# Partnering With Passive Private Investors To Increase Your Production

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All underlined words used herein are defined **either** in your hand out materials **or** in the upcoming slides; please refer to such materials as needed during this presentation.

# Harry needs money.

- Harry needs $1mm to start his new venture farming Hybrid Red Snapper in ponds on his farm.
- Harry has $100,000.00 of savings, a mortgage, a wife who works part-time, two children and two dogs.
- Harry has one (1) year of prior aquaculture farming experience raising catfish and has a full time sales job making $75,000.00 per year.

# Finance Options: Self-Finance

- Harry doesn’t have enough money.
- Even if he did, currently no sufficient insurance to cover a loss (Non-Insured Crop Disaster Assistance Program ***limited*** exception (55% to 65% harvest value coverage, as determined by USDA / loss must result from natural disaster))
- Even if Harry only needed $50,000.00 to $100,000.00, Harry’s wife disapproves due to risk of loss.

# Finance Options Continued: Farm Service Agency ("FSA")

- Money limitation
  - Operating Loans capped at $300,000.00 per cycle
- Personal Liability
  - Direct liability or personal guaranty if entity the borrower; spouse not required to sign (unless co-applicant)
- May not qualify for loan
  - Harry doesn't satisfy FSA's "managerial ability" requirement (exception for micro-loan program)

# Finance Options Continued: Traditional Bank

- $1mm needed will not be limited by most banks, unlike FSA
- Down payment of 10 to 20 percent common; even if Harry's wife allowed him to use all of their savings to reach 10 percent, traditional bank will require personal liability from husband and wife (unlike FSA)
- Insufficient insurance and collateral are issues with industry (may be resolved by FSA Operating Guaranty, current maximum $1,399,000.00; still down payment issue)
- Interest rates higher with banks than FSA (as of November 1, 2017, FSA direct and microloan operating loans equal 2.750%); expect 4.5% to 5.5% floating interest rate with traditional lender

# Finance Options Continued: Angel Investors/Venture Capitalists/Private Equity Firms

- No interest in Harry’s investment pitch; proposed returns not high enough
- These types of investors traditionally seek high risk, high return investments (i.e. technology startups, Facebook, Twitter, etc.).
- Even if interest, these types of investors may demand certain levels of control that Harry isn’t willing to give.

# Options Continued: Passive Private Investor

- No monetary cap and no personal guaranty, unlike FSA and traditional bank loans
- No tap into savings for down payment, unlike traditional bank loan
- Likely more **passive** in demands for general control, as well as control of day-to-day operations, as compared to Angel Investors, Venture Capital, and Private Equity Firms

# Meet Sally

- Sally, a high net worth individual, is passionate about the future of aquaculture and wants to invest in an aquaculture company.
- Sally reaches out to Karen Hudson with VIMS.
- Karen refers Sally to Harry.
- Harry and Sally meet to discuss terms.

# Sally's wants as an investor

- Priority return of invested capital, share in unknown profits, or a mixture of both
  - Sally wants a return of capital prioritized over other operating net cash flow payments to the owners of the business
- Some level of control
  - Sally wants to have input when the business is sold, when Harry incurs debt, and when the business is terminated, among other big picture items; Sally doesn't want to get involved with the day to day operations of Harry's Hybrid Red Snapper venture.

# Harry’s wants as <u>operator</u>

- Give up as little economic position as possible
- Give up as little control as possible
- Quit full time job to devote full attention to Hybrid Red Snapper operations
- Harry will have to give up as much economic and control rights as necessary to strike the deal with Sally.

# How Harry and Sally strike the deal

- Sally invests $1mm in Harry's business, Red Snap Attack, LLC (the "business").
- Harry and Sally balance out the control and economic terms.
- Harry needs to ensure that he makes enough money as operator to quit his sales job and focus all of his time/energy to running the business.

# Deal on Control Terms

- As operator, Harry controls the day-to-day operations of the business, i.e. making sales, setting sales prices, etc.
- Harry controls determination of net cash flow (and specifically the reserves to set aside for potential future use by business) (see upcoming slides).
- Sally must preapprove any incurring of debt by the business, as well as sale or termination of the business
- Sally must preapprove any individual matter that concerns more than $50,000.00 (i.e., business buying large equipment, tanks, etc.).
- Sally cannot be forced to make extra capital contributions into the business without her prior consent; Harry cannot raise money from new investors without offering Sally the ability for her to maintain her ownership interest percentage in the business (i.e. anti-dilution).

# Deal on Economic Terms

- Sally receives a 25% ownership interest in the business.
- The net cash flow from the business will first be applied towards the return of capital of Sally’s $1mm investment.
- Harry has a 75% ownership interest in the business, and a guaranteed payment of $50,000.00 (for services rendered as operator of the business / salary equivalent).

# Deal on Economic Terms Continued

- Business pays Harry's guaranteed payment first, treated as business expense.
- Once net cash flow is determined by Harry in his capacity as operator, then the order of payment priority is as follows:
  - First, Sally's return of capital
  - Second, any remainder distributed pursuant to respective ownership interests in business (75% to Harry and 25% to Sally)
- Net Cash Flow equals gross cash proceeds from business operations **less** the portion of all such proceeds used to pay or establish reserves set by Harry as operator of the business for all Company expenses, debt payments, capital improvements, replacements, and contingencies.

# Example: Harry's Venture YRs 1-2

- The hybrid red snapper takes three years to reach harvest size.
- The business has $0.00 in net cash flow in years 1 and 2. In both years, Harry receives a $50,000.00 guaranteed payment and Sally does not receive any return of capital.

# Example Continued: Harry's Venture YR 3

- Harry sells his entire surviving livestock that was purchased at the beginning of year 1.
- As a result of the sales, the business received \$2mm in gross sales and \$1mm net cash flow to be distributed pursuant to the economic terms of Harry's and Sally's deal.

# Example Continued: Harry's Guaranteed Payment in YR 3

- The business received $2mm in gross sales in YR 3.
- Per economic deal terms, Harry is to receive his $50,000.00 guaranteed payment; this is paid before the distribution and determination of net cash flow.

# Distribution of the Net Cash Flow for YR 3

- $1mm to distribute at year end of YR 3
  - First and only, Sally receives the entire $1mm of <u>net cash flow</u> in the form of <u>return of capital</u>. As a result, the <u>business</u> has returned Sally's entire $1mm investment back to her. All future <u>net cash flow</u> distributions will be distributed 75% to Harry and 25% to Sally.

# YRs 4+: The Sweet Spot

- Utilizing the results as set forth in the previous examples, YRs 4 and onward for both Harry and Sally are optimal.
  - Sally's benefit: Sally's return of capital has been paid in full, and now Sally has a 25% ownership interest in the business practically without risk on her original $1mm investment
  - Harry's benefit: Now that the return of capital has been paid in full, this means that more of the net cash flow is payable to Harry based upon the 75/25 split previously discussed, from year 4 onwards. If Harry receives more than $25,000.00 each year in net cash flow distributions, then he will be making more than the $75K sales job that he quit.

# Alternative Forms of Economic Deal Structuring – Preferred Returns

- Sally could have demanded a preferred return on her unrecovered invested capital; preferred returns can be **cumulative** or non-cumulative.
- Think of preferred return as substantially equivalent to interest on a promissory note.
- Preferred returns end once the unrecovered invested capital has been fully recovered.

# Alternative Forms of Economic Deal Structuring – Ownership Interest Variations

- Sally could have demanded a higher <u>ownership interest</u>.
- In response, Harry could have demanded modification to the priority of <u>net cash flow</u> distributions.
- Both Harry and Sally could have struck a deal with Sally having a higher <u>ownership interest</u> with the priority of <u>net cash flow</u> distributions being split between <u>return of capital</u> to Sally and pursuant to <u>ownership interests</u> (75% to Harry/25% to Sally).
- Said split could be made either via firm $$ amount or percentage of <u>net cash flow</u>. Example: For any given year, first $100,000.00 of <u>net cash flow</u> to Sally's <u>return of capital</u> with the remainder of <u>net cash flow</u> 75% to Harry and 25% to Sally.

# The new ways to find your Sallys for your business capital needs

- Traditionally, the Sally example is a customary way non-professional investors are linked to <u>business</u> operators seeking capital.
- Now, there are new ways to find non-professional investors: new crowdfunding portals are allowing <u>business</u> operators to find every day investors anywhere throughout the U.S.A., subject to certain income and other threshold limitations.
- The new crowdfunding rules and portals are well suited for the aquaculture industry as many of your investor owners should be proud of your product (think the investor-marketer), as the industry is generally viewed as an environmentally sustainable and thus a worthwhile industry to invest in.

Summary: If you can find the right investors and strike the right economic and control terms of the deal, then obtaining private financing from passive private investors is preferable to both the operator and the investor for the following reasons:

## Operator Benefits

- No personal guaranty
- No capital limits (theoretically)
- No down payment
- No bank costs
- No unduly oppressive bank terms
- Ability to leverage invested amount for loan
- <u>Guaranteed Payment</u> Preserves Salary Concept, allowing part-timers to go full-time aquaculture

## Investor Benefits

- *Expectation* of higher returns than Certificates of Deposits, Treasury Bonds/Bills/Notes, Private Bonds, as well as most low to moderate risk public stocks
- Value of <u>ownership interest</u> not influenced by conjecture of stock analyst report made on Wall Street, unlike many publicly traded stocks

# Questions?

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