

Training Module: Growth Financing Opportunities

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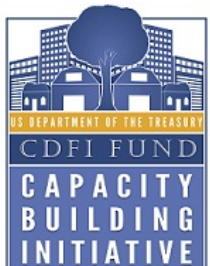
Business "Gazelles"

- 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

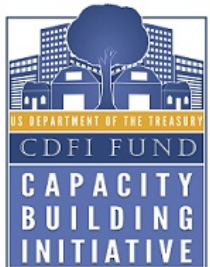
- **The nature of their business model, projections, and/or growth strategies push them out of the target zone for community banks and venture capital firms**
 - Inability to get growth or intangibles financing from a bank due to insufficient collateral or failure to meet banking norms
 - Low book equity (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**



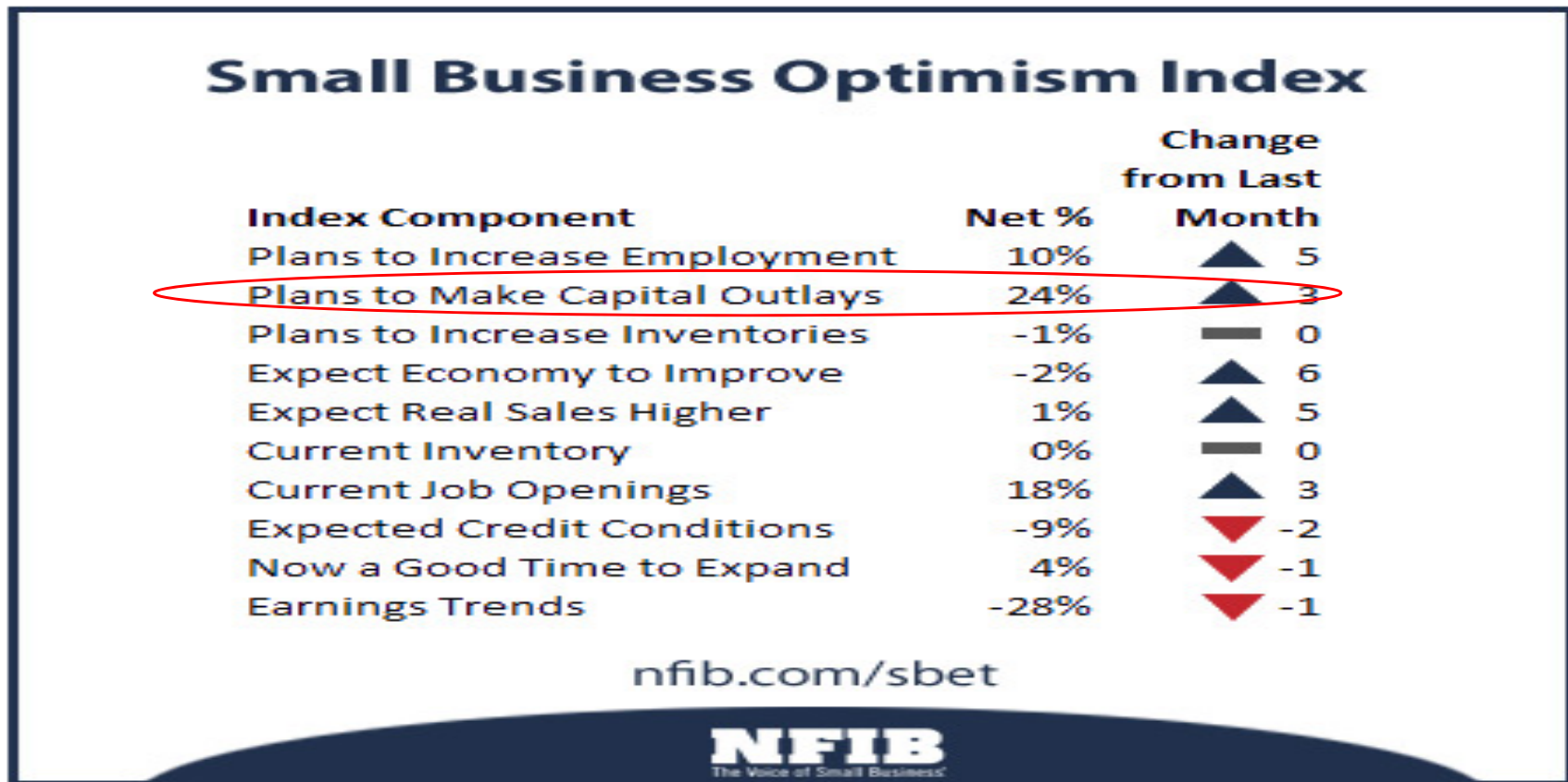
*-Based on Census Bureau and NVCA data

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

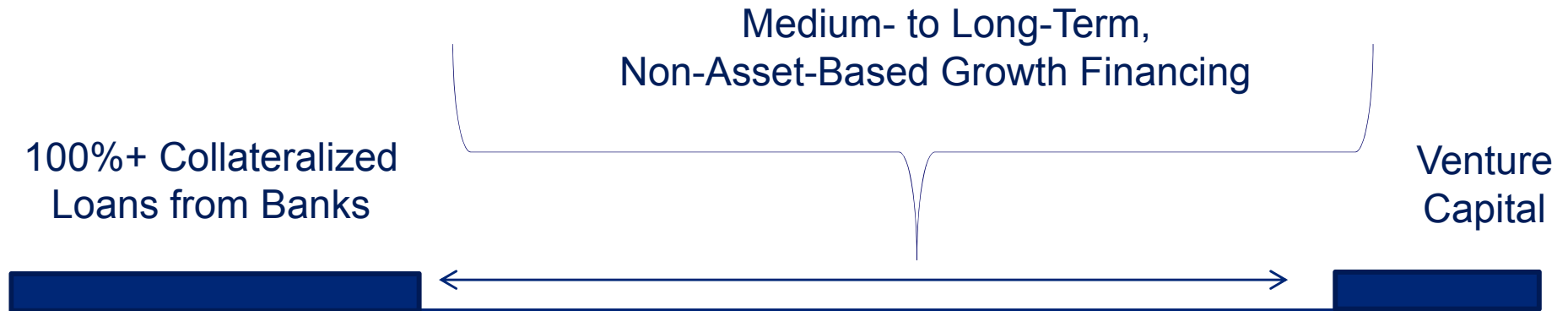


Percent of surveyed companies planning a capital expenditure during the next three to six months is highest since 2008. – This means planned growth and potential gazelles.



Source: NFIB Small Business Optimism Index, May 2012

Gazelle Financing: Filling the “Instrument Gap”



- 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”

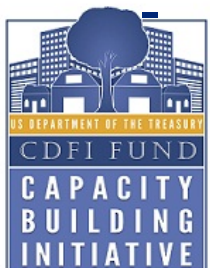
Combining Revenue Capital and Equity
for Financing Gazelles

ABC Energy Inc. Financing: Filling the “Instrument Gap”



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

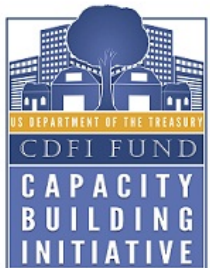
Employees: 5 – two consultants and three support staff

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%

Projected sales growth (per year):

1	2	3	4	5
35%	50%	10%	15%	25%



*-Illustrative example

Royalty-Based Loans

Terms:

Base Interest Rate Royalty Percentage

5.0%

3.0%

Flows:

Pre-Money Year

Year 1

Year 2

Year 3

Year 4

Shareholder Loan
Equity Investment

250,000

Sales Growth

35%

50%

10%

15%

Gross Sales

250,000

337,500

506,250

556,875

640,406

Principal Payments

0

62,500

62,500

62,500

Interest Payments

12,500

12,500

9,375

6,250

Royalty Payments

10,125

15,188

16,706

19,212

Equity Buy-Back

Returns

Total CDFI Revenues

-250,000

22,625

90,188

88,581

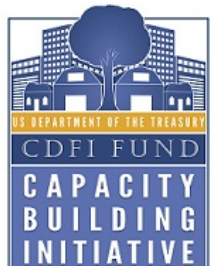
87,962

IRR on Investment

13.66%

Return Multiple

1.5



*-Illustrative example

Shareholder Loan Investment: Management Buy-Back

Terms:	Base Interest Rate	Royalty Percentage	Equity Exit Multiple	Exit Basis
	5.0%	3.0%	3.0	purchase

Flows:	Pre-Money Year	Year 1	Year 2	Year 3	Year 4	Year 5
Shareholder Loan	225,000					
Equity Investment	25,000					

Sales Growth		35%	50%	10%	15%	25%
Gross Sales	250,000	337,500	506,250	556,875	640,406	800,508

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						75,000

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:

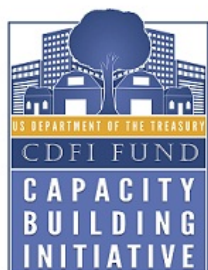
Base Interest Rate	Royalty Percentage	Equity Exit Multiple	Exit Basis
5.0%	3.0%	1.0	sales

Flows:

	Pre-Money Year	Year 1	Year 2	Year 3	Year 4	Year 5
Shareholder Loan	225,000					
Equity Investment	25,000					
Sales Growth		35%	50%	10%	15%	25%
Gross Sales	250,000	337,500	506,250	556,875	640,406	800,508
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

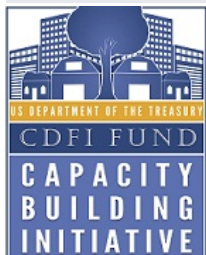
Total CDFI Revenues	-250,000	21,375	82,688	81,394	81,087	883,586
IRR on Investment	43.05%					
Return Multiple	4.6					



*-Illustrative example

SLI: Typical Loan Terms

Terms and Conditions	Typical Industry Terms
Payment Terms	<ul style="list-style-type: none"> • 3 - 6 years, grace of 6 – 18 months on principal • Interest and royalty paid monthly with no grace period
Collateral	<ul style="list-style-type: none"> • Generally take all available collateral but will never require 100%
Interest Rate	<ul style="list-style-type: none"> • Low base interest rate, may be below prime, but <u>must</u> be within “market” levels
Royalty Terms	<ul style="list-style-type: none"> • 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)



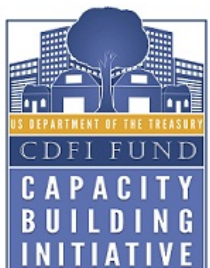
SLIs: Advantages of Royalty-Based Loan

- **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

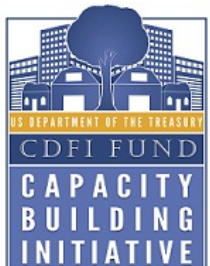
Factors that can be adjusted in projections

- 1) Buyback
- 2) Royalty Fee
- 3) Interest



SLIs: Advantages of Equity Component

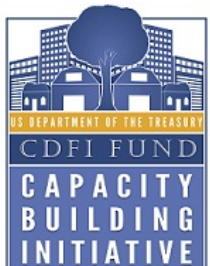
- **"Incentivizes" the investees' principals to buy back the CDFI's equity**
- **Forges closer partnership, helping CDFI to:**
 - Influence investee to be socially responsible
 - Be a sounding board to the entrepreneur
 - Provide meaningful assistance
- **Enhances CDFI's approval/blocking rights and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



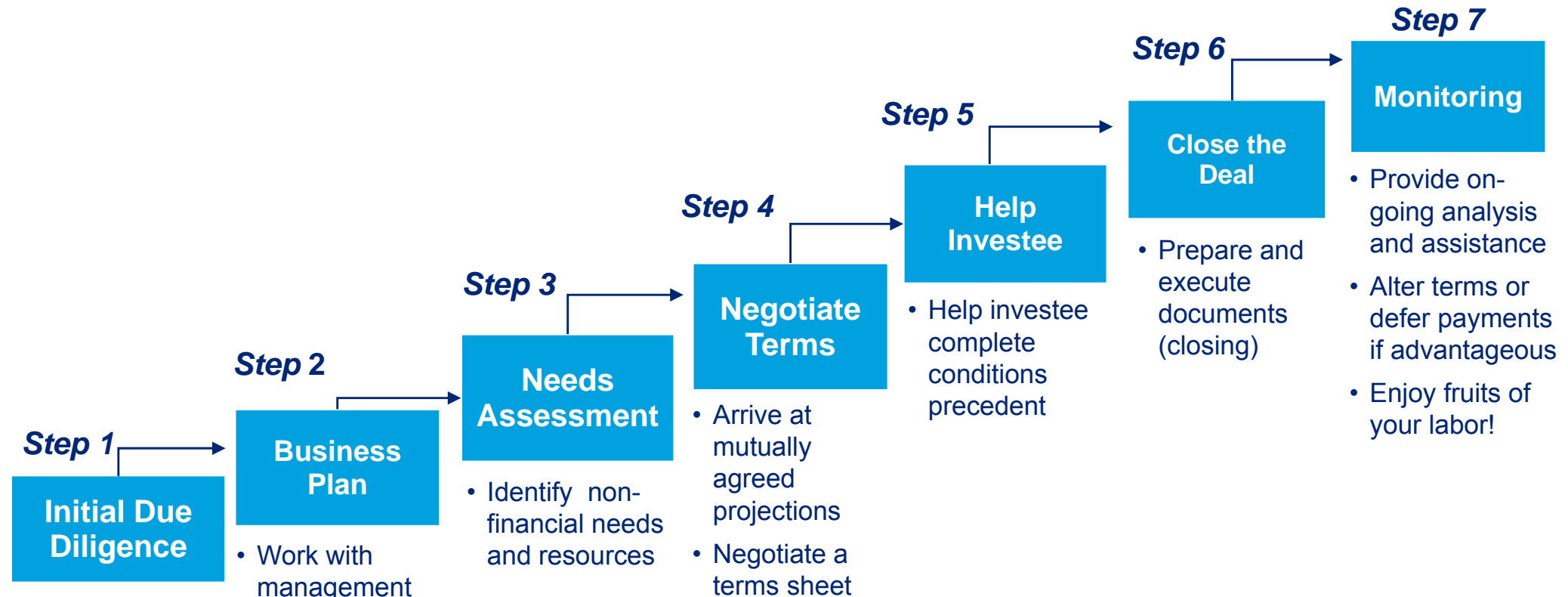
Revenue Capital Investing *In Practice*

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



SLIs: Negotiating Terms and the Relationship

Relationship

- Take a sincere interest in the business

Risk-Capital

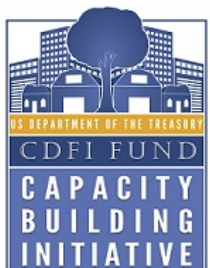
- Add value at every meeting
- Work with one set of projections
- Focus on growing sales
- Point out where interests are aligned
- Disclose everything possible
- Negotiate on-site at the business

Projections- Based Negotiations

- Work with one set of projections

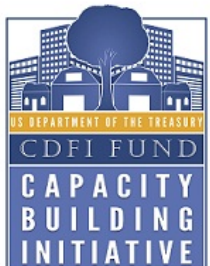
Three factors that can be adjusted in projections

- 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

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