

2009 OPPORTUNITY FINANCE NETWORK CONFERENCE

THE NEW NORMAL

New Growth Financing Option: Focus on Royalty

John Hamilton, Vested For Growth
A program of NH Community Loan Fund
Wednesday October 28, 2009

25
Years of
OPPORTUNITY
FINANCE

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Expand CDFI Lending with Royalty

- ♦ The Market: A Growth Financing Gap
- ♦ The Mission: Expand the Economy with Better Jobs
- ♦ The Deals: Win/Win Uses for Royalty
- ♦ The First Steps: Issues to Consider with Royalty
- ♦ Q & A
- ♦ Case Study

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What Growth Capital?

- ♦ Need for collateral limits lending for growth
- ♦ Equity focus is on rare breed of company
- ♦ Current economy: Even less growth capital

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Types of Finance

Debt
→ Risk
Equity

← Banks
Angels & VC →

*Past
Collateral
Formula*

*Future
Growth Proposition
Flexible*

Royalty = Hybrid

- Future / Growth Proposition / Flexible
- Payments from cash flow, not exit
- "High touch" partner but no decision making

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Fill Gap: Expand Overall Economy

- ♦ Lost economic activity when good plans are not funded
- ♦ More choices discourage capital "mismatches"
- ♦ Be additive to market: disrupt choice between debt or equity

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Royalty: A Tool for Better Jobs

- ♦ Grow existing businesses, not start new or recruit in others to state
- ♦ Good fit for "High Impact Firm" SBA Study
 - ♦ On average, 25 yrs old
 - ♦ Not just high tech
 - ♦ All size businesses
- ♦ Partnering leverages more mission
 - ♦ Share best management practices

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A Royalty Story: Bortech

- ♦ **Opportunity:** Local buyer vs. Out of state
- ♦ **Deal:** Debt plus Royalty
 - ♦ 1.44% gross sales for 3-5 yrs
- ♦ **Financial Results:**
 - ♦ 24% IRR
 - ♦ Company bankable after 3 yrs
- ♦ **Mission Results:**
 - ♦ Jobs doubled
 - ♦ Profit sharing for all

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VFG Investment Criteria

- ♦ **Strong growth proposition**
 - ♦ Team
 - ♦ Market
 - ♦ Product
- ♦ **Range of jobs**
 - ♦ Without 4 yr college degrees
- ♦ **Niche business**
 - ♦ GPM of 25% plus

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Royalty Scenarios

- ♦ **When Bank says no:**
 - ♦ Business growing, but recent losses
- ♦ **When Bank lends more, but not all:**
 - ♦ Capital need goes beyond collateral coverage. Royalty can do overhang
- ♦ **When CDFIs want to loan, but see risks:**
 - ♦ Do royalty to move company forward but keep risk/reward in balance

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Advantages of Royalty

- ♦ Solves the exit question
- ♦ IRR is higher because payments start earlier
- ♦ Aligned with entrepreneur in a "win/win"
- ♦ Net cost of capital lowered by tax deductibility of royalty payments

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Tradeoffs with Royalty

- ♦ Due diligence is labor intensive
- ♦ Requires business with good margins
- ♦ Requires highly involved portfolio management
- ♦ Fewer partners available (...this is changing)

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Other Royalty Deal Structures

- ♦ No Debt
 - ♦ Percent of sales paid monthly until fixed return (multiple) achieved
- ♦ Vary Royalty Index
 - ♦ All sales vs. only on net sales growth
- ♦ When to Apply Royalty
 - ♦ 12 months vs. Avoid slowest 1-2 months

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Learn What You Don't Know

- Recruit diverse Advisory Board
- Need broad-minded / hybrid thinkers
- Bankers and equity investors need to unlearn

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Walk Before You Run

- PILOT 6-8 deals with grant/loan resource blend
- Build track record before attract investors
- Investors to share upside/downside

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Build "High Touch" Resources

- ♦ To Mentor/Manage and not just to Assess/Invest
- ♦ Be a value added partner
- ♦ CEO Peer Groups can be symbiotic

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Lessons Learned

- ♦ Be disciplined to avoid early stage
- ♦ Seek investment partners
 - ♦ Spread risk
 - ♦ Add expertise
 - ♦ Create options for follow-on financing
- ♦ Do not wear mission on your sleeve

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Challenges

- ♦ Educate the market to generate deal flow
 - ♦ Growth Financing Seminars
 - ♦ Ownership Transition Seminars
 - ♦ Network CPA/Lawyers/Angels
- ♦ Funding to cover early losses

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Growing Field of Royalty Investors

- ♦ Arthur Fox of "Royalty Capital Fund"
- ♦ VFG Has Participated Deals With:
 - ♦ Regional Development Corporations
 - ♦ Angels looking to diversify portfolio
 - ♦ RSF Finance
- ♦ Near Equity Group – 15 CDFIs in New England Meeting Quarterly

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Advice on Pricing

- ♦ Plan on losses
 - ♦ Price above expected portfolio return
- ♦ Price is relative
 - ♦ Has your prospect sought equity?
- ♦ When / how to present pricing?
 - ♦ Pay for performance

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Advice on Deal Structure

- ♦ Index off gross sales, not net profits
- ♦ Negotiate a minimum period for royalty, but allow debt prepayment
- ♦ Monthly royalty, not quarterly or annual

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Financing Options

	DEBT	SUB DEBT	ROYALTY PARTICIPATING DEBT	EQUITY
TERMS	Pay set principal and interest	Pay set principal and interest	No set cost. % of future revenue	No set cost. % of ownership
TYPICAL COST	Interest paid on debt at prime plus 0-3%	Interest paid on debt at prime plus 4-10%	¼% to 3% of sales	5%-40% of company
REQUIREMENTS	Collateral and cash flow to cover repayment Profitable for past 3 yrs	Established business Healthy cash flows	Good growth prospects Strong management GPM 25% or better	High growth prospect Compelling market GPM 45% or better
ADVANTAGES	Lowest cost capital Lowest growth threshold Maintain ownership	More patient Goes beyond collateral Maintain ownership	Cost adapts to performance No ownership dilution Growth & business continuation	No fixed payments No credit claim Maximizes growth
TRADEOFFS	Fixed cost obligation Low asset leverage Credit claim on assets	Fixed cost obligation Pricier than debt Credit claim on assets	Must pay as grow	Dilution of ownership Highest growth threshold & capital cost
INVESTOR ROLE	Arms length transaction Focus on repayment	Close monitoring Focus on repayment and growth	Value-added partner Focus on growth and continuation of business	Central player Focus on high growth and exit/sale
SOURCES	Traditional lenders and Economic Development Groups (EDG)	Mezzanine Financiers EDGs Private Investors	Royalty Financiers Some Mezzanine Some Angel	Angels Venture Capital



VFG Investment Appetite and Market Niche

- Threshold criteria:
 - NH based business
 - Strong growth proposition
 - Strong management team
 - Retain/create jobs for people who did not have a 4 yr college degree

- Deal Stage:
 - Later stage companies are preferred – especially with an established sales track record.
 - No interest in Start-up / Early Stage businesses i.e. an entrepreneur with a business plan looking to start operations.
 - Development stage – only if detailed sales pipeline can convincingly document how the business reaches break even/profitability.

- VFG's capital can be used to:
 - Acquire a business – consolidate a competitor, vertically integrate, or create a more value-added solution for customers.
 - Accomplish a succession plan – allow older generation an “earn out” that keeps the business going with an ongoing and strong legacy.
 - Introduce a new product
 - Expand an existing product/service into a new market.
 - Achieve a turnaround – if the right lessons have been learned and there is an underlying change in the business that is driving new growth. Waiting for the market to turn is insufficient.

- Types of companies:
 - Value-added – Sell products/services based on solving business problems, not on having the lowest price.
 - Mainly niche manufacturers, unique products/services, or other businesses that charge more for a brand premium.
 - 20-50 employees and \$2 to \$10 million in sales.
 - This is a reflection of having enough employees to make the mission compelling and enough sales to make our royalty a relatively small percentage of revenue. However a company with a larger amount of sales may need capital at a level beyond our appetite.

- Reasons prospects are not bankable may include:
 - Hiccup in sales/profitability in past 3 years
 - Insufficient/intangible collateral
 - Concentration of sales
 - Succession
 - Bankruptcy

- Reasons prospects are not interested/appropriate for equity may include:
 - No clear exit plan or desire to sell the business in the near term
 - Market/growth projection are good but not large enough for equity investors
 - Not want to lose control of key decisions

VFG website: www.vestedforgrowth.com

VFG Contacts:

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James Key Wallace	856-0724

VFG is a program of the NH Community Loan Fund www.nhclf.org



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Term Sheet

This Term Sheet summarizes the principal terms of a proposed financing of Company Z, Inc., a New Hampshire corporation (the “Company”), by New Hampshire Community Loan Fund, Inc. (the “Lender”). In consideration of the time and expense devoted and to be devoted by Lender with respect to this investment, the provision of this Term Sheet entitled Closing Expenses shall be a binding obligation of the Company whether or not the financing is consummated. No other legally binding obligations will be created until definitive agreements, drafted by Lender’s counsel, are executed and delivered by all parties. This Term Sheet shall be governed in all respects by the laws of the State of New Hampshire.

I. General

Company:	Company Z. Yellow Brick Road Emerald City, NH 12345
Lender:	New Hampshire Community Loan Fund, Inc. 7 Wall Street Concord, NH 03301
Loan Amount:	\$500,000 in the form of a Subordinated Note, a royalty agreement, and warrant agreement.
Use of Proceeds:	Company will use Loan Proceeds for the purchase of inventory, new product development, and general working capital.

II. Terms of Subordinated Note

Term:	Five (5) years
Interest Rate:	10% per annum.

Default Interest Rate: During the period the company remains in default of any of the financing agreements the interest rate shall be 15% per annum.

Late Fees: Company will pay a late fee equal to 5% of any amount not paid within ten (10) days of the payment due date.

Payments: All payments are due on the 15th of each month. Company will make monthly interest-only payments for the first twelve (12) months of the Note. Thereafter, Company will make forty-eight (48) monthly principal and interest payments in equal monthly installments based on an amortization schedule of four (4) years, with a final payment due on the fifth anniversary of the Note, which shall include all outstanding and unpaid principal, plus all accrued and unpaid interest.

Note Prepayment Penalty: Company may prepay Subordinated Note at any time without penalty.

III. Terms of Royalty

Royalty: As additional consideration for risks undertaken by Lender, Company will enter a royalty agreement for the payment of a royalty of 0.250% on the gross sales of the Company.

Royalty Term: The later of (i) five (5) years of continuous business operation of the Company, or (ii) until the Subordinated Note has been paid in full.

Royalty Payments: Company shall make royalty payments on the 15th of each month for royalties accrued in the immediately preceding month. For purposes of illustration, royalties accrued from June 1st through June 30th of a given year will be paid on July 15th of that same year.

Royalty Pre-Payment Penalty: The royalty agreement may not be prepaid for the first three (3) years of the agreement. Following the third anniversary, the Company may prepay the royalty agreement provided that:

- (1) the Note has been paid in full;
- (2) Company is not in breach of any of its financing agreements; and
- (3) Company pays a royalty pre-payment penalty.

The royalty pre-payment penalty is an amount equal to the amount required that when combined with all payments received from the Company under the financing agreements (excluding any Late Fees or amounts associated with the Default Interest Rate or any payments or value related to the Warrant Agreement) the Lender will receive an internal rate of return of 22% on the Loan Proceeds.

If at that time the Lender has already received payments as described above such that Lender has received an internal rate of return of 22% or higher, no royalty pre-payment penalty is required.

IV. Warrant Agreement

Warrant Amount:

Each Warrant shall be exercisable for a ten (10) year period commencing on the date of issuance of the accompanying Subordinated Note. Each Warrant shall be exercisable for such number of shares of Series D Preferred Stock as is equal to twenty five percent (25%) of the original principal amount of the accompanying Note divided by a stock price that will result in Lender possessing warrants exercisable for Series D Preferred Stock representing a 1.25% ownership stake in the Company (as defined in the Company's Certificate of Incorporation), given a company valuation of \$10,000,000 at the time of this financing, with an exercise price of \$0.01 per share.

V. Terms and Conditions of Financing

Security:

Company shall grant Lender a second position security position (with first position being held by Community Bank) on all corporate assets and a junior mortgage (behind Community Bank) on all real estate owned by the Company.

Subordination:

Lender agrees to subordinate its claims to payments and assets in favor of Community Bank (or a subsequent

Senior Lender), provided, however, terms of the subordination will allow Lender to receive scheduled payments of principal and interest on the Note and royalty payments under the royalty agreement so long as Company is not in payment default with Community Bank (or a subsequent Senior Lender).

Community Bank (or a subsequent Senior Lender) will also be permitted to prevent payment to Lender if the Company's DSCR as calculated on a rolling four quarter basis falls below 1.20, and at the same time, Company has borrowed more than 80% on their available Line of Credit with Community Bank.

For any missed payments for any reason, unrestricted catch-up payments will be both allowed and required to be made to Lender so long as the catch up payments do not violate the above conditions.

Information Rights:

Lender will be granted access to Company facilities and personnel during normal business hours and with reasonable advance notification. Lender shall have the right to receive from the Company:

- (1) an annual budget at least 30 days prior to the beginning of each fiscal year;
- (2) monthly financial statements (balance sheet, income statement and cash flow statement) within 30 days following the end of each month;
- (3) quarterly financial statements (balance sheet, income statement and cash flow statement) within 45 days following the end of each quarter;
- (4) annual audited financial statements (balance sheet, income statement and cash flow statement) within 120 days following the end of each fiscal year, recognizing that the Company will endeavor to provide them as early as possible;
- (5) promptly following receipt by the Company, each audit response letter, accountants management letter and other written report submitted to the Company by its independent public accountants in connection with an annual or interim audit;
- (6) promptly after the commencement thereof, notice of all actions, suits, claims, proceedings investigations and inquiries that are likely to

materially adversely affect the Company; and

- (7) promptly upon the occurrence thereof, notice of any breach of any provision of any of the financing documents. The aforementioned information shall be submitted in a form acceptable to Lender.

In addition, Company shall provide the following information and/or reports in a form acceptable to Lender:

- (1) Monthly Inventory Report;
- (2) Monthly Sales Pipeline Report;
- (3) Monthly Accounts Receivable Aging Report;
- (4) Monthly Accounts Payable Aging Report;
- (5) Copy of Company's Federal Income Tax Return within 150 days of the fiscal year end;

Board Observer Rights:

Lender shall have the right to designate one (1) representative to attend all board meetings as an observer. Company shall provide to Lender reasonable advance notice of all board meetings and a copy of all information provided to board members. Lender's representative shall be entitled to reimbursement by the Company of travel expenses for attending board meeting provided that Company provides such reimbursement for any other board member or Company policy provides for such reimbursement.

Non-Compete Agreements:

All shareholders and key employees of the Company will enter into a non-compete agreement with Company in a form acceptable to the Lender or Lender's counsel. Key employees include The Scarecrow, CEO, The Tin Man, CFO, and Toto, VP of Sales, and any other key employee as determined by Lender in the course of its due diligence.

Guarantors:

None.

Key Person Insurance:

Company to acquire life insurance on The Scarecrow, CEO, in the amount of \$500,000 to be collaterally assigned to Lender.

Covenants:

Company shall comply with standard affirmative and negative covenants and any other usual or customary documentation for transaction of this nature deemed necessary or advisable by Lender's counsel.

In addition, Company shall comply with the following covenants:

- (1) The Company shall have insurance policies on its assets and operations for the types of coverage and in the amounts as typical within the industry and such other insurance coverage reasonably requested by Lender. The Lender shall be designated as loss payee and mortgagee (as its interest may appear) on all such policies for the life of the loan.
- (2) Annual audited financial statements by an accounting firm selected by the Company and approved by Lender.
- (3) No payment of dividends or distributions to shareholders unless approved in writing by Lender.
- (4) Payments to Lender take payment priority over cash bonuses to Company's senior staff.
- (5) In the event of a relocation of Company headquarters, Company agrees to keep New Hampshire as its primary location.

Closing Conditions:

Company shall comply with standard Closing Conditions for a transaction of this nature deemed necessary or advisable by Lender's counsel.

In addition, Company shall comply with the following Closing Conditions:

- (1) Company shall negotiate and enter into a binding agreement with Community Bank (or another Senior Lender) to extend the date of renewal of the Company's line of credit to at least May 31, 2011, in a form acceptable to Lender or Lender's counsel.
- (2) Execution of an Intercreditor Agreement between Community Bank (or another Senior Lender) and the Lender on terms satisfactory to Lender and Lender's counsel.
- (3) 50% of Loan Proceeds provided by a partner acceptable to the Lender, on the same terms

listed herein, as a Participation Loan, Co-Lender arrangement, or other structure acceptable to the Lender and Lender's counsel.

- (4) All shareholders of the company shall enter into a subordination agreement, subordinating all of their current and future claims to payments and assets in favor of Lender.

V. Other Terms and Conditions

Origination Fee: Company shall pay an Origination Fee of 1% of the loan amount for underwriting and administrative services, payable at Closing from the Loan Proceeds.

Closing Expenses: Company to pay all legal, out-of-pocket business, technical, and accounting due diligence and documentation costs of Lender, regardless of whether or not the financing is consummated.

Disbursement: Loan Proceeds (less the Origination Fee and Closing Expenses) will be distributed at Closing.

Closing: As soon as practicable following the Company's acceptance of this Term Sheet and satisfaction, or waiver by Lender, of the Closing Conditions.

Expiration: This Term Sheet expires on August 25, 2009 if not accepted by the Company by that date.

IN WITNESS WHEREOF, the parties have executed this Term Sheet as of the date last signed below.

COMPANY Z , INC.

Date: _____

By: _____
Company Z, Inc.

CEO
Duly Authorized

**NEW HAMPSHIRE
COMMUNITY LOAN FUND, INC.**

Date: _____

By: _____

Its Managing Director
Vested for Growth
Duly Authorized

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