooley, Gunderson Dettmer, Angellist, Wilson Sonsini, DLA Piper, Foley Hoag, and Goodwin
- Others common providers: Carney Badley Spellman, RPKK, Thompson Hine, Harvey Esquire, Blue Dot Advocates, and All Places
- The most notable law firms are not necessarily the best fit for your fund, and they typically charge \$50K+

### 3. Bank

- Most common service providers: First Republic Bank and Silicon Valley Bank
- Others common providers: Grasshopper Bank, Angellist, and local/regional banks

### 4. Deal Flow/Pipeline CRM

- Most common tools: Airtable, Affinity, Google Sheets, Hubspot, and Salesforce

### 5. Project Management

- Most common tools: Notion, Airtable, Trello, and Asana

### 6. Data Room

- Most common tools: Dropbox, Google Drive, Box, and Carta
- Others common providers: DocSend

### 7. Communication

- Calendar
  - Most common tools: Google Calendar, Calendly, X.ai, and Vimcal
- Virtual Meetings
  - Most common tools: Zoom, Google Hangouts, WhatsApp, and Microsoft Teams
- Email
  - Most common tools: Gmail, Superhuman, and Spark
- Team
  - Most common tools: Slack
- Investor Relations
  - Most common tools: Mailchimp, DocSend, Anduin, DocuSign, Passthrough, and Visible

## 8. Accounting

- Most common tools for expenses management: Expensify, Dext, and Excel

## 9. Website

- Most common tools: Wordpress, Medium, Squarespace, and Wix

## 10. Audit & Tax

- Most common service providers: Frank Rimerman, Andersen, AngelList, PwC, EY, and RSM
- Others common providers: Sensiba San Filippo and Withum

## What are the five docs you need in your data room at launch?

### 1. Pitch Deck

### 2. Fund Model

### 3. Fund Budget

- Expenses usually fall into one of three categories: organizational, management company, and fund.

### 4. Track Record

- Spreadsheet with key financial metrics for attributable investments made at a previous fund and/or angel investment portfolio

### 5. Team Bios & Resumes

## What are the additional docs you need in your data room by final close?

### 1. Legal

- Limited Partnership Agreement (LPA)
- Organizational chart
- Incorporation documents for LP, GP, and Management Co.
- Subscription agreement

### 2. Fundraising

- Due Diligence Questionnaire (DDQ)

### 3. Team

- Hiring plan
- Advisors bios
- References
- Fund service providers

### 4. Portfolio

- One-pagers on portfolio companies
- Fund performance

### 5. Governance

- Board & board observer seats
- Policy statements—includes investment, ESG, DEI, valuation, privacy, and cyber security policies
- SOC 1 Report

### 6. Marketing

- Fund news
- Portfolio company news
- Thought leadership

# Resources

## Tech Stack

[Full List of Tools](#) by VC Tech Stack 2021

[Fund Launch Checklist 2.0](#) by Doug Dyer

[Our Stack at a \\$10M Fund](#) by Weekend Fund

[2021 VC Tech Stack](#) by Miguel Pinho

[Tech Stack Survey](#) by Samir Kaji

[Solo Capitalist Tech Stack Options](#)

[Track Record template](#) by Sapphire Ventures

[VC Portfolio Construction Model](#) by SVB

[Venture Fund Portfolio Construction](#) by Tactyc

[9 Data Room Components LPs Need from Emerging Managers](#) by Silicon Valley Bank

<https://lawofvc.substack.com/p/three-ways-to-form-a-venture-capital-fund>

<https://oper8r.substack.com/p/interview-what-costs-to-expect-when>

**For more tools and resources, visit [innovative.finance/resources](https://innovative.finance/resources).**

# Acknowledgments

# Acknowledgments

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---

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---

Darrin Redus at **Minority Business Accelerator**

---

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---

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---

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---

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---

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Chintan Panchal at **RPCK**

---

Brian Mikulencak at **Blue Dot Advocates**



John Berger at **Women of the World Endowment**

---

James Hart at **HBS Group, Inc.**

---

Bill Stoddart at **Iroquois Valley Farms**

---

Greg Brodsky at **Start.coop**

---

Curt Nichols at **Glade**

A dark blue background with a light blue vertical bar on the left side. In the center, there are three overlapping squares of varying shades of blue, creating a layered effect. The text 'Project Team & Contributors' is written in white, bold, sans-serif font across the middle of these squares.

# Project Team & Contributors

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