VERMONT SMOKE & CURE™

THE EVOLUTION OF A SMOKEHOUSE

Vermont Smoke and Cure (VSC) started out as a small, local meat processor back in 1962. When the owner wanted to sell the business (then located in the back half of a gas station and store) in 1999, a small diner business with a mission of promoting local agriculture through its food purchases bought the business. Their idea was to operate VSC as part of its mission of serving farmers — and to serve as a key local supplier for the diner.

Cathy Berry, lead investor in the diner, became the primary owner of VSC when it spun out from the diner in 2006. Her goal was to continue VSC's mission of creating opportunities for farmers by providing processing services and purchasing their locally grown meats. Chris Bailey joined VSC in 2005, initially to work with the diner in marketing and finance. Chris had hands-on experience as a farmer with pasture-raised pork and other livestock, and with a pasture-based cow dairy. In addition to his understanding of farming and agriculture, Chris brought business acumen to the company, getting his MBA and then working in food marketing, a slaughter facility and with a branded meats business.

Chris understood that in order to fulfill its social mission, the company needed to succeed financially, but that focusing 100% on the social mission was not a viable business strategy at that time. He was instrumental in growing sales of VSC's own branded products; innovating and moving towards a fully natural product line of products; and consolidating the limited available Vermont grown meats into a 100% Vermont-grown line of items.

Before 2012 (and probably for several decades previously), a year-round supply of pork, for farmers processing for their own sale or for wholesale carcasses to a buyer such as VSC, didn't exist in Vermont. For a processing facility focused on value-added products, it could be fatal if the thin and seasonal pork supply in Vermont was the only source of their processing work and meat supply. Chris and his team realized that they had to create, and largely pay for, the production capacity they would in turn make available to farmers by growing the VSC business using the best meats they could find from outside of Vermont. Certified humane, raised without antibiotics pork from DuBreton in nearby Quebec and similarly naturally raised beef from the Vermont and northeast U.S. suppliers of Pineland Farms in Maine allowed VSC to move into natural meats, with no constraints on supply, and stay regional.

The strategy started to work. Sales grew from $370,000 in 2005 to $1.7M in 2009; processing services for, and purchases from, farmers also grew, and space became snug in the 3,300 square foot facility. Chris began what would become a three-year process of finding the right property and pulling together the financing package to expand into a larger, more efficient facility.

MULTIPLE ITERATIONS: LOCATION SEARCH AND BUILDING CREDIBILITY

To understand the challenges VSC faced, here's a short primer on the requirements of meat processing facilities, based on customer and USDA specifications and the way in which they drive requirements and costs. Basic infrastructure needs for VSC include 3-phase power (2,200 amps @480V to handle current and future needs), town water and sewer, and loading docks.

Requirements for "fit up" include:

- Every room needs washable everything, which gets hosed down daily with caustic foamer.
- There must be no potential for any pooling of water on the floors, which means slopes to drains must match each room's size and layout.
- Refrigeration in all processing and storage spaces.
- Any spaces that may go below freezing for any extended periods require special under-floor preparation, including circulating heated coils deep below the freezers to prevent the ground from freezing and heaving.

So it's easy to understand how VSC could spend $135/sq ft in an existing structure (including demolition of interior mechanicals and partitions).

As VSC started the process of securing a new facility, it soon became a chicken and egg conundrum: the right space would only wait so long, but without the space identified, VSC couldn't get accurate cost figures on fit up (i.e., drawings to engineering to quotes). Without accurate costs, VSC couldn't raise the funding for the expansion (costs to business plan to equity and debt funders).

> **"LOCAL FOOD INVESTING DOLLARS MAKE THE COMMUNITY MORE RESILIENT AND PROVIDE LOCAL JOBS. I BELIEVE THAT WE NEED TO REBUILD THE LOCAL PROCESSING SYSTEM AND AS AN INVESTOR, FELT THAT VSC WAS MY CONTRIBUTION TO MAKING A SMALL PIECE HAPPEN HERE IN VERMONT, WHERE THERE IS A GROWING COMMITMENT TO MAKING IT HAPPEN."**
>
> **—CATHY BERRY**

The high capital costs of building a new facility (at that time estimated at $175/sq ft vs $125 sq ft for an existing building) argued for finding an existing structure. For over two years, Chris looked closely at six existing buildings and one open lot, and spoke with four potential landlords and multiple regional development agencies and bankers. VSC paid for one set of "phase one" drawings for a building that it subsequently could not close on quickly enough because VSC didn't have the financing in place. After that experience Chris started to use Excel as a drafting tool to sketch out how the operation would fit into an existing building so he could ballpark the fit up costs.

At the same time, the business continued to grow, from $2.3M sales in 2010 to $2.9M in 2011. VSC was processing meats as a service for over 650 farmers each year. VSC made do in the old facility, first by moving dry goods and inventory into rented storage lockers, and then by renting office and warehouse space two miles from the processing facility. VSC stored fresh meats and finished goods in refrigerated trailers and relied on the young workforce to move many boxes by hand every week. Despite the logistical inefficiencies but thanks to the low overhead, VSC came close to profitability as sales grew.

Because VSC continued to grow and make progress despite challenging conditions, VSC was able to attract the attention of potential landlords, debt providers and equity investors during 2009-2011. The business plan included the intention to build a professional board of directors, which the company had not yet created, and the offering and shareholder agreement stated the required structure. This detailed plan for a board created additional confidence with investors that the closely held company would continue to increase the extent of its professional management. The business plan and financial projections also included plans for how the leadership team would be built out as the company grew, another important concern for potential investors. VSC was starting to build the credibility that was crucial to the eventual facility deal and funding coming together.

INHERENT CHALLENGES

Raising debt and equity for a small, growing company is never easy, but a meat processor who seeks to remain a resource for the local community faces four additional and significant inherent challenges.

First, it takes time to grow into a facility… The costs to build suitable space are high for the amount of revenue and profitability that are likely to be generated in the initial years of occupying the space. In VSC's case, it had an existing building, costing $135 per square foot (for 21,000 sq ft) in fit-up that will ultimately have a maximum throughput of $12 to $15M and net income projected at approximately 5-10% of gross sales. VSC moved into the building when revenue was tracking at $3.7M for the year.

Second, much of these costs are "set in stone" (i.e., can't be removed and sold), and so can't be counted as collateral by lenders (the maximum "loan to value" number will be far smaller than what is required). This includes demolition, plumbing, electric, most of the refrigeration expense (installation and piping), and so on. This added up to roughly half of VSC's total cost. So, the amount of debt that can be secured is limited. This isn't entirely bad: debt and equity must be kept in balance so that the debt can be repaid from cash flows even in a near-worse-case scenario.

Brian Nevins Photography

Third, most traditional angel and venture capital investors don't like the high investment needed to expand vs the capacity and margins it creates. Some do understand, though, that people always need to eat and that food processing and marketing businesses can be profitable. They typically look for a return on their money averaging 30%+ annually and in a 3-5 year time window.

Fourth, VSC determined that providing a high, fast return to this traditional investor - while remaining a local or regional resource — was almost certainly mutually exclusive. As a result, VSC did not pursue traditional equity funding except in forums where there were investors with an interest in investing locally in food and agriculture. This self-imposed restriction severely limited the already-small pool of potential equity investors. It did attract and open the door, however, to mission based investors interested in healthy food systems and building local economies.

Despite these limitations, Vermont Smoke and Cure was able to achieve its expansion with the help of debt and equity investors interested in making this expansion happen.

PUTTING THE PIECES TOGETHER

By the end of the summer of 2010, a commercial property owner and re-developer with whom VSC had already been in discussion on other properties purchased a 90,000 square foot former cheese production facility in Hinesburg, VT. The developer was able to buy it at an extremely low cost, given that the structure was sound, but the interior was in rough shape and would need a lot of work. The interior of any existing building would offer little value to VSC with its specific fit-up needs and so from a cost perspective, this was an ideal potential facility.

The financing package that VSC was able to secure was both complicated and synergistic and involved a number of players who all had value to add to the company. In essence, they became partners in VSC's success.

LOANS AND NEAR-EQUITY DEBT

VSC's lenders were invaluable in driving forward the debt funding and took time to recognize the value beyond the business proposition and see how VSC's expansion could help re-build a community hit by job losses and provide value-added services in Vermont's local food system.

Community National Bank (CNB) and Vermont Economic Development Authority (VEDA) provided term debt using a USDA guarantee, and CNB provided a Line of Credit with an U.S. Small Business Administration guarantee. Loans were used for fit-up, equipment, and in the case of the line of credit, for short-term financing of receivables and inventory. Both lenders looked hard for each available dollar of collateral. They took a "we'll work with it and figure it out" rather than "pass/fail" approach to evaluating the deal.

A Vermont mission-based investment fund, the VSJF Flexible Capital Fund L3C, (a.k.a. the "Flex Fund") provided the "near equity" financing in the form of subordinated debt and royalty (revenue-share) financing needed to fill the gap in the VSC funding package. The Flex Fund was willing to be deeply subordinate to the Bank, VEDA, and other lenders in terms of collateral position, and was willing to defer royalty payments, (and to subordinate royalty payments to CNB for a period of time), in order to provide time for the company to ramp up operations in the new facility. In exchange for their flexibility and higher risk associated with the loan structure, the Flex Fund required higher potential return on their investment using the royalty percentage as their "upside" as the company grows revenues.

"The Flex Fund is designed to help Vermont companies expand into new markets, reach new customers, and diversify their products," said the Flex Fund's President Janice St. Onge. "Vermont Smoke and Cure is a mission-based company, helping more than 600 farmers get their products to market – not only by providing smoking

"IN THE END, WE NEED ALL KINDS OF MONEY FOR BUSINESSES TO GROW AND STAY IN VERMONT: ANGELS, VENTURE CAPITALISTS, FOUNDATIONS, TAX INCENTIVES, BANKS AND COMMUNITY LENDERS. OFTEN YOU NEED TO MIX AND MATCH TO MAKE THE RIGHT PACKAGE TO ENSURE A COMPANY HAS THE CAPITAL TO FIT THE STAGE OF GROWTH AND SCALE OF THE BUSINESS."

— JANICE ST. ONGE, FLEX CAP FUND

services but also by purchasing local meat for their own branded products. It's a national brand in a growing market. We've invested in one company, but our loan is having a positive impact on Vermont's local food system and other producers who are creating jobs in their communities."

The Flex fund was able to facilitate bringing in additional capital from clients of Zevin Asset Management in Boston. These investors were interested in investing but wanted an alternative structure to VSC's Preferred Series A equity offering. According to St. Onge, "the investors liked the structure the Flex Fund offered (sub-debt with a royalty component). We served as lead on the due diligence and were willing to share information with them because we knew it would facilitate their participation (essentially purchasing a portion) in the Flex Fund debt."

Vermont Community Loan Fund was an existing lender in the deal and was the stalwart of the crowd. They had a pre-existing working capital note that was due to begin amortizing at the time of expansion. They were willing to delay for an additional year of interest-only.

The Vermont Community Development Program at the Vermont Agency of Commerce and Community Development provided a Community Development Block Grant to the town of Hinesburg, who in turn lent the funds at low cost (and delayed amortization) and for a longer term than VSC could have otherwise received from a traditional lender for the purpose of rural economic development and job creation. The CDBG program was willing to be fully subordinate in terms of their collateral position to all lenders.

"THE COMMUNITY FOUNDATION HAD RECENTLY DECIDED TO LINK A PART OF ITS VERMONT INVESTMENTS STRATEGY WITH ITS PROGRAMMATIC WORK AROUND LOCAL FOOD AND FARM VIABILITY. IT WAS AT THIS TIME THAT VERMONT SMOKE AND CURE'S INVESTMENT OPPORTUNITY WAS PRESENTED TO US AND WE'RE EXCITED TO PARTICIPATE IN THE OFFERING. THE INVESTMENT IN VSC HIT SEVERAL KEY AREAS FOR US: LOCAL FOOD, FARM VIABILITY, JOB CREATION, AND COMMUNITY IMPROVEMENT."

—DEBRA ROONEY, VERMONT COMMUNITY FOUNDATION

LANDLORD FINANCING

VSC's new landlord and developer helped the deal succeed in several ways. He provided VSC precious time (on the order of 9 months) to secure a deal, as well as investment in the business and offered reasonable cost of work done to get the building ready for fit up. The "base" (pre-fit up) lease price for the space that the landlord set reflected the low cost at which he acquired the building. The landlord / developer also provided a loan for fit-up that is being paid back as part of the lease.

Hinesburg facility under construction.

EQUITY INVESTMENT - SERIES A CONVERTIBLE PREFERRED STOCK

VSC was able to secure equity investment (ownership) from foundations (using Program Related Investments) that had an interest in agriculture and food systems (in keeping with VSC's mission), as well as high net worth individuals, including family and friends, and clients of Clean Yield Asset Management in Norwich, VT.

Eli Moulton at Merritt & Merritt and Moulton, a law firm in Burlington, handled all the legal aspects of these various asset class purchases / offerings.

All of the investors had in common a commitment to helping VSC secure the right match of capital to grow the business. There were those who were in it primarily for the mission aspect, those who wanted an empty space filled, and those who were looking for a fair return. In the end, all of the funders understood that without everyone working together, it just wasn't going to happen.

"CLEAN YIELD WAS GLAD TO HAVE THE OPPORTUNITY TO INVEST IN VS&C BOTH INDIRECTLY THROUGH THE FLEXIBLE CAPITAL FUND AND DIRECTLY THROUGH THE COMPANY'S OFFERING. WE FEEL THE COMPANY HAS A COMPELLING STORY AND THE KIND OF BUSINESS PLAN AND MANAGEMENT TEAM THAT INSTILLS CONFIDENCE. THE FLEXIBLE CAPITAL FUND PROVIDES A GREAT WAY FOR INVESTORS TO DIVERSIFY THEIR LOCAL INVESTMENTS IN A BASKET OF SUSTAINABLE AGRICULTURE AND CLEAN ENERGY COMPANIES. DIRECTLY INVESTING IN VS&C PROVIDED AN EVEN MORE TANGIBLE WAY FOR OUR CLIENTS TO SUPPORT AND PARTICIPATE IN THE COMPANY'S SUCCESS."

—ERIC BECKER, CLEAN YIELD ASSET MANAGEMENT

EPILOGUE

The move into the new facility marked a starting point for Vermont Smoke and Cure and a continuation of the financing story as well.

The actual physical move went smoothly. Operating two facilities simultaneously was not an option and so VSC moved in one jump, with both feet. So, at the start of May, 2012, VSC operated in its old facility on a Friday and started operations in the new one the following Tuesday. The relative simplicity and lack of unknowns of the physical move contrasted with the challenges of the new facility, however.

The first eight months involved challenges across multiple aspects of the building and equipment. From thermostats that failed to under-built blast chillers, equipment that arrived or was installed months late, to equipment that didn't work as advertised or contracted, to older equipment that decided to fail rather than live on for a few more years, these challenges and others made operations difficult. For several months, completing orders was a challenge and for eight months, Costs of Goods suffered. Everything new was under warranty and got fixed, but with little or no compensation by manufacturers (or in the case of some compensation, it was inadequate) for the lost production time and, often, product ruined. The additional operating and capital expense ate through the store of working capital and hurt operating results.

Moving equipment into new facility.

Production personnel who had previously commuted five to ten minutes but who found themselves commuting most of an hour lasted just through the six months of incentives to stay on board despite the significant raises that accompanied the move of the facility into a part of the state with a higher cost of living. Almost all of them declined to move and eventually quit. It was assumed that some would move and so smooth the transition from experienced to new hires. Several quit in a disruptive fashion at the height of the pre-holiday season and so put a kink in operations, but at that point it was just another challenge to get through.

In general, with the change in facility and equipment, product and equipment behaved differently, requiring new sets of adjustments and a greater depth of knowledge. Rather than the new equipment making production easier, the complexity level went up, an effect that plant management under-estimated. Asking the "pro's," from those who sold us the equipment to people with decades of production experience, often led to conflicting answers and so getting equipment and processes to work as needed required many trials and added costs in time and materials.

All the while, sales grew at a 40% annual rate. Stockouts sapped momentum at retail, but VSC finished 2012 just below its sales target for the year of $3.7M.

Expenses also ran higher than expected. Combined with the high Cost of Goods during the first 13 months, the breakeven point ran over $1M in sales higher than originally projected. Net Income losses were significantly worse than expected.

VSC needed additional cash to recover from this near-disastrous first year and breathing room before starting principal repayments. Fortunately, it was able to secure additional equity from individuals and foundations, debt

Hanging Beef Sticks at Hinesburg facility.

"THE VSC FINANCING TRANSACTIONS ARE A GREAT ILLUSTRATION OF WHAT IS OFTEN REQUIRED IN VERMONT TO FINANCE A LARGER PROJECT -- ITS ALL ABOUT DRAWING FROM A PATCHWORK OF DIFFERENT SOURCES TO CREATE THE OVERALL PACKAGE. FORTUNATELY IN VERMONT WE HAVE A GREAT COMMUNITY OF LOCAL INVESTORS WHO WANT TO PUT THEIR INVESTMENT DOLLARS TO WORK IN THE STATE, ITS THESE INDIVIDUALS THAT ARE KEY TO GETTING PROJECTS LIKE THIS OFF THE GROUND, BECAUSE WITHOUT THE EQUITY DOLLARS DEALS LIKE THIS ARE NOT POSSIBLE."

—ELI MOULTON, MERRITT & MERRITT AND MOULTON

from VEDA / VT SBDC and the Flex Fund, and a delay of principal payments to all debt holders. Equity and debt holders took the long view and understood that the post-move growing pains could be made to go away and that the fundamental opportunities for the business and for its farmer customers and suppliers had not changed. After a bank delayed making a negative decision about expanding a line of credit and so contributed to a cash crunch, an emergency bridge loan allowed VSC to continue to develop.

In April of 2013, a new Plant Manager started and by June significant improvements in Cost of Goods became apparent and have continued since. Year/year sales growth in excess of 65% along with these operating improvements have brought VSC to above EBITDA and cash flow breakeven and almost to Net Income profitability by July of 2013.

To undertake this expansion and then regain its footing after stumbling initially in the new facility, VSC has been highly fortunate for its group of investors and their cooperative, collaborative approach in which they recognized their shared self-interest in this business succeeding.

We help small farmers go to market by processing their meats using our recipes.

VERMONT SMOKE & CURE™

BUSINESS OPPORTUNITIES IN COMMUNITY DEVELOPMENT LENDING

SMALL BUSINESS: THE COLLABORATIVE PATH TO THE DEAL

Project Costs		Project Funding	
26.35%	Purchase of Machinery and Equipment, Parts and Tooling	37.53%	CNB, 21.47% of loan at fixed rate for 6.5 years, thereafter adjusted quarterly to FHLB+3.0%. Interest only 18 months, thereafter 10 year term and amortization. 80% USDA-RD guarantee. 16.06% VEDA Participation in CNB's Loan, resulting in 64.9% guarantee. VEDA, EROP WSJ Pr-3%, floor of 2.0% for 3 years, thereafter VEDA Tax-Exempt rate. Interest only up to 18 months, 10 year terms and amortization.
55.32%	Fit-Up Expenses; 17.40% as Equipment, and 37.92% of fit-up affixed to lease facility		
3.85%	Construction carry costs, professional fees, lease deposit	10.44%	CDBG Grant, 1%, interest only for 2 years, 10 year term.
4.95%	Moving costs, lease carry costs	12.04%	VSJF Subordinated Debt, Fixed rate, 8 year term, interest only 18 months, negotiated royalty based on % of gross sales.
3.51%	Lease payoff	20.07%	Landlord Fit-Up Contribution
3.01%	Project Contingency	19.92%	Owner Equity
3.01%	Working Capital		
100%	Total Project Costs	100%	Total Project Funding

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GLOSSARY OF TERMS:

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 not readily available in Vermont. It 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.

Near-equity investments: Consists of debt that is convertible to equity and debt with warrants, royalties or participation payments. Near-equity can be structured to act like equity, with deferred payments that give young firms the patient capital they need in their early years.

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).

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.

*Definitions from www.investopedia.com and www.businessdictionary.com.