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Should Your Company Offer Revenue-Based Financing Options?

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Traditional and nontraditional lenders have a variety of loan and financing options available for small- to medium-sized businesses (SMBs), from equipment and inventory financing to a business line of credit and merchant cash advances. But events like Covid-19, global supply chain issues, geopolitical conflicts, inflation and talks of a recession have pushed lenders and borrowers alike toward relatively more conservative loan options, like revenue-based financing (RBF).

RBF promises a percentage of a business's future revenue to the financier until a fixed, predetermined amount is reached. This amount is often the value of the original loan, plus a flat fee. Clearco (formerly Clearbanc) co-founder and president Michele Romanow believes that in 2022, business leaders are likelier to choose RBF over traditional financing methods. Since 2005, there's been a steady rise in revenue-based financing firms, with 32 U.S. firms managing a minimum of 57 distinct funds representing an estimated $4.31 billion in capital.

Although B2B software is the largest RBF borrower, revenue-based loans are becoming more popular with SMBs because they tend to have cheaper and more flexible repayment terms. Even if borrowers have a bad month, they won't have a large repayment they can't afford because they only owe a percentage of monthly revenue.

RBF is also less costly than a lot of other financing options like debt and equity financing. SMB owners retain greater control and ownership, with no risk of collateral. On the flip side, lenders love revenue-based loans because they have the potential to produce substantial returns with relatively little risk —with some able to achieve profits of 20% even in a health and economic crisis like Covid-19. Moreover, both the financier and company have goal alignment to grow revenue, and funding can often be provided in as little as four weeks.

RBF is a smart choice for young SMBs that have low credit scores, few assets and a small investor and venture capital network, all of which may reduce their access to traditional financing options. As such, RBF increases the number of loans available to businesses, increases a lender's borrower rate and allows lenders to provide more loans.

Lenders interested in adding RBF to their loan offerings to appeal to a wider SMB customer base can streamline the process by incorporating accounting data into their underwriting decisions. Accounting systems are a treasure trove of information for lenders, and accounting data paints a much more accurate picture of a borrower's financial health. Using accounting data, lenders can determine:

• Good versus bad debt.

• Average payment terms and days to pay.

• Average invoice value.

• Customers who pay on time versus those who don't.

• Paid versus outstanding invoices and costs.

However, lenders typically shy away from using accounting data for multiple reasons. Business customers may miss outstanding invoices, which makes it difficult to assess the company's actual financial situation. Furthermore, PDFs and Excel sheets can easily be manipulated since accounting data is self-reported. They can also be outdated, especially if the SMB or startup is in its growth stage. Lastly, not every small business is using cloud-based accounting software, so extracting accounting data in a ready-to-use format can be expensive.

Revenue-based financing can be very profitable for lenders. It improves loan accessibility to businesses and the rate with which lenders can choose borrowers, and it allows lenders to serve more loans. Modern technology can help lenders offer revenue-based financing options and increase their pool of qualified commercial customers. For vendors looking to expand their SMB loan offerings, RBF can be a great option.

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