

# Quasi-Equity

Case study in using Revenue Participation Agreements

Venturesome

Venturesome is a social investment fund, an initiative of the Charities Aid Foundation (CAF). Venturesome provides capital to civil society organisations, operating in the space between providers of charitable grants and providers of bank loans at market rates. Since launch in 2002, over £12.5m has been offered to some 200 organisations. In addition to accumulating practical deal experience, Venturesome has endeavoured to have a central role in building a robust social investment market, adopting an open-book approach to share knowledge and build experience, but also ready to operate in competition so as to raise standards.

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# Quasi-Equity

## A Venturesome case study in using Revenue Participation Agreements

### Introducing

Charities and social enterprises not only need revenue funding to cover day-to-day activities, but also capital investment - funding to cover cash flow fluctuations, to weather difficult periods or to invest in future growth. Most of charities' income and expenditure goes directly on day-to-day activities, leaving them with little surplus to hold in reserves. This can leave charities fragile, unable to manage cash flow difficulties or to invest in innovation and development so that they may grow.

While there are many barriers to charities effecting social change, Venturesome believes that a lack of access to financial capital is a key constraint. Very little capital investment is available to charitable organisations. Grants are concentrated on revenue funding. At the other end of the spectrum, the banking market has historically lent very little to charities. Whilst there is evidence that the availability of bank lending is growing, such finance is only appropriate for a portion of the capital requirements of charities.

Social investment<sup>1</sup> offers investors and charities the mechanisms and financial instruments to tackle this issue – by filling the market gap between self-generated capital from surpluses (hard to achieve) and senior debt on commercial terms.

The financial needs which Venturesome most usually helps with are:

- **working capital** eg a charity receives its grant payments quarterly in arrears but needs to pay for staff and materials on a monthly basis. We could lend money to bridge the timing gap between expenditure and receiving grant income.
- **pre-funding the raising of capital** eg a building project that requires £250,000 but only £175,000 has been raised so far. We could underwrite the remaining £75,000 to get the building work started and the charity would continue to fundraise to fill the gap.
- **soft development capital** eg a charity wants to hire a new member of staff to develop its factsheets which it already sells. Venturesome might lend the money needed to hire the person and would be repaid from

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<sup>1</sup> Social investment is the use of money to achieve both a social and financial return.

the surpluses from factsheet sales over three to five years. However, if a charity wants to borrow to buy a tangible asset e.g. a building or some equipment, we describe this as 'hard development capital' and would probably refer them to a longer-term lender such as Charity Bank or Triodos Bank.

These different types of financial needs are met by different types of financial instruments – for example, unsecured loan, secured loan, standby facility, grant, equity etc.<sup>2</sup>

Together with others, Venturesome has sought to develop a new financial instrument that fills the gap between debt on the one hand, and grants/equity on the other (but is not debt nor equity nor grants). This has led to a type of financial instrument known as 'quasi-equity'.

## Introducing Quasi-Equity

There are situations in which debt financing is inappropriate or too onerous for charities or social enterprises (especially in early stage, high-risk start-ups), while the use of share capital is simply not possible because of the way many such enterprises are legally structured (eg companies limited by guarantee or unincorporated trusts).

In such circumstances, quasi-equity instruments may offer a useful source of finance.

Quasi-equity is a financial instrument that aims to reflect some of the characteristics of shares (preference or ordinary).

The following case study illustrates how such quasi-equity instruments may be used.

## Charity Technology Trust: A Case Study<sup>3</sup>

### (i) The financial need for quasi-equity

Charity Technology Trust ('CTT') is a rapidly growing social enterprise with charitable status. It is beginning to transition from a traditional grant-dependent charity to an organisation whose activities are both increasingly commercial and able to compete within a competitive market.

<sup>2</sup> See Appendix A for a diagrammatic illustration of how different funding needs might be matched to different financial instruments.

<sup>3</sup> This case study is for illustrative purposes only, and does not reflect the exact details of the actual investment that was made.

The charity completed its fourth financial year of operation on 31 December 2006, and its accounts report a surplus of around £100k on a turnover of over £465k. Before grants, the charity is achieving P&L breakeven. The CTX initiative (its technology donation web portal) was launched in July 2006, and by December 2006 had generated over £80k of income to CTT with £850k worth of software distributed to over 650 charities. However, £100k of investment expenditure was initially required to launch CTX.

CTT ideally requires £50k (or more) of grant money to strengthen its balance sheet, so that it has sufficient reserves to invest in future growth or meet unexpected cashflow shortfalls. The charity has so far been unsuccessful in securing such grants, which is partly a reflection of the fact that it is seen by grant-makers as a trading operation which no longer requires grant support.

CTT is, therefore, caught in a transitional phase. On the one hand, grant funding is difficult to obtain (and, even if CTT is successful and generates surpluses, is not an efficient use of charitable capital). On the other hand, if debt were available, the repayment schedules of such finance would not leave sufficient working capital to invest in future development, since the amount and timing of trading surpluses are difficult to forecast.

## (ii) The financial solution

The appropriate funding instrument for CTT at this stage of its development is a quasi-equity investment.

Quasi-equity shares the risk and reward of the investment between the investor and the investee by allowing the investor to take a share of future revenue streams. Unlike a loan, this investment is truly 'at risk' ie should CTT not achieve the expected financial performance, a lower – possibly zero – financial return to the investor is payable.

If CTT performs better than expected, then a higher financial return might be payable. Of course, this requires investors to make a judgment about the likely levels of those future revenue streams.

### (iii) Revenue Participation Agreements ('RPA')

The mechanism through which Venturesome has offered quasi-equity is a legal agreement known as a Revenue Participation Agreement, developed by Venturesome in 2007.

In this case, Venturesome pays to CTT £50,000 for a Revenue Participation Right. CTT sells this right to Venturesome. The relationship is one of buyer and seller, not lender and borrower.

The Revenue Participation Right entitles Venturesome to 2% of CTT's gross annual (audited) revenue<sup>4</sup>, payable quarterly. It is worth noting that investors participate in revenue, not profit. This is because the investee is not primarily motivated by making profits for distribution. Also, there may be an incentive to manipulate profitability in order to avoid paying out under the contractual agreement.

Typically, in the event that cumulative total payments to Venturesome under the Revenue Participation Right reach double the initial payment, the Revenue Participation Right would be extinguished.

### (iv) Internal Rate of Return ('IRR')

In order to compensate Venturesome for assuming a higher risk than a loan, the quasi-equity instrument is structured so as to target an IRR of around 10%.

In other words, the percentage royalty payment attaching to the Revenue Participation Right is based on projected future cashflows (revenue) and aims to achieve an IRR of 10%.

The table below illustrates how a royalty payment might relate to a series of forecast cashflows<sup>5</sup>:

IRR=	10%					
Year	0	1	2	3	4	5
Forecast Revenue		£600,000	£690,000	£793,500	£912,525	£1,049,404
% Royalty Payent		2%	2%	2%	2%	2%
Income Stream	-£50,000	£10,044	£11,551	£13,284	£15,276	£17,568
Present value	-£50,000	£9,131	£9,546	£9,980	£10,434	
Net present value	0					£10,908

<sup>4</sup> In this paper, the terms 'income' and 'revenue' are used interchangeably

<sup>5</sup> IRR is defined as any discount rate that results in a net present value of zero of a series of cash flows

## Types of Quasi-Equity

Broadly speaking, there are two approaches to structuring a quasi-equity instrument:

### (i) Returns linked to gross revenue

As in the case of CTT above, the Revenue Participation Right entitles the investor to a specified percentage of gross annual revenue. This is relatively easy to calculate and implement – and avoids potential misunderstanding between the parties. In an existing business, this is akin to a preference share because some income is reasonably certain (unless the charity collapses immediately). In a startup, however, this is closer to an equity risk approach.

### (ii) Returns linked to incremental revenue

An alternative approach is for the Revenue Participation Right to entitle the investor to a specified percentage of (a) gross annual revenue less restricted grants; and/or (b) annual revenue above a certain threshold level.

This is a higher risk approach because the investor only participates in revenue streams attributable to 'trading' activities, and/or only participates above a 'hurdle rate'. This risk, however, can be offset by aiming for a higher IRR of, say, 15%. In case (b), this is close to an equity approach.

## The Benefits of Quasi-Equity

Quasi-equity instruments offer a way for funders and their investees to share the risk and reward of entrepreneurial activities more flexibly than debt will allow.

Quasi-equity offers social enterprises and charities the following advantages over debt and equity:

- better alignment of the cost of capital with business performance
- less costly and time-consuming than raising equity finance
- no dilution of ownership and control

Quasi-equity also offers funders a number of advantages over debt and equity. These include:

- legal structure of investee is not normally a constraint
- an opportunity to achieve a higher IRR than a loan
- a flexible method of investing directly into growing trading activities

## Learning from Venturesome's experience

Over the last five years, Venturesome has made five quasi-equity investments. Some key learnings emerge from this practical experience:

### (i) Keep it simple

We believe that the terms of any quasi-equity instrument should be kept as simple as possible. Overly complex arrangements (e.g. with numerous thresholds, elaborate distinctions between different types of income and 'trigger' events) tend to become unworkable in practice. This is because such complexity often leads to serious (but bona fide) arguments between the investor and investee as both sides struggle to understand what the agreed terms actually mean – maybe months or years after the original legal agreement was signed.

For example, Venturesome provided a charity with a quasi-equity facility of £75,000. The purpose of the support was to provide development capital for a fundraising drive (by way of a direct mailing campaign) to attract individuals as supporters. The repayment was structured so that the charity would pay Venturesome a sum equal to 25% of any 'Unrestricted Income' (ie certified as such by the auditors) which in any financial year totalled more than £175,000.

Unrestricted income, *so defined*, never reached the required thresholds – and Venturesome never received any payments. Yet the charity's financial situation improved during this period – and even the charity acknowledged that this was in part due to Venturesome's investment. The problem which was overlooked at the time of the agreement was that certain types of income could, as a matter of legitimate accounting treatment, have been classified as 'Restricted' or 'Unrestricted' depending on unpredictable variables (or at least not dependent on preset criteria).

In order to avoid such misunderstandings, the most effective approach is simply to define the Revenue Participation Right as an entitlement to a specified percentage of gross annual (audited) revenue.

### (ii) Unrestricted and restricted income

There is a common misconception that 'restricted income' should be excluded from the gross income figure when calculating the percentage participation right. It is argued that this is because grant funders will object to their restricted money being used to repay other funders.

However, this is a misunderstanding of how the Revenue Participation Right actually works. Even though restricted income is included in the gross income figure, no restricted money is transferred to the quasi-equity investor, who is paid out of unrestricted income. This is because the gross income figures (and gross income forecasts) are merely the bases of calculation which the investor uses to aim for his target IRR.

A '*keep it simple*' approach suggests using the gross income figure only.

### (iii) Accounting treatment of a revenue participation right

Accounting for any instrument of this kind is not straightforward, and it will always be important to get the views of the auditors of both the buyer and seller of the Revenue Participation Right.

Our experience so far suggests that the following practices are emerging:

- Income which the seller receives as the Revenue Participation Fee goes through his Income and Expenditure as unrestricted income.
- As a matter of prudence, the seller's auditor will probably insist that the quasi-equity investment is treated as a liability on the balance sheet (and not merely as a contingent liability)<sup>6</sup>. Initially, this liability (payable over several years) is likely to be at least equal to the fee received, with a new estimate made periodically of the amount which will be paid over the life of the instrument and 'interest expense' (ie payments under the RPA) accrued accordingly.
- Similarly, the buyer of the Revenue Participation Right would account for an asset, although he should probably consider impairment provisions which could make the accounting asymmetrical.

Regardless of whether the Revenue Participation Right is treated (and presented as such in the accounts) as a liability or not by the seller, it is important to appreciate that quasi-equity is useful precisely because

<sup>6</sup> Under UK Financial Reporting Standards (FRSs), a liability (provision) must be recorded on the balance sheet if:

'a. an entity has a present obligation (legal or constructive) as a result of a past event; b. it is probable that a transfer of economic benefits will be required to settle the obligation; and c. a reliable estimate can be made of the amount of the obligation.'

In other words, it does not matter how a contract is structured or what an instrument is called – you need to look at the reality of what is going on in order to decide how to account for it. In terms of the 'reliable estimate' requirement, the standard is very clear that it expects an estimate to be calculable except in very rare cases:

'An entity will normally be able to determine a range of possible outcomes and can therefore make an estimate of the obligation that is sufficiently reliable to use in recognising a provision. In the extremely rare case where no reliable estimate can be made, a liability exists that cannot be recognised. That liability is therefore disclosed as a contingent liability.'

it is NOT debt. Unlike debt, payments under quasi-equity will decline in proportion to declines in the investee's revenue streams. In this way, quasi-equity better matches the cost of capital with the commercial reality of the investee.

#### (iv) Doing deals which will be accepted

In our experience, actual quasi-equity investments run the risk of not being accepted by charities or social enterprises unless the amount payable under the RPA is capped (usually at twice the amount invested and/or limited by a fixed term). Of course, both parties to the agreement should be comfortable with the target IRR of the deal. However, unless there is a cap, the investee is likely to withdraw on the basis that such quasi-equity money is perceived as being 'too expensive'.

#### (v) The adverse selection problem

In trying to engage in quasi-equity investment opportunities of the type described in this paper, the investor may encounter a curious phenomenon.

At the heart of every quasi-equity deal is a calculation of expected return based on forecast revenue streams. Whether or not the investor will achieve his target IRR depends crucially not only on how accurate those forecasts are, but also on the margin of error the investor thinks is implicit in those forecasts. So, for example, an investor may want to achieve an overall IRR of 10%, but may decide to aim for an IRR of 20% because he believes that the forecasts are optimistic (and factors this into his calculations).

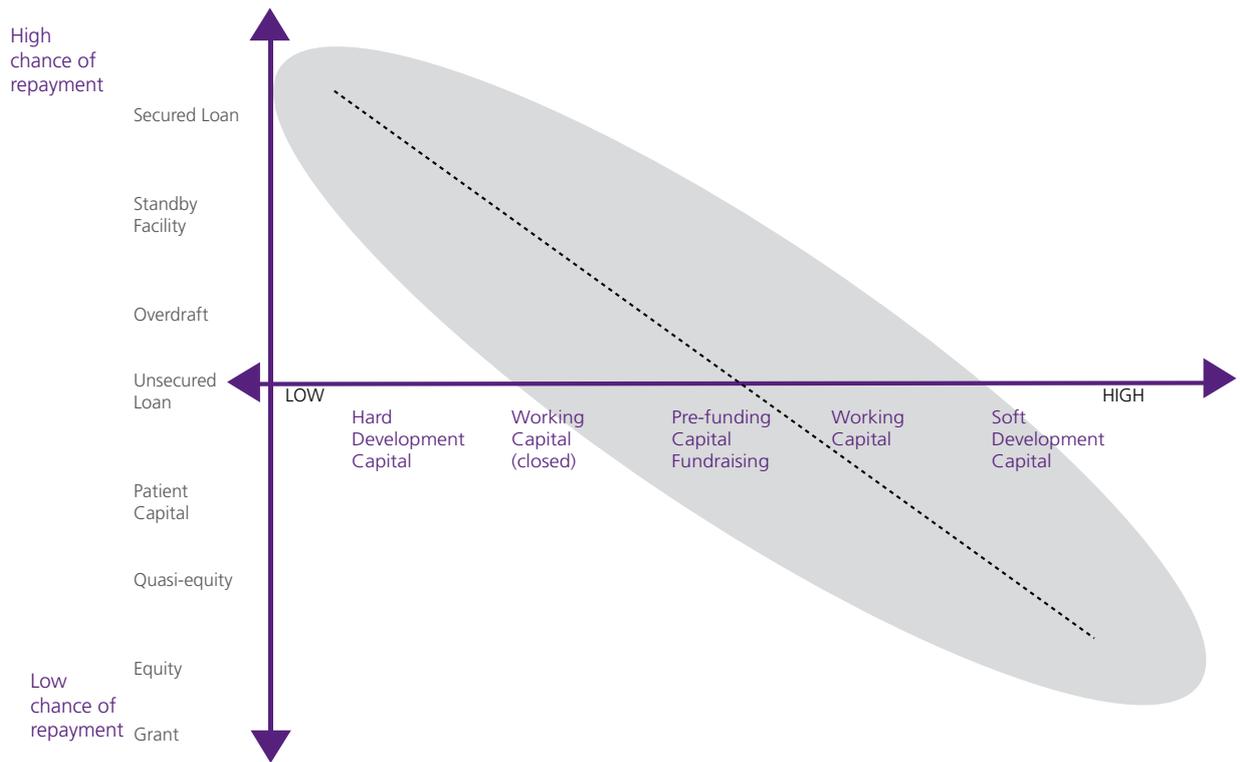
The danger for the unwary investor is that those organisations who privately believe that their future revenue streams will be disappointing are the same organisations who are more likely to accept any quasi-equity deal – in effect, they treat the quasi-equity investment as a 'grant'.

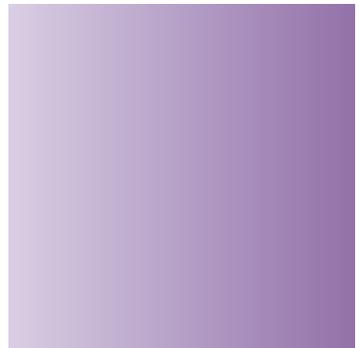
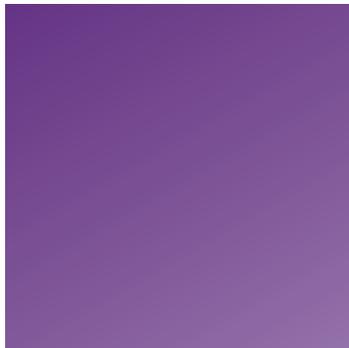
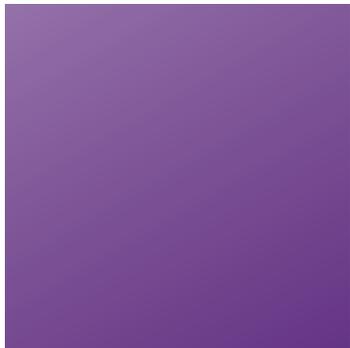
Other the other hand, those organisations who privately believe that their future revenue streams will be very strong are the same organisations who are more likely to reject any quasi-equity deal – because they believe that they will thrive and the investment will therefore prove expensive.

In other words, the market for quasi-equity products suffers from a potential adverse selection problem. Eager sellers of Revenue Participation Rights may turn out to be the lemons. Caveat emptor.

# APPENDIX A

## Matching funding needs to financial instruments





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