

Real Deals

SSBCI 2.0 Product Playbook

Alternative Equity

Drexel's Nowak Metro Finance Lab & Kauffman Foundation

Executive Summary

Background

*The **State Small Business Credit Initiative (SSBCI 2.0)** is a federal program authorized by the 2021 American Rescue Plan that gives **\$10 billion to states** to create programs that invest in — and help grow — small businesses. Each state is tasked with designing the programs and financial products to distribute funds from this unprecedentedly large program.*

Challenge

*How do states structure capital, administer programs, and build the partnerships necessary to successfully leverage this federal investment to create jobs, reach and support businesses, and **permanently** strengthen their state economies?*

Opportunity

***Alternative Equity** helps reach businesses poised for growth but not a fit for venture capital and other forms of traditional equity investment. States can direct SSBCI funds towards firms and seek patient capital match for investments that support specific types of sectoral growth and public benefits while realizing modest returns for investors, such as philanthropies and foundations.*

About the Nowak Metro Finance Lab

The Nowak Metro Finance Lab is a research lab based at Drexel University to help local governments identify and implement public finance strategies to support strong and inclusive cities and states. The Lab's current and founding director is Bruce Katz, co-author of The New Localism and The Metropolitan Revolution: How Cities and Metros are Fixing Our Broken Politics and Fragile Economy.

*The Lab has partnered with the **Ewing Marion Kauffman Foundation** to provide free research and support to states as they implement the \$10 billion State Small Business Credit Initiative, with the goals of:*

- 1) **Strengthening and building local small-business capital ecosystems;***
- 2) **Reaching underserved entrepreneurs without access to capital; and***
- 3) **Driving catalytic innovation in metropolitan regions and states***

Definitions

Capital Product: *An agreement wherein one entity or firm invests money into another; examples included loans, equity investments, and other means of extending credit and capital to businesses.*

Equity Investment: *a capital product that is an investment in a company that purchases ownership, conferring rights to dividends, board membership, or other funder benefits as terms of initial investment, with flexible repayment options, usually at the discretion of the board, but with potential for high returns*

Venture Capital: *A type of equity investment that makes high-risk investments, often in early-stage companies, with the expectation that only a few firms with exponential growth will bring fund returns, often a dilutive investment with significant equity ownership and/or board seats.*

Alternative Equity: *A type of equity investment that, instead of exponential growth in firms, looks for modest financial returns and/or public benefits as a result of its investment, often from institutions that traditionally invest equities in index funds beyond their local market, maintaining ownership and decision-making with the firm's founders.*

Aunnie Patton Power's *Adventure Finance* (2021) helped guide these definitions

Alternative Equity Product: *Redeemable Equity*

Redeemable Equity: *an equity capital product that allows investors to share the benefits of founders' growth, while founders maintain a higher share of company ownership compared to other forms of equity investment.*

In a redeemable equity structure, investors purchase a portion of a founder's business with an initial investment. As the founder's company grows, it repays the investor with dividends or other forms of repayment, often calculated as a share of company revenues. As the business makes payments to investors it reduces its predetermined obligation and buys back the investor's ownership shares of the business. Redeemable equity can be structured so founders buy back all or some of the investor's shares.

Redeemable equity may be a good fit for businesses with:

- *Established track record (at least one year of financial statements)*
- *High levels of year-over-year growth (>50%)*
- *High gross margins (>40%)*
- *Path to profitability within five years*

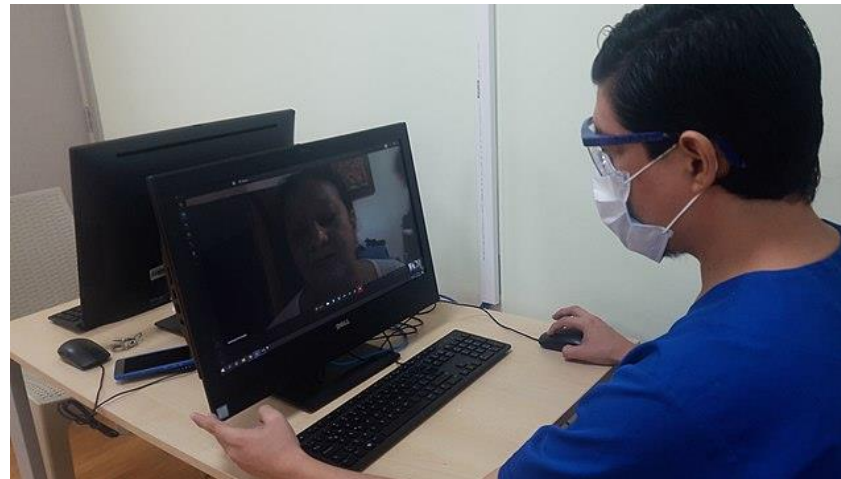
Not all Alternative Equity products are redeemable, making Redeemable Equity a subset of Alternative Equity products.

Example Deal: Business Profile

Family Care Clinic (Hypothetical)

Business Background: A local healthcare company with two small clinics and promising innovation in telemedicine services 2,500 patients in the region, with fast growth over the past 18 months.

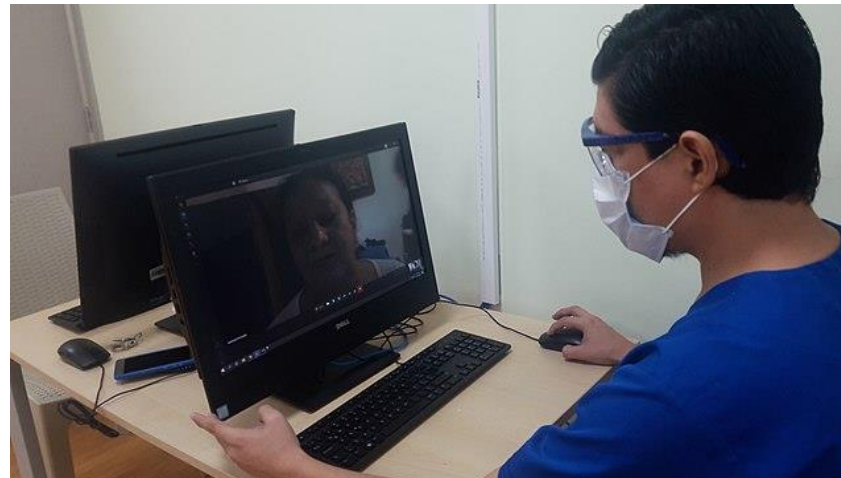
Capital Need: Family Care Clinic looks to open a third location, which requires hiring more doctors and expanding its online telemedicine presence. The company is asset-light, and reducing or eliminating debt-service costs would increase the firm's ability to reinvest funds in growth.



Example Deal: Redeemable Equity Fit

Family Care Clinic (Hypothetical)

Redeemable Equity's Core Criteria	Business Profile Fit
1+ Year(s) of Financial Statements	Opened 2019 ✓
High Year-over-Year Revenue Growth (>50%)	60% growth in 2020 and 2021✓
High Gross Margins (>40%)	45% gross margins since opening ✓
Path to Profitability within 5 Years	Projected profitability in 2023 ✓



Example Deal: Equity Redemption Schedule

Individual Investment w/ Revenue Based Redemption

Sample Deal — Family Care Clinic

Annual revenues at investment: \$2M

Investment amount: \$500k

Investor equity at investment: 15%

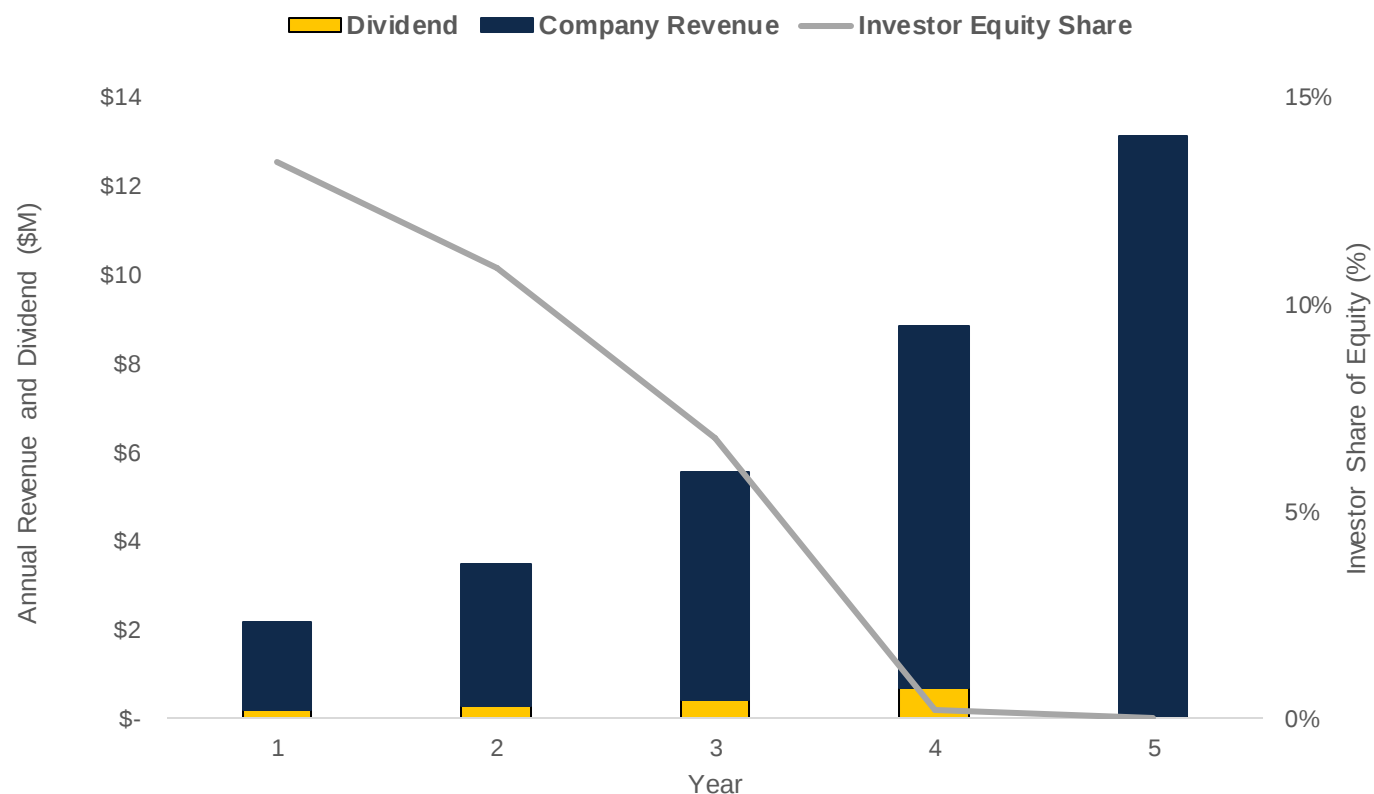
Avg. annual revenue growth: 60%

Revenue share as dividend: 8%

Return Cap: 3x original investment

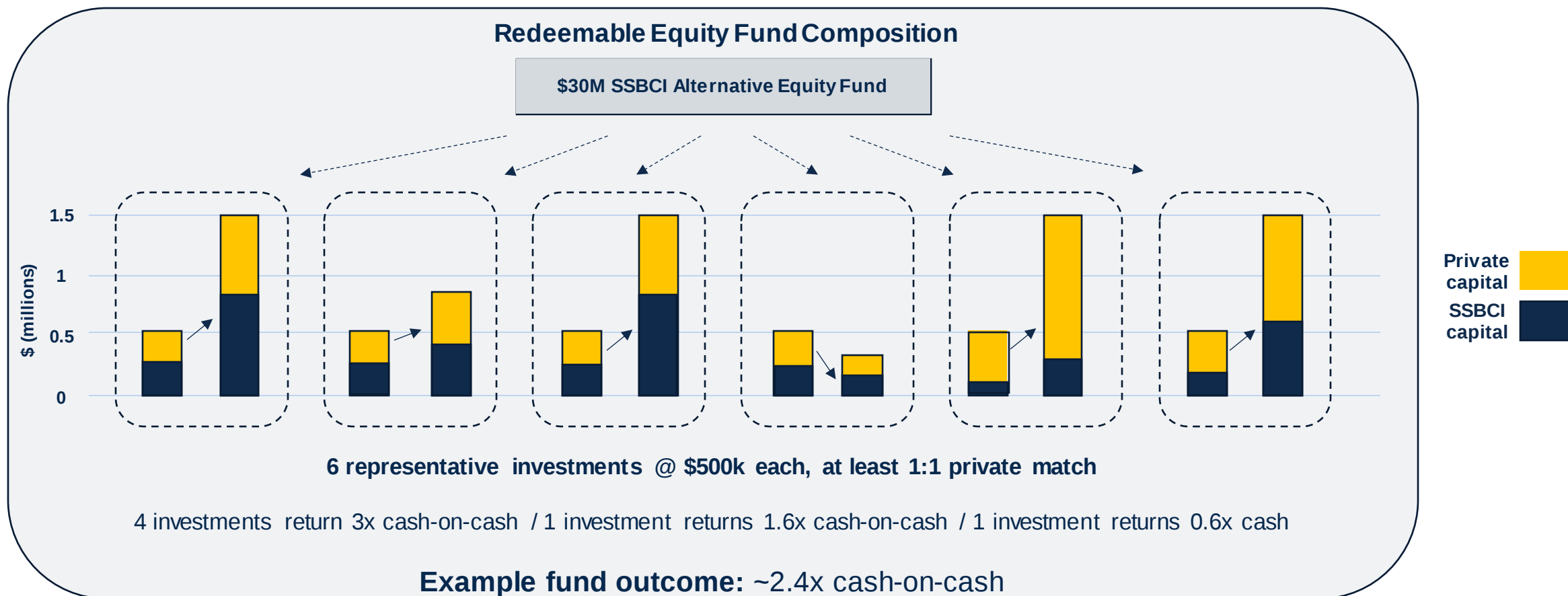
Investor equity can be structured to be fully repurchased by founders or for investor to retain residual equity stake

Annual Revenues, Dividends, and Investor Equity Share



Fund-Level Returns

Outcomes Projected Over 5 Years



Alternative Equity Optionality

Most Flexible

Repayment



Example 1: Investors maintain passive ownership with dividends counting towards redemption at board discretion

Example 2: Firm begins with grace period, begins redeeming equity with payments equaling 50% of free cash flow in years when gross margins exceed 40%

Example 3: After 3 years, obligation converts to revenue-based loan, payments equal to 7% monthly revenues, with total obligation due year 5

Least Flexible

Specific Tools/Terms

Type of Payments: mandatory or elective (board discretion)

Grace period: redemption doesn't begin until:

- after X years,
- after company gets \$Y gross revenues/profits
- or earlier of the two

Early payment discount: reduced total obligation if redeemed early

Obligation due date: drop-dead date of when full obligation is due

Residual Ownership: investors retain ownership to maintain upside or passive ownership

Upshot: Alternative Equity provides almost infinite options to meet entrepreneurs' needs and funders' objectives

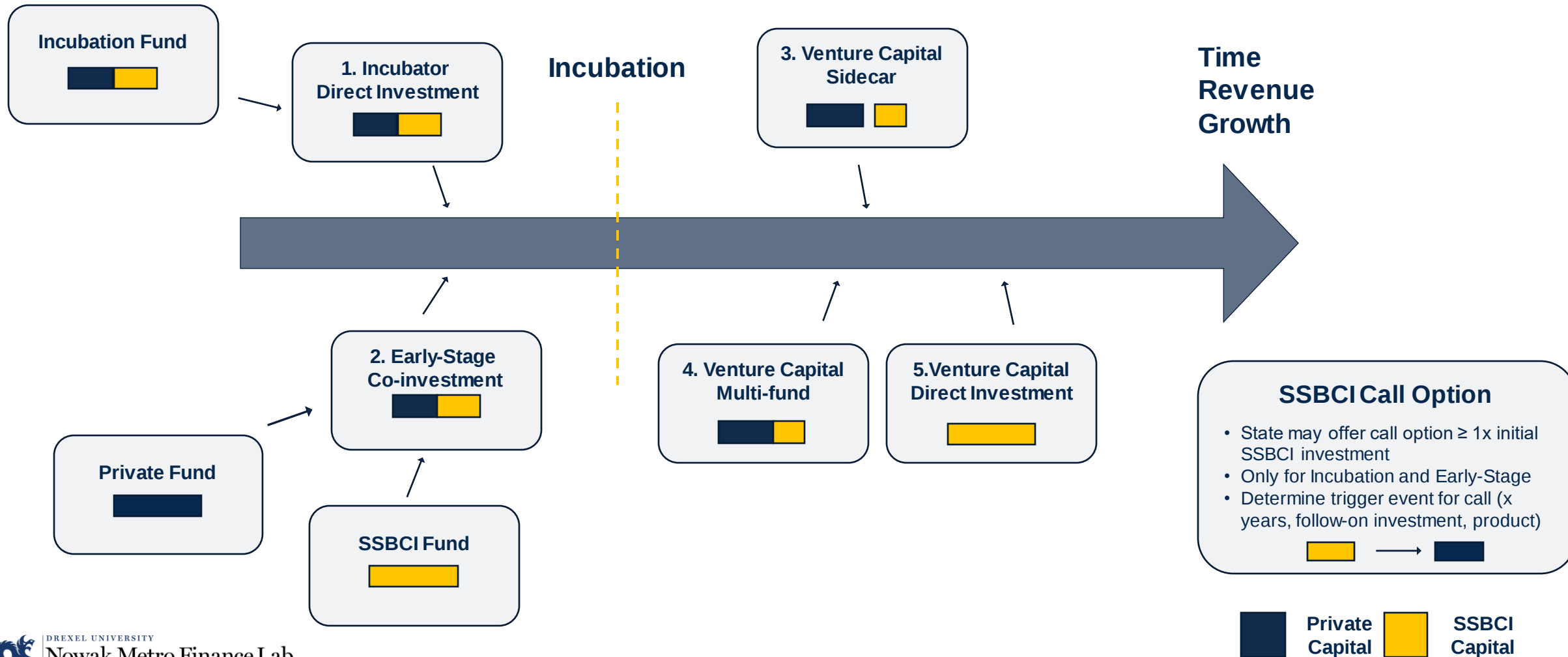
SSBCI Equity Program Integration

Program Options with Equity Investments

Four SSBCI-supported equity investment options, per Treasury's capital guidelines:

- 1. Seed-stage investments:** The state invests in funds/businesses alongside incubation services; seed-stage investments may also include call option for private investors to buy SSBCI portion at multiple (>1x)
 - **Incubation Funding Model:** invests into funds that provide incubator service
 - **Early-Stage Co-investments:** state co-invests w/ early-stage investors providing incubator services
- 2. Multifund:** also called "fund of funds," states invest SSBCI dollars in multiple funds meeting SSBCI objectives and other state priorities
- 3. Sidecar Fund:** state provides pool of funds to private investors to invest alongside their portfolio, sometimes subdividing their portfolio to meet SSBCI and state objectives
- 4. Direct Investment:** the state manages investment decisions while attracting private investors to meet 1:1 initial match

SSBCI Fund Types over Life of a Firm



Key Roles for Patient Capital

Supportive Direct Investment:

- 1:1 match on earliest-stage, riskiest investments but potential for community impact
- 1:1 early-stage match on businesses with modest growth potential
- First-loss capital to entice private investment and overcome pari passu requirements

Capacity-Building and Ecosystem Support:

- Supplement low SSBCI fees of fund managers, create incentive rates
- Fund incubation services for investees, support success

Recommendations for States

1. ***Review your Treasury application** for possible Alternative Equity integration*
2. ***Contact your local capital and business coaching providers** to assess current practice and capacity for Alternative Equity Investment*
3. ***Check out the Innovative Finance Playbook**, a Nowak Metro Finance Lab collaboration with Catalyze to identify and scale innovative financial products; resources include:*
 - ***Sample term sheets for Redeemable (Alternative) Equity***
 - ***Investment guidelines and best practices***
 - ***Trainings and webinars***
4. ***Reach out to the Nowak Lab** for more information: bryan.jeffrey.fike@drexel.edu*

Contact

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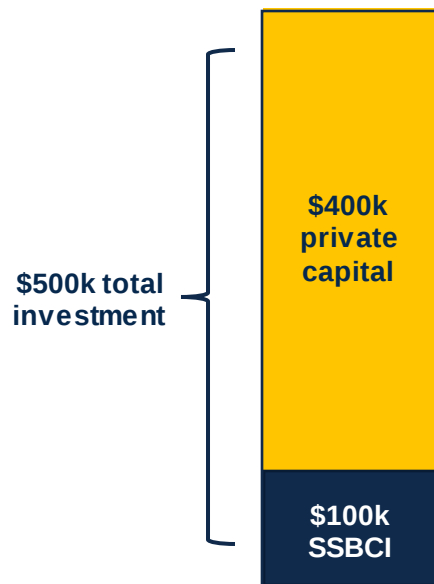
Research Officer

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Appendix – Alternative Equity

Traditional VC vs. Alternative Equity

Individual Investment



Policy Objective:

Firms with growing but cyclical cash flows look to expand operations or hire staff and seek appropriate capital. Owners wish to retain control and ownership stake over firm and do not wish to further fundraise.

Policy Challenges:

Mainstream growth capital products can be exclusionary:

- Traditional debt products require collateral or loan guarantees
- VC favors a narrow set of firms – tech-enabled, asset-light companies with opportunity for exponential growth - and has significant racial, gender, and geographic disparities
- Firms may never undergo valuation, but still need growth capital
- Impact investors are looking for vehicles to invest patient risk capital

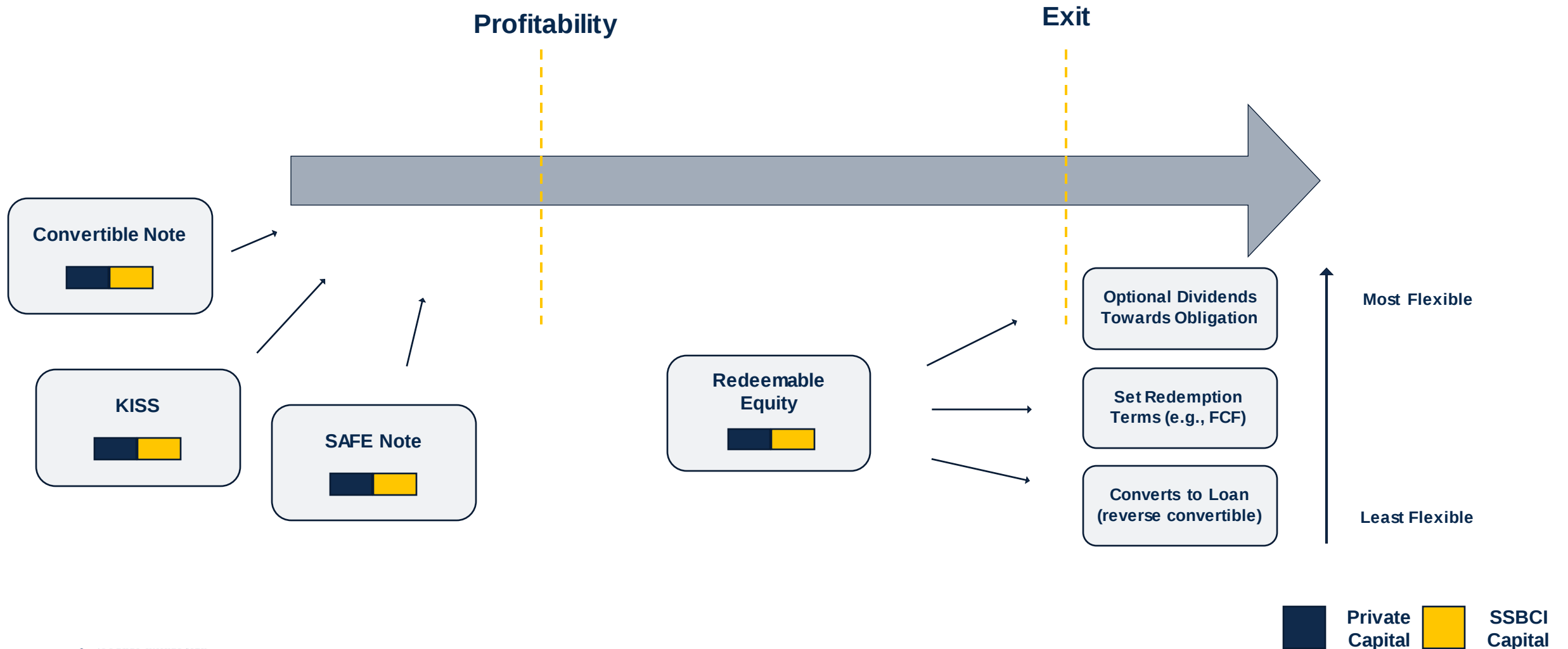
Stronger evidence base needed to scale viable alternatives

Policy Tool:

Expand knowledge base on redeemable equity product with risk-tolerant capital

Equity over Life Cycle of a Firm

Product Options



Ex 1: SSBCI Equity Program

Fund Structure(s) – SCF

Product	Description	Pros/Cons
Convertible Note	➤ Debt that converts to equity with liquidity event ➤ Can be repaid as loan/with cash flow ➤ Discount applied to purchase of future shares	Debt agreement that converts into equity; does not require valuation/priced round; includes downside protections for investors
SAFE (Simple Agreement for Future Equity) Note	➤ Pre-valuation investment in a company ➤ Stipulates discount rate and valuation cap at which funder can buy future shares	Most founder-friendly, depending on terms; best for getting capital into promising early-stage firms.
KISS (Keep It Simple Security)	➤ Accrues interest ➤ Converts to preferred share equity on maturity date ➤ Cross between convertible note and a SAFE	A cross between a SAFE (does not require priced round) and convertible note (accrues interest); more funder-friendly than SAFE
Redeemable Equity	➤ Range in flexibility on repayment ➤ Can convert to debt, set repayment ➤ Can also create passive ownership, optional dividends	More flexible equity than VC; extent depends on redemption terms, ranging from very flexible redemption to conversion to a term loan.