Training Module: Growth Financing Opportunities

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Business "Gazelles"

- Roughly 3% to 5% of all U.S. businesses sustain revenue growth at 20%+ over a period of 4 years
- Known as "gazelles" they create 70% to 100% of all net new jobs
- Today there may be as many as 300,000 small business gazelles in the U.S. – scattered roughly equally across the country
- According to an SBA study, “high-impact” gazelles exist in almost all regions, states, metropolitan statistical areas, and counties, and with only a marginal bias in favor of major urban areas
Things to know about gazelles

• According to an interview with David Birch, who coined the phrase "gazelle", they exhibit:
  – tolerance for uncertainty and fear,
  – lack of obsession with the external economic conditions, and
  – the ability to promote an entrepreneurial culture among colleagues and employees

• Gazelles are not all in high-technology sectors
  – Roughly 30% of all gazelles are in wholesale and retail trade and another approximate 30% are in services

• Gazelles are associated with innovation, but not necessarily with high-technology or proprietary technology
  – Think Starbucks, Wal-Mart, Amazon, Office Depot, and FedEx and the firms that supply to them
Things to know about gazelles

• The nature of their business model, projections, and/or growth strategies push them out of the target zone for community banks and venture capital firms
  – Inability to get growth or intangibles financing from a bank due to insufficient collateral or failure to meet banking norms
  – Low book equity (to minimize equity component of investment)
  – Exit strategies are not clear or viable
  – Growth model doesn’t fit into VC firms “boom or bust” target zone

• Of roughly 6 million U.S. businesses with payrolls*, 150,000 to 200,000 are gazelles as compared with fewer than 20,000 VC-backed firms

*–Based on Census Bureau and NVCA data
Where can you find gazelles?

- Bankers (look for good companies that may have been rejected for traditional financing)
- Consultants, accountants, and lawyers
- Technical assistance and training programs
- Universities
- Large firms sourcing locally
- “Mixers” and “deal shows” sponsored by VC groups
- Direct meetings with VCs and SBICs
Small business optimism means gazelles will increasingly seek creative financing options

<table>
<thead>
<tr>
<th>Index Component</th>
<th>Net %</th>
<th>Change from Last Month</th>
</tr>
</thead>
<tbody>
<tr>
<td>Plans to Increase Employment</td>
<td>10%</td>
<td>▲ 5</td>
</tr>
<tr>
<td>Plans to Make Capital Outlays</td>
<td>24%</td>
<td>▲ 3</td>
</tr>
<tr>
<td>Plans to Increase Inventories</td>
<td>-1%</td>
<td>0</td>
</tr>
<tr>
<td>Expect Economy to Improve</td>
<td>-2%</td>
<td>▲ 6</td>
</tr>
<tr>
<td>Expect Real Sales Higher</td>
<td>1%</td>
<td>▲ 5</td>
</tr>
<tr>
<td>Current Inventory</td>
<td>0%</td>
<td>0</td>
</tr>
<tr>
<td>Current Job Openings</td>
<td>18%</td>
<td>▲ 3</td>
</tr>
<tr>
<td>Expected Credit Conditions</td>
<td>-9%</td>
<td>▼ -2</td>
</tr>
<tr>
<td>Now a Good Time to Expand</td>
<td>4%</td>
<td>▼ -1</td>
</tr>
<tr>
<td>Earnings Trends</td>
<td>-28%</td>
<td>▼ -1</td>
</tr>
</tbody>
</table>

Percent of surveyed companies planning a capital expenditure during the next three to six months is highest since 2008. This means planned growth and potential gazelles.

Source: NFIB Small Business Optimism Index, May 2012
Gazelles need non-asset-based and participating financial instruments designed to fit their growth patterns. They also need financing that breaking free from dependence on exits and consistent cash flows.

“Revenue capital” is an option to fill the instrument gap.
Royalty Loans and “Shareholder Loan Investments”

Combining Revenue Capital and Equity for Financing Gazelles

100%+ Collateralized Loans from Banks

Medium- to Long-Term, Non-Asset-Based Growth Financing

Venture Capital

Some Options for CDFI’s to Support ABC Energy Inc.’s Needs

1. **Royalty-Based Loans**: ties the investor return to a more fundamental metric – gross sales – with a flat % of sales paid to the investor over a period of time

2. **Shareholder Loan Investment**: shareholder given promissory notes, with repayment made out of company operating profits
   - *(w/ Management Buy-Back provision)*: shareholder and company share in upside on possible debt repurchases
   - *(w/ Trade Sale provision)*: shareholder and company share in upside on possible company acquisitions or sales
Gazelle Example: ABC Energy Inc.*

**Product / Service:** ABC Energy Inc. is a hybrid of an energy consulting firm and Angie's List. It advises homeowners on energy savings along with data on service providers, receiving revenues from both client groups.

**Current sales:** $250,000 p/a

**Employees:** 5 – two consultants and three support staff

**Financing need:** $250,000 for energy testing equipment and permanent working capital in order to expand to larger area and publish local newsletter on energy efficiency

**Operating margin:** 32%

<table>
<thead>
<tr>
<th>Projected sales growth (per year):</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>35%</td>
<td>50%</td>
<td>10%</td>
<td>15%</td>
<td>25%</td>
</tr>
</tbody>
</table>

*Illustrative example*
## Royalty-Based Loans

### Terms:

<table>
<thead>
<tr>
<th>Base Interest Rate</th>
<th>Royalty Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>5.0%</td>
<td>3.0%</td>
</tr>
</tbody>
</table>

### Flows:

<table>
<thead>
<tr>
<th></th>
<th>Pre-Money Year</th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
<th>Year 4</th>
</tr>
</thead>
<tbody>
<tr>
<td>Shareholder Loan</td>
<td>250,000</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Equity Investment</td>
<td>250,000</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Sales Growth</td>
<td>35%</td>
<td>50%</td>
<td>10%</td>
<td>15%</td>
<td></td>
</tr>
<tr>
<td>Gross Sales</td>
<td>250,000</td>
<td>337,500</td>
<td>506,250</td>
<td>556,875</td>
<td>640,406</td>
</tr>
<tr>
<td>Principal Payments</td>
<td>0</td>
<td>62,500</td>
<td>62,500</td>
<td>62,500</td>
<td>62,500</td>
</tr>
<tr>
<td>Interest Payments</td>
<td>12,500</td>
<td>12,500</td>
<td>9,375</td>
<td>6,250</td>
<td></td>
</tr>
<tr>
<td>Royalty Payments</td>
<td>10,125</td>
<td>15,188</td>
<td>16,706</td>
<td>19,212</td>
<td></td>
</tr>
<tr>
<td>Equity Buy-Back</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

### Returns

- **Total CDFI Revenues**: -250,000, 22,625, 90,188, 88,581, 87,962
- **IRR on Investment**: 13.66%
- **Return Multiple**: 1.5

*Illustrative example*
# Shareholder Loan Investment: Management Buy-Back

## Terms:

<table>
<thead>
<tr>
<th>Base Interest Rate</th>
<th>Royalty Percentage</th>
<th>Equity Exit Multiple</th>
<th>Exit Basis</th>
</tr>
</thead>
<tbody>
<tr>
<td>5.0%</td>
<td>3.0%</td>
<td>3.0</td>
<td>purchase</td>
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## Flows:

<table>
<thead>
<tr>
<th>Pre-Money Year</th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
<th>Year 4</th>
<th>Year 5</th>
</tr>
</thead>
<tbody>
<tr>
<td>Shareholder Loan</td>
<td>225,000</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Equity Investment</td>
<td>25,000</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

### Sales Growth

- Gross Sales: 250,000, 337,500, 506,250, 556,875, 640,406, 800,508

### Returns

- Total CDFI Revenues: -250,000, 21,375, 82,688, 81,394, 81,087, 158,078
- IRR on Investment: 16.28%
- Return Multiple: 1.7

*-Illustrative example*
# Shareholder Loan Investment - Trade Sale

## Terms:

<table>
<thead>
<tr>
<th>Base Interest Rate</th>
<th>Royalty Percentage</th>
<th>Equity Exit Multiple</th>
<th>Exit Basis</th>
</tr>
</thead>
<tbody>
<tr>
<td>5.0%</td>
<td>3.0%</td>
<td>1.0</td>
<td>sales</td>
</tr>
</tbody>
</table>

## Flows:

<table>
<thead>
<tr>
<th>Pre-Money Year</th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
<th>Year 4</th>
<th>Year 5</th>
</tr>
</thead>
<tbody>
<tr>
<td>Shareholder Loan</td>
<td>225,000</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Equity Investment</td>
<td>25,000</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

### Sales Growth

<table>
<thead>
<tr>
<th>Sales Growth</th>
<th>Gross Sales</th>
<th>35%</th>
<th>50%</th>
<th>10%</th>
<th>15%</th>
<th>25%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pre-Money Year</td>
<td>250,000</td>
<td>337,500</td>
<td>506,250</td>
<td>556,875</td>
<td>640,406</td>
<td>800,508</td>
</tr>
</tbody>
</table>

### Royalty Payments

- Principal Payments: 0, 56,250, 56,250, 56,250, 56,250
- Interest Payments: 11,250, 11,250, 8,438, 5,625, 2,813
- Royalty Payments: 10,125, 15,188, 16,706, 19,212, 24,015
- Equity Buy-Back: 800,508

### Returns

<table>
<thead>
<tr>
<th>Total CDFI Revenues</th>
<th>IRR on Investment</th>
<th>Return Multiple</th>
</tr>
</thead>
<tbody>
<tr>
<td>-250,000</td>
<td>43.05%</td>
<td>4.6</td>
</tr>
</tbody>
</table>

*Illustrative example*
## SLI: Typical Loan Terms

<table>
<thead>
<tr>
<th>Terms and Conditions</th>
<th>Typical Industry Terms</th>
</tr>
</thead>
</table>
| **Payment Terms**    | • 3 - 6 years, grace of 6 – 18 months on principal  
                       • Interest and royalty paid monthly with no grace period |
| **Collateral**       | • Generally take all available collateral but will never require 100% |
| **Interest Rate**    | • Low base interest rate, may be below prime, but **must** be within “market” levels |
| **Royalty Terms**    | • Royalty generally set at 1% - 4% of gross revenues, payable monthly with interest payments  
                       • Royalty ends when principal, interest and, royalties paid and equity repurchased  
                       • Royalty payment based on greater of actual or projections on which the investment was based |
SLI: Typical Equity Terms

- Assumes at least 95% of equity participations are liquidated through management buying back the CDFI's shares (MBOs)
- Equity limited to 20% of total investment, therefore 80% is self-liquidating
- Equity repurchase price capped at low multiple of the original purchase price or fraction of gross sales in final year (e.g., 3 x $50,000 original equity investment = $150,000; 5% x $3,000,000 gross sales in year prior to exit = $150,000)
- In case of acquisition or IPO, CDFI has a "tag-along" right (with "claw-back") to sell its equity at the same price as the principal(s)
SLIs: Advantages of Royalty-Based Loan

• Royalties for upside incentives CDFIs to participate in planning and projections, understand key drivers of investee business, and look for opportunities to grow sales
• Current income means easier to monitor by CDFI investment officers and CDFI's investors
• Less pressure on exits means more time for portfolio investees
• Royalties and fixed exit price eliminate arguments over earnings
• Unlike straight lending doesn't de-link effort from returns
• Higher returns mean more staff per investee

Fast Filter Tip
Factors that can be adjusted in projections
1) Buyback
2) Royalty Fee
3) Interest
SLIs: Advantages of Equity Component

• "Incentivizes" the investees' principals to buy back the CDFI's equity
• Forges closer partnership, helping CDFI to:
  – Influence investee to be socially responsible
  – Be a sounding board to the entrepreneur
  – Provide meaningful assistance
• Enhances CDFI's approval/blocking rights and access to information
• Gives investee a break on financing costs throughout expansion period
• Preserves working capital at beginning of expansion
Revenue Capital Investing

In Practice
What CDFIs need to know

• Need someone on staff that is practiced in subordinated relationships with banks to negotiate the terms of payment in the case of default, especially for a “technical default”
• 4 out of 5 relationships are with a bank
• Have about 100 inquires for every 1 deal, about 50 of those are immediately screened out - Need to be picky
• Need to understand the underlying operations of the company to gauge the key drivers of success
• Businesses in distressed areas must also have a strong growth plan
Transaction Steps

**Step 1**
Initial Due Diligence
- Interview the entrepreneur (“principal”) and add value
- Do “light” due diligence

**Step 2**
Business Plan
- Work with management to develop the business plan

**Step 3**
Needs Assessment
- Identify non-financial needs and resources

**Step 4**
Negotiate Terms
- Arrive at mutually agreed projections
- Negotiate a terms sheet

**Step 5**
Help Investee
- Help investee complete conditions precedent

**Step 6**
Close the Deal
- Prepare and execute documents (closing)
- Alter terms or defer payments if advantageous
- Enjoy fruits of your labor!

**Step 7**
Monitoring
- Provide on-going analysis and assistance
- Alter terms or defer payments if advantageous
- Enjoy fruits of your labor!
SLIs: Negotiating Terms and the Relationship

Relationship
• Take a sincere interest in the business
• Add value at every meeting
• Work with one set of projections
• Focus on growing sales
• Point out where interests are aligned
• Disclose everything possible
• Negotiate on-site at the business

Risk-Capital
Projections-Based Negotiations
• Work with one set of projections

Three factors that can be adjusted in projections
• Base interest
• Royalty percentage
• Equity buy-back multiple
Action Plan and Deal Flow

1. Study the training materials on shareholder loan investments
2. Review the materials with colleagues and legal counsel
3. Develop a presentation, a pitch, and a term sheet
4. Use current clients as a focus group to test strategy
5. Make presentations at "deal flow sources"
6. Identify "latent/second stage gazelles" and businesses "to look for"
7. Negotiate terms sheet with a candidate
8. Invest, assist, hand-hold, and focus on sales growth
Summary

• Every market has fast-growing gazelles and "latent gazelles"
• Fast growth (20% plus revenue increases p/a) businesses cannot sustain high growth with short-term, fully collateralized loans
• Capital gains-driven venture capital is for extremely rare situations
• Taking risk of unsecured financing requires upside potential
• Royalty-based financing limits risk while providing upside opportunity
• Royalty financing has the potential to increase the social and financial benefits of CDFI investments

"...keeping good growth plans from being shelved"
For sources and further information, see the “Growth Financing” section of the Virtual Resource Bank