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**Funding Companies in a Deleveraged Economy:
A New Corporate Finance Solution for Companies and Investors**

By Andrew D. Clapp, Managing Partner

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Funding Companies in a Deleveraged Economy: A New Corporate Finance Solution for Companies and Investors

By Andrew D. Clapp¹

Don't look back. It's only a memory now, however pleasant, when investors 'invested' and banks lent money. Now everyone is waiting in the bunkers for the 'all clear,' signal to come out and resume investing . . . yet everyone knows that the rules might change; no, they have changed! Liquidity has been lost, and capital, not talent, is the scarce commodity. But for how long?

The problem is that the familiar tools of corporate finance don't work anymore. Like the old car engine that always responded on a cold day to a shot of starting ether . . . nothing happens now. While Company executives try to figure out what will work . . . hopefully before they run out of gas . . . the opportunistic funds have stepped forward with financing terms that are designed to punish existing investors and founders.

The problem is that investors, both institutional and individual, are loath to return to the market that burned them so severely. However the need exists to generate returns on their idle cash that is higher than the 1-2% level now being paid on CD's. Investors are fearful, recognizing the risk of investing in the current environment, and are unwilling to venture forth except to shore up some of their past investments that are running low on cash.

These are the conditions that characterize our economy and the financial markets . . . we will have to live with this longer than most people realize. One economic historian and fund manager we spoke with recently has completed an analysis of the long term economic cycle, and believes that the DJIA will fall to 3,500 or 4000 before bottoming out, and he believes that the 'recession' will run through 2010.

There are no clear solutions in sight. The President's program will barely have any impact this year. On the corporate front, venture and private equity funds are cautiously offering money but on draconian terms that may precipitate defaults. For those that survive, their shareholders may be crushed by the terms of financing that some funds are now offering

Just as the capital market adapts to changing conditions, so do companies. Good companies will continue to need financing and investors will find ways to extract risk adjusted returns. However, we are at a juncture in time where the need for innovation of practical and transparent financial structures is crucial and a time where the art of finance can yield new solutions that satisfy both investors and companies. Out of this environment was born a new financing instrument, the TIGRcub[™].

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A Non-dilutive, Tax Deductible Financing Alternative²

A group from Chicago has developed a platform of security structures known as TIGRcubsTM (an acronym for Top-line Income Generation Rights Certificates that has no connection to Julian Roberts' spin off funds (sometimes known as Tiger Cubs) that, in their base form, enable a firm to obtain capital and repay investors with a fixed percentage of the Company's top-line gross revenues for a finite period of time. While at first glance, TIGRcubsTM may appear similar to financings known as royalty-based transactions. However TIGRcubTM securities differ materially from royalty contracts in both form and substance in both legal and accounting respects. The intent of this paper is not to present these differences, but to identify the corporate finance applications of TIGRcubTM securities.

The TIGRcubTM security platform has been undergoing development by Entrex for over the last three years with the support of legal specialists that validated the security structure and developed guidance for issuer and investor tax treatment. The U.S. Patent and Trademark Office has issued a patent that allows Entrex protection to promulgate the TIGRcubTM by licensing the intellectual property to issuers and creating a market place and exchange for secondary trading of the security. Entrex has since filed several other patents related to the prior art and worked extensively with one of the Big-4 accounting firms on accounting treatment research and guidance for companies issuing the security.

TIGRcubsTM were first announced publically by Entrex in the third quarter of 2008, and Arctaris' founding partner, Andrew Clapp, learned of them in late November. Since then he has been working with Entrex to perfect several variants of the security and to position Arctaris as one of the first groups to provide TIGRcubTM financing to companies through private placements and raising a fund, The Arctaris Income Fund, LP.

The approach being followed by Clapp and his team towards companies interested in issuing TIGRcubTM securities has been one of openness and transparency of information. Typically Arctaris explains the TIGRcubTM structure to a Company seeking financing and when appropriate, conducts a feasibility study to determine the proper financing metrics based on the Company's position and requirements. The study provides management with a structure for a TIGRcubTM financing that allows them to see how the funds flow and the cost of capital compared to equity and/or subordinated debt alternatives.

Advantages of a TIGRcubTM Financing

Companies are attracted to issuing TIGRcubTM securities because the structure has a number of desirable features, chiefly, the fact that it *doesn't dilute the ownership* of the current shareholders. This is an enormous advantage under most market conditions, but especially in an environment where valuations are as low as they have been in recently. Founders and management recoil at the dilution each time an equity financing is closed, seeing their ownership stake dwindle because of valuations that they don't believe reflect the true value of their Company. Furthermore, as sequential equity financings occur, the "waterfalls" of preferred securities

² Generally speaking, according to FAS, payments in excess of the principal are eligible for federal income tax deduction as the equivalent of interest expense under certain forms of TIGRcub security structures where the issuer undertakes a non-contingent obligation to repay principal on or by a date certain, Issuers and investors should seek specific advice

become more complex and are difficult for founders or even major shareholders to understand. This often creates an adverse tension between a Company and investors that can be avoided with a TIGRcub™ issuance. The use of a TIGRcub™ does not require that a valuation for the investment be agreed upon as is necessary in the case of convertible preferred equity structures or even sub-debt financing where warrants are usually attached as a compliment to further align interests. This security truly aligns the interests of management with investors in growing the top-line as opposed to squeezing out costs as in a debt financing. Further, the TIGRcub investors' interests are aligned with previous investors as everyone is trying to grow the top-line without diluting the existing shareholders.

In these instances when valuations are much lower than they were as recently as the summer of 2008, a TIGRcub™ financing allows a Company to raise capital without a 'down round'. A Company can postpone a larger equity financing until valuations have risen or until the Company's performance justifies the desired valuation.

Institutional investors that have already invested in a Company may view a TIGRcub™ issuance as a bridge to the next institutional round. TIGRcub™ structures are agnostic with respect to the amount invested, the size of the Company, or its stage, provided there are sufficient revenues to fund the return required by the investors. Take for instance a Company with institutional investors that only need \$500,000 or \$1 million of financing, an amount too small to attract a new investor who would, by virtue of the investment, establish a new equity valuation. Or, an instance where the current venture investor may be approaching the upper limit of what they can invest in a Company. In these instances a TIGRcub™ financing can be compatible with the Company's capital structure since, with a TIGRcub™, there are usually no conflicts of governance (no new board seats, etc.), no dilutive effect to existing shareholders, and the financing is viewed favorably by key management participants. These are factors that can go a long way towards helping a Company achieve its financing needs.

A major benefit to the Company issuing a TIGRcub™ is that investors derive current income and investment returns from a fixed percentage of top-line GAAP gross revenue each period, typically monthly, unless the Company has publicly registered securities and discloses its financial statements quarterly. The practical effect of this is that during the early years, when revenue is lower, the cash outflow is lower and increases only as revenues rise at a time when the Company can better afford it. If the Company hits a bump and revenues decline for a period, the TIGRcub™ payment obligation declines as well, offering some relief to the Company when they most need it.

Unlike equity securities, or securities with an equity component such as mezzanine-debt, TIGRcub™ securities do not require a liquidity event for investors to receive their investment return. Their return is derived over the course of time from revenues. This kind of "patient capital" allows companies to focus on building equity value on a timetable that is in management's best judgment, but does not prevent a liquidity event to take place if management and the Board believe that is in the best interest of the shareholders. In the event of a change of control, the TIGRcub™ security would be redeemed.

TIGRcub™ securities enjoy another feature: the amount paid to the investor above the repayment of the original investment is fully tax deductible. In essence the Federal Government is paying 40% of the cost of the financing.

Finally, the capital proceeds show as cash on the assets side of the balance sheet but the investment does not have a corresponding liability as with debt or subordinated/mezzanine debt, as the repayment of the principal amount is contingent upon revenue being generated. The net effect is to increase the net worth of the Company. Under FAS, it will probably have to be footnoted in the Company's financial statements as a *Contingent Liability*³

Candidates for TIGRcub™ Financing and Next Steps

There are some characteristics that a Company should possess before considering a TIGRcub™ financing. The Company should:

- Be profitable or nearing profitability;
- Possess high gross margins above 40%; and
- Be forecasting *growth*.

The exception might be a Company that is early stage, whose current investors would like to do a rights offering or a non-dilutive financing, and the Company intends to raise most of the capital from current investors. A TIGRcub™ issuance might work well for them as it is essentially an 'inside' round and is not intending to compete for capital in the open market.

Possessing these characteristics, most Companies can and should consider a TIGRcub™ issuance. Of course other factors enter into the underwriting decision such as management, volatility or concentration of sales, competitive risk, and external economic and market factors. There is no constraint as to the size of funding that can be structured provided that the Company's revenues and cash flows can realistically support the TIGRcub™ payments). Arctaris is evaluating the applicability of the TIGRcub™ structure in financings upwards of \$30 million.

Arctaris has developed a financial model for evaluating the issuance of a TIGRcub™ security based on forecasted revenue in which Arctaris and management of the company work together to prepare a realistic forecast that everyone can agree on. Through the use of the model the financing cost and funds flow can be seen over the life of the financing and compared to the cost of capital for similar sized equity or debt financings. This model has been useful for review by institutional investors of a Company as well as by Company executives and their Boards. The model also illustrates the effect of the financing on the Company's enterprise value and shows how the shareholder value could increase faster than without the proposed funding because the TIGRcub™ targets growth in the top-line which leads to a higher exit value for shareholders. Of course, as with any projections, realistic revenue growth forecasts are essential so that the various financing structures can be modeled accurately.

A TIGRcub™ financing can also be used in other ways. For example, to recapitalize a Company to enable investors or owners to sell some of their shares back to the Company. Or for instance, a family owned Company undergoing a generational succession plan where the older

³ See FASB 133 and ETIF 88-18, respectively, for general technical guidance on accounting treatment of contingent payment debt obligations and the sale of future revenues. Issuers and investors should seek specific advice and counsel from their accountants and attorneys regarding facts and circumstance in order to make a final determination concerning tax and accounting treatment.

generation wants some form of liquidity, but is sensitive to the ownership dilution or the presence of investors outside the family or immediate ownership group. Another application of TIGRcub™ financing is with ESOP companies, where new equity issuances are complex and often encumbered by highly leveraged balance sheets, and where outside investors other than the employees are generally not welcome. And, last but not least, the TIGRcub™ can be used effectively by thinly traded public companies to raise cash that otherwise had planned to utilize the currently dysfunctional public market to do so. TIGRcub™ financing could be used in a tender offer to take the Company private.

A Platform of Security Structures

A standard TIGRcub™ maturity (obligation) is 10 years. However, Entrex is refining two variations:

- The Perpetual TIGRcub™ - an analog to an equity investment that represents permanent financing. This version of the TIGRcub™ has no finite life and has fund-out provisions similar to a convertible preferred equity security. However, it brings all of the other advantages of the base model TIGRcub™. This version will likely be suitable for more mature companies, or younger venture-backed companies. Its primary benefit is the lower monthly payout, however as with all TIGRcub™ securities, it can be, or may be required to be, redeemed early as noted below.
- The Min/Max TIGRcub™ - a TIGRcub™ that has an IRR floor and ceiling. This may be important to existing investors that want some limit to the upside to giving the TIGRcub™ holders a disproportionate return on their investment, in exchange for a floor.

The TIGRcub™ security can be redeemed or accelerated prior to the maturity date, which might be triggered by the acquisition of the Company (a change of control) or through a recapitalization that replaces the TIGRcub™ with lower cost financing such as debt. But the most common reason to redeem a TIGRcub™ is when the Company is acquired or raises money through a public offering. Prepayment is accomplished with a lump sum payment that is calculated using the same internal rate of return (IRR) that was agreed upon at the inception of the financing. A small pre-payment penalty is also applied, which declines to zero as the TIGRcub™ security matures.

Typically the IRR used for modeling the case for a TIGRcub™ issuance, and calculating a prepayment falls between the current price market for sub-debt and equity financing. When compared to mezzanine financing or convertible preferred financings TIGRcub™ transactions should require less time to close because of the use of standardized documentation. That translates to lower closing costs. In the current challenging economy, TIGRcub™ financing may be the optimal funding solution for many companies. But even in healthier economic times, when traditional funding sources are more available, the features of the TIGRcub™ (including but not limited to its non-dilutive effect) will continue to make it a popular funding option for many companies and an attractive security to invest in because of its current income features for investors.

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