



Cookie Royalty:

How *Liz Lovely* used royalty financing to grow at a pace that made sense

Prepared By:

Carrie Abels





Key Messages

- ▶ A wide variety of financing options across the **capital continuum** are available to assist with the capital needs of Vermont's food system businesses. However, navigating through the multitude of financing options can be overwhelming.
- ▶ The *Financing Cross-Cutting Team* of the *Farm to Plate Network* convened a series of panels that illuminated financing options that different food system businesses have used—*High Mowing Organic Seeds* and convertible debt, *Bread & Butter Farm* and a complex farmland deal, *Liz Lovely* and royalty financing, and *Aqua Vitae* and private offerings.
- ▶ These Financing Case Studies help to fulfill *Goal 20* of the *Farm to Plate Strategic Plan* by exemplifying how different businesses have found the right match of capital.

CAPITAL CONTINUUM



Note: We recognize that there have been other capital providers involved in Liz Lovely's launch and growth. However, for purposes of this case study, we have listed only those funders and resources that were involved in this specific royalty financing deal.



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to grow at a pace that made sense*

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If there's one constant in the story of **Liz Lovely**, it's that the company has always been flexible. When opportunities have arisen, they've been seized; when hardships have occurred, new paths have been forged. The company has especially been flexible in its marketing, first emphasizing its vegan ingredients, then its gluten-free ones.

Similarly, the 2013 royalty financing deal that helped **Liz Lovely** increase its annual sales from \$1 million to \$2 million in just one year was also flexible, designed to move with the ebbs and flows of the company. Royalty financing, in which a loan is repaid based on a percentage of revenue over time (vs. a fixed monthly principal and interest payment), allowed Liz Lovely to endure fluctuations in revenue without having to make pre-set loan payments.

As a result, **Liz Lovely, Inc.** could grow at a pace that made sense, and now it's a viable Vermont business with 20 employees that continues to innovate and that recently launched its newest product, the Cookie Truffle. The company's success has led Robin Morris, founder of the **Mad River Food Hub** and shareholder of Liz Lovely, to become a big supporter of royalty financing.

"We need to do more of this," he says. "This is just the beginning for Vermont."



Liz Lovely staff.

Going Beyond Liz's Kitchen

In 2003, Liz Holtz and her former partner, Dan Holtz, were “dot-com refugees” in Philadelphia. They wanted “to do something different, do something tangible,” so they began selling the decadent vegan cookies Liz had started baking in their tiny attic kitchen. Their intention was to eventually move the business to the Green Mountain state.



Stack of Snicker Dudes.

Pretty soon **Liz Lovely** cookies caught the attention of **Whole Foods'** Mid-Atlantic stores — a lucky break. But in early 2004 the couple was unable to keep up with demand solely with the cash they had borrowed from banks and family. On a whim, they got in touch with Fred “Chico” Lager, who had written a book about being a CEO of **Ben & Jerry's**, and Chico suggested they talk to Robin Morris.

At the time, Robin (a former CEO at **American Flatbread**) wanted to invest in local food businesses and open a commercial space for food processors. He quickly became a mentor, an investor in Liz Lovely, and its landlord. In the summer of 2004, the company moved into a building of Robin's in Waitsfield—next door to what would eventually become the **Mad River Food Hub**. Extra space was set aside, in anticipation of Liz Lovely's eventual expansion, and the company was given a break on rent.

“The key issue with food manufacturing companies, is that there's a lot of need for leasehold improvements,” Robin says, “and leasehold improvement can't be collateralized. So the reason you need to raise equity investment, or get a good landlord, is to get that leasehold improvement financed.”

“THE KEY ISSUE WITH FOOD MANUFACTURING COMPANIES, IS THAT THERE'S A LOT OF NEED FOR LEASEHOLD IMPROVEMENTS, AND LEASEHOLD IMPROVEMENT CAN'T BE COLLATERALIZED. SO THE REASON YOU NEED TO RAISE EQUITY INVESTMENT, OR GET A GOOD LANDLORD, IS TO GET THAT LEASEHOLD IMPROVEMENT FINANCED.”

—ROBIN MORRIS, MAD RIVER FOOD HUB



Truffles!

Liz Lovely's Growth in the 2000s

After moving to Vermont, Liz Lovely, Inc. enjoyed a growth spurt for a few years, aided by loans from Chittenden Bank (now **People's United Bank**) and the **Vermont Economic Development Authority**. This allowed the company to purchase a larger mixer, a larger oven, and a machine for automated packaging.

Then the recession hit in 2008, sales dropped, fuel costs spiked, and an experiment with distribution on the West Coast didn't work out, partially because of those fuel costs. Yet the company needed to stay on target with its debt service, even as its revenues were plummeting – a fact that made royalty financing attractive a few years later.

The company got creative with limited resources and developed an e-commerce website, built up their social media platforms, added new products, and began selling directly to retailers rather than through distributors. By 2010, profitability was back up, thanks to some re-financing of loans, but it was in need of permanent working capital – staff to handle the new sales that were coming in.

Liz and Dan didn't want to dilute the business by offering more equity ownership in exchange for capital (They already had enough shareholders to their liking). So Robin Morris suggested they contact Janice St. Onge at the **VSJF Flexible Capital Fund**.

"WE FUND THE KIND OF THINGS THAT A BANK CAN'T — WHETHER IT'S HUMAN CAPITAL, LIKE MARKETING STAFF, OR COMMUNICATIONS EXPENSES...WE CAN BE MORE FLEXIBLE IN HOW REPAYMENT IS STRUCTURED."

—JANICE ST. ONGE, VSJF FLEXIBLE CAPITAL FUND, L3C

Why Royalty Financing Made Sense

In 2011, Janice St. Onge and the **Vermont Sustainable Jobs Fund** launched the **VSJF Flexible Capital Fund, L3C**, or the "Flex Fund," as it's called. Funded by mission focused equity investors, the Flex Fund provides "near equity," or mezzanine financing, to growth stage companies in the value-added agriculture, forestry and clean technology sectors in Vermont.

Near equity capital, also known as mezzanine financing, includes a range of financing instruments such as subordinated debt, royalty financing, warrants or some combination thereof. Near equity is not start-up capital but fuel for existing businesses that need to augment traditional sources of financing in order to produce new sales, enter new markets and create new products.

Royalty financing has traditionally been used in industries such as publishing (i.e., book deals) and mining, but has recently gained momentum as an alternative debt instrument for growing businesses. It is financing based on selling a piece of the revenue stream instead of selling ownership.

In exchange for a loan, a company will share a percentage of its revenues with the Flex Fund until the Fund has received back its principal plus the additional return that it negotiated with the portfolio company. The royalty payments can be structured over a fixed time period or until the investor reaches the negotiated rate of return. Royalty financing allows for flexible repayment that adjusts to a growth company's actual revenue, and offers a "natural" way to exit the deal. Royalty financing is distinctly different from equity, in which an investor owns a percentage of the company and will need a sale, merger or public offering to exit and get the financial reward.

This was an attractive option for **Liz Lovely** because the company would not have to make fixed debt payments to the **Flex Fund**. If its revenues were to drop, its debt payments would drop. Also, by 2012 it had exhausted its options with its new bank, **Northfield Savings Bank**; without collateral, the bank was reluctant to fund what the business primarily needed: new staff to handle anticipated growth.

"We fund the kind of things that a bank can't - whether it's human capital, like marketing staff, or communications expenses," Janice explains. "Or often times it's for that last piece of equipment they need, when a bank can only lend up to 80%. We don't rely on collateral to do

the deal and we can be more flexible in how repayment is structured. ”

The **Flex Fund** made a \$100,000 loan to Liz Lovely in 2013. The company had to pay back 2% of the company’s monthly revenues for the following 6 years, up to \$161,000. If, after 6 years, the company hadn’t paid back \$161,000, the deal could be renegotiated as a term loan.

The Fund was looking to make back 1.6 times its investment, whereas most angel investors and venture capitalists are looking for 2.5 to 3.5 times their investment. Inherent in the revenue-sharing model is the risk that a company’s

revenues won’t pan out the way an investor might expect them to, so it follows that royalty financing is typically priced higher than traditional debt and lower than angel investment.

Given that royalty financing is high risk capital, and is typically subordinate (or secondary) in payment and collateral security to senior lenders such as banks and community loan funds, the **Liz Lovely** deal also required that Liz and Dan personally guarantee the loan, in the event of default.

In 2014, the **Flex Fund** provided an additional \$50,000 in royalty financing to **Liz Lovely**. And in early 2015, following Dan’s departure from the company, the **Flex Fund** did an additional follow-on financing of \$150,000 to support Liz’s restructure plans, which included raising working capital, enhancing vendor and customer relationships, and charting a new direction to aggressively pursue new sales opportunities.



A Bigger Team, Eyeing Future Growth

When decisions are made by the Flex Fund on which companies to fund, the management team of the company is looked at most critically—“because the reality is, we are banking on that team to make their revenue growth plan happen,” Janice says.

With Liz and her team, she adds, “We see passionate young people who really love what they’re doing and have been extremely successful already. The team is knowledgeable, not only about their market but about their business and their finances. They have it together, which I don’t see all the time.”

Since receiving the original Flex Fund loan, as well as the additional two, and an infusion of loans from other sources, Liz Lovely has hired new staff and launched new marketing programs. The number of employees has gone from single digits to 20.

It takes a lot of cash to grow a food business that’s also a brand, and for Liz Lovely, that cash has come from numerous sources, which is seen as a good thing. Often the more lenders in the mix, the more stakeholders who are pulling for a company’s success.

Resources

VSJF Flexible Capital Fund, L3C

www.flexiblecapitalfund.com

Montpelier, VT 05602

janice@vsjf.org

Northfield Savings Bank

www.nsbvt.com

Montpelier, VT 05602

rosemarieW@nsbvt.com

Mad River Food Hub

www.madriverfoodhub.com

Waitsfield, VT 05673

rsmorris@cimark.com

Definitions

Debt: Amount of money borrowed by one party from another. A debt arrangement gives the borrowing party permission to borrow money under the condition that it is to be paid back at a later date, usually with interest.

Subordinated Debt: A loan (or security) that ranks below other loans (or securities) with regard to claims on assets or earnings. In the case of default, creditors with subordinated debt wouldn't get paid out until after the senior debt holders were paid in full. Therefore, subordinated debt is more risky than unsubordinated debt.

Royalty Financing: Is based on a company selling a piece of gross revenue instead of selling ownership—hence it's often called "near equity." In exchange for a loan, the company gives the investor a percentage of sales until the investor has received back principal plus additional interest negotiated with the investor.

Convertible Debt: Instruments that are essentially asset-backed loans that can require the business owner to give up some future equity (ownership) in the business if the lender wishes to convert the debt to an equity position in the company.

Convertible Equity: A form of financing that gives investors the right to preferred stock once a triggering event occurs.

Equity Financing: The act of raising money for company activities by selling common or preferred stock to individual or institutional investors. In return for the money paid, shareholders receive ownership interests in the corporation.

Grants: Contribution, gift, or subsidy (in cash or kind) bestowed by a government or other organization for specified purposes to an eligible recipient. Grants are usually conditional upon certain qualifications as to the use, maintenance of specified standards, or a proportional contribution by the grantee or other grantor(s).

Investment Clubs and Networks: A formal investment club is a group of people who pool their money to make investments. Usually, investment clubs are organized as partnerships and, after the members study different investments, the group decides to buy or sell based on a majority vote of the members. Club meetings may be educational and each member may actively participate in investment decisions. For the SEC definition, visit www.sec.gov/investor/pubs/invclub.htm. There are also informal investment networks that can organize around making connections between entrepreneurs and investors.

Peer-to-Peer Lending: The practice of lending money to unrelated individuals, or "peers," without going through a traditional financial intermediary such as a bank or other traditional financial institution. This lending takes place online on peer-to-peer lending companies' websites using various different lending platforms and credit checking tools. Two recent peer-to-peer lending portals have been approved in the State of Vermont for small business loans up to \$35,000: Prosper (www.prosper.com) and Lending Club (www.lendingclub.com).

Program Related Investments (PRIs): Investments made by foundations to support charitable activities that involve the potential return of capital within an established time frame. PRIs include financing methods such as loans, loan guarantees, and even equity investments in charitable organizations or in commercial ventures for charitable purposes.

Accredited Investor: Term used by the Securities and Exchange Commission (SEC) under Regulation D to refer to investors who are financially sophisticated and have a reduced need for the protection provided by certain government filings. Accredited investors include individuals, banks, insurance companies, employee benefit plans, and trusts.

*Definitions from www.investopedia.com, www.businessdictionary.com, and www.sec.gov/answers/accred.htm.