As appeared in the December 2 edition of the Wall Street Journal, noting Arctaris' royalty-type fund alternative and its recent investing activity in Michigan where it has an investing mandate and has opened an office in Detroit.

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Alternative Financing Option

Entrepreneurs Going the Royalty Route Use a Share of Revenue to Pay Back Loans

By SCOTT AUSTIN

When first-time entrepreneur Philip Vaughn recently began searching for start-up capital, he traveled down two conventional paths.

Mr. Vaughn, co-founder of travel-review aggregator Raveable.com in Kirkland, Wash., says he wasn't interested in forking over a large chunk of equity to venture capitalists or committing to ambitious investment-return expectations. He also considered a loan, but knew that banks had made it onerous for young companies like his to obtain debt financing.

"We're in a weird spot" but we have "a decent amount of revenue coming in," says Mr. Vaughn who expects Raveable's sales to grow two to three times annually.

So he's considering an alternative called royalty financing, in which a company pays back a loan using a percentage of revenue. Traditionally found in industries such as mining, film production and drug development, royalty financing is being seen more among technology companies and other early-stage firms with growth potential.

In the past year, new firms such as **Arctaris Capital Partners LP** in Waltham, Mass., Cypress Growth Capital LLC in Dallas, and Revenue Loan LLC in Seattle have sprung up to provide royalty financing.

The exact financing structure varies between investment firms. **Arctaris**, which is raising $200 million from institutional investors, is coupling the royalty financing with a five-year amortized loan. Cypress, which is putting together a $30 million fund, and Revenue Loan, backed by $6 million in venture capital, are attaching a small stock warrant as a safeguard in case the company becomes the next Google, Inc.

But one thing remains constant: The companies receiving the loans agree to pay a percentage of incremental revenue, usually from 2% to 6%, either over a specified time period or until a negotiated multiple of the investment is paid back.

There are caveats. The cost of capital may be more expensive than bank debt, especially if a company's revenue rises well above expectations and there is no negotiated ceiling. Also, because these are loans, it's still possible to default on them. And it can be difficult for a young company to manage its cash flow when some of its revenues are already spoken for.

Many start-ups may not be attractive candidates for royalty financing, either. "A lot of entrepreneurs could end up chasing down this rabbit only to find out that their financial metrics really don't line up with a consistent recurring revenue model attractive to a potential lender," says John Yates, a partner in charge of the technology practice at law firm Morris Manning & Martin LLP in Atlanta.

But royalty investors say the default provisions of royalty loans are generally less onerous than bank debt, and the payments are variable not fixed, allowing for flexibility if a company loses a major customer or has a down year.

Perhaps more importantly to entrepreneurs like Dan French, the chief executive of independent brokerage house Leonard & Co. in Troy, Mich., entrepreneurs give up little or no equity in these royalty scenarios. Mr. French previously turned down investment offers from two private-equity firms, one of which offered $15 million in exchange for nearly half of the firm.

"Believe me, it's very difficult to say 'no' to money of that magnitude," says Mr. French, whose firm expects to make $16 million to $18 million in revenue this year. "But the dilution from the shareholders' standpoint was dramatic."

He's now in discussions with **Arctaris** about a funding deal to help Leonard & Co. expand its client base.

Arctaris Managing Partner Andy Clapp says his firm is targeting growing companies in a mix of industries with at least $5 million in annual sales and profitable or nearing profitability.

The firm, which recently opened an office in a Detroit manufacturing plant, is investing up to $7 million per company, offering a five-year amortizing loan at up to 14% interest, plus a royalty loan payable over 10 years.

Keith Smith went the royalty-financing route last year for his Seattle-based Web start-up, BigDoor Media Inc., after a bad experience with bank debt ruined his previous start-up, Zango Inc. At one point, that company, which he founded in 1999 to offer ad-supported software, had more than 200 employees and revenue over $75 million. But it ran into difficult times in 2008 and defaulted on $44 million owed to banks. Mr. Smith was forced to close Zango's doors in April 2009 and sell its assets.

"If you're a small company, and you fall down and you're bleeding, banks have the ability to put their foot on your neck and pump the blood out even faster," Mr. Smith says.

For his new company, Mr. Smith raised $250,000 from angel investors plus $250,000 in royalty financing from seed fund, Founders Co-op. BigDoor went on to raise $5 million in venture funding in June, and the royalty loan converted into Series-B equity.

Raveable's Mr. Vaughn is currently in talks with Revenue Loan for financing.

"Some people might be spooked by" royalty financing, Mr. Vaughn says, but in his situation, "it's practical."

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About Arctaris Income Fund, LP

Arctaris Capital Partners, based in Waltham, MA, and with an office in Detroit, MI, provides funding to private as well as small publicly held companies seeking $1-7 million, utilizing a unique royalty-type instrument that does not dilute ownership and is repayable over 5-10 years. For further information about financing as well as the Arctaris Income Fund, email info@arctaris.com or call 617-535-9928, ext. 703.

About Royalty-Type Financing

For information about royalty-type financing, request a copy of a white paper entitled: *Funding Companies in a Deleveraged Economy: A New Corporate Finance Solution for Companies and Investors – Revisited* by sending an email to info@arctaris.com

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