Andy Sack, Flush With $6M, Builds Revenue Based Financing Company That Could Disrupt Venture Capital, Startup Ecosystem

Gregory T. Huang | 6/7/10 | Follow @gthuang

Andy Sack has been working behind the scenes for more than a year. Yes, we know he's been busy bringing the first session of **TechStars**, the startup bootcamp, to Seattle this fall. He's also been co-leading **Founder's Co-op**, the seed-stage investment fund, for the past couple of years. But just when you think the Seattle tech entrepreneur and angel investor has his hands full, he busts out with a new venture. This one could have even greater implications for startups, entrepreneurs, and innovation—and not just in Seattle.

It's called **RevenueLoan**, and Sack is the founder and CEO of this new company. Its goal is to provide capital for promising startups in the Pacific Northwest, and across the country, using a different kind of investment model called "revenue-based financing" (sometimes called "royalty-based financing"). Before we get into exactly what that means, here are the hard facts. RevenueLoan has raised $6 million from Seattle-based firms **Voyager Capital**, **Summit Capital**, and **Founder's Co-op**, to make investments and support operations. Sack says he will remain a partner with Founder's Co-op, but will step away from co-leading that fund to focus on RevenueLoan and TechStars. (Founder's Co-op **will be led by Chris DeVore and Geoff Entress**.)

The idea of RevenueLoan is to make investments in the range of $100,000 to $500,000, Sack says, targeting companies that already have between $500,000 and $5 million in annual revenue. Instead of taking an equity stake in the company like a traditional VC firm would, RevenueLoan will receive a percentage of future revenues (typically 1 to 10 percent). The investor can generate a of future revenues (typically 1 to 10 percent). The investor can generate a maximum of a 3-to-5 fold return on his investment. That's the "revenue-based" part of the equation, and the goal is to open up a wider range of companies to invest in, where the investment returns will flow if the company is able to execute on its business plan. Such an investment model doesn't depend on a company going public or getting acquired, like traditional venture capital.

Since the IPO market has been in a drought for years, and acquirers in such an environment can afford to drive a hard bargain, this revenue-based model definitely has appeal. After all, early-stage investors are starving for some way to generate returns. And for entrepreneurs, it can offer a new way to get the capital they need for expansion, while allowing them to spend more energy executing on their business plan rather than chasing the all-important "exit" that VCs crave.

"We're going after a segment that is today underserved by traditional equity like VCs and banks," Sack says. "It's a huge market."

Revenue-based finance is not a new idea. As **I first described in a feature last October**, the model dates back to traditional mining companies and government economic development programs. Since the early 1990s, it has been applied to early-stage technology startups by a handful of people, including Arthur Fox, the founder of Royalty Capital Management in the Boston area. RevenueLoan represents the first major revenue-based financing effort in the Northwest—and one of only a few such projects around the country.

Sack says he first heard about the investment model about a year ago, through Thomas Thurston of **Growth Science International** in Portland, OR (**whose work I wrote about last month**), and Erik Benson, a managing director at Voyager Capital, who is leading his firm's investment in RevenueLoan. "I've thought the venture capital model has some real strengths, and some real flaws," Sack says. He adds that the revenue-based model "just resonated with me immediately."

So at Founder's Co-op, Sack and his team **made a couple of investments with a fledgling revenue-based structure** to test it out. Those deals were with Seattle-area Internet startups BigDoor Media and Nearlyweds. Sack says they "proved the concept with those two deals" and that "both companies are doing well." But he admits those companies were earlier-stage than what RevenueLoan will seek to invest in. Sack says RevenueLoan wants to make a minimum of five investments a year, and is aiming to make 10 to 20 investments with the first fund.

The big question is what kinds of companies will fit this model? Sack says there are something like 30,000 companies that have annual revenues of a few million dollars but have modest annual growth rates—20 percent, say—that won't attract VCs, who are searching for 10x home-run returns. Instead of chasing those same companies, Sack says he'll focus mostly on technology startups with 50 percent gross margins, because that's the field he knows. But the revenue-based model also can be applied to companies outside of traditional tech. Interestingly, Sack says he expects to make a number of investments in companies from places outside Seattle proper, like Aberdeen, Bellingham, Tacoma, and Olympia, WA, because those entrepreneurs tend to have less access to angel and venture capital. “I’ll be looking for companies not on the beaten path,” he says.

A couple of hypothetical examples of companies he’d consider investing in: a wine distributor that wants to use radio frequency identification (RFID) tags to change its distribution channel; or an organic pet food e-commerce site with a unique value proposition. Other promising areas include lead generation, online education, financial services, and Web hosting services, Sack says.

Over the past few months, I’ve also talked with outside experts about the merits and challenges of royalty-based capital in general—and whether it could reshape the venture investing landscape. “It’s a pretty interesting tool for startups,” says Jeff Schrock, a venture capitalist with **Intel Capital**. He adds, “It offers growth capital to companies that can’t participate in debt or equity [financing]…What I like about it is, compared to classic debt, it’s success-oriented. An entrepreneur doesn’t have to put all his chips on the table.”

Schrock thinks the model makes sense for certain software, gaming, and IT companies (hardware, not so much). Or even as a growth-capital tool for life sciences companies—especially those on the verge of gaining FDA approval of their product. It also could work for venture-backed companies whose prospects no longer merit further equity investment. There might be hundreds of those companies in a given year, Schrock says.

Nevertheless, some investors caution that it’s too early to know how successful the royalty-based model will be. “It’s exotic at this point compared to venture or debt. It’ll take some time to prove it out,” Schrock says. And he adds, “This is not a panacea. This does not solve all problems in venture. I don’t know if it’s going to solve the startup funding issue.”

Which, in fact, is precisely why others think it could eventually become huge. Thurston, a Portland-based consultant and researcher **who has been testing “disruptive innovation” theory across different industries**, says royalty-based financing for healthcare companies was already a $3.3 billion market in 2008. Yet few people have really studied it, and it doesn’t compete head-to-head with the venture industry. (For comparison, VCs invested about $28 billion in 2008—$8 billion of it in biotech and medical devices—according to the **National Venture Capital Association**.)

“Royalty-based financing has the potential to be very disruptive to traditional venture investing,” says Thurston, who has studied the new model with author Clay Christensen of Harvard Business School. “I don’t think it’ll ever replace equity, but it may end up creating such a big market that it’ll look a lot bigger than equity market investing. It’s like angioplasty. It didn’t replace heart surgery, but it created a much larger market for preventative heart care. Royalty-based financing in the next decade or two will be a much bigger market in terms of dollars invested over time.”

The proof will be in the proverbial pudding, of course. In the meantime, Sack is putting the finishing touches on his new fund’s structure and operations. Joining him on the management team at RevenueLoan will be vice president Randall Lucas, who was formerly a senior associate at Voyager Capital.

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It will take some time and effort to explain the revenue-based model to ... entrepreneurs will see the ... ave to sign a personal ... y valuation, or give up ownership, like they would with a VC. RevenueLoan will take just a 1 percent “equity kicker” in warrants, Sack says. On the other hand, entrepreneurs will have to pay back their investors right away out of their hard-earned revenues. But everyone seems to agree that if a company’s projected growth is a good fit, the structure makes sense—and that this should lead to a wider range of companies getting the money they need to expand.

“It makes a huge difference when you align the incentives between the investor and entrepreneur,” Sack says. “As I’ve been talking to more entrepreneurs, I’m super stoked by the prospects…It’s a really innovative product to help finance early-stage technology companies. It will move to fill in the gap that the banks have left, and focus on a segment of the market that VCs just don’t do.”

Asked about the long-term prospects of RevenueLoan, Sack says, “I have a strong belief that revenue-based finance will be a major source of capital for a huge underserved market…Today there’s less than $100 million in revenue-based finance focused on technology, but I predict it will be a multibillion-dollar market in a few years.”

If that turns out to be true, it is also a huge opportunity for the Seattle innovation community to stake its claim to a new investment sector, and take the lead over places like Silicon Valley and Boston, which have much larger traditional VC establishments. Sack, for his part, doesn’t think the revenue-based model will take off in the Valley because the traditional flow of venture capital is too strong. As for Boston, who knows? The birthplace of revenue-based capital applied to tech startups just might have some surprises up its sleeve.

For now, my money is on the Northwest. After all, as disruption theory tells us, the innovations that turn out to be truly disruptive almost always come from the edges of the industry, and the smaller players. RevenueLoan, coming from Seattle—and inspired by Boston and Portland—could fit the bill.

Gregory T. Huang is Xconomy's Deputy Editor, National IT Editor, and the Editor of Xconomy Boston. You can e-mail him at gthuang@xconomy.com or call him at 617-252-7323. Follow @gthuang

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