Beyond the Bank

A Primer on Non-Traditional Financing Strategies for the Recycling Industry

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Prepared by:
Environmental Capital Network
416 Longshore Drive
Ann Arbor, MI 48105
734-996-8387
734-996-8732 (f)
ecn@bizserve.com; www.bizserve.com/ecn

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David Bluhm
President
EAC Financial Services, Inc.
4450 Arapahoe Ave.
Suite 100
Boulder, CO 80303
(303) 415-2041

Brian Bond
CapCo
7799 Leesburg Pike
Suite 900 N.
Falls Church, VA 22043
(703) 847-8281

Craig Bonnell
Vice-President
Global Commercial Credit
31780 Telegraph Rd.
Suite 201
Bingham Farms, MI 48025
(248) 646-6900

Gary Ford
Senior Director
FL Financial Services, Inc.
100 Pine St. 5th Floor,
Ste. 560
San Francisco, CA 94111
(415) 288-4075

James Frey
President/CEO
Resource Recycling Systems Inc.
416 Longshore Dr.
Ann Arbor, MI 48105
734-996-5595

David Kirkpatrick
Principal
KirkWorks & The Sustainable Jobs Corporation
PO Box 15062
Durham, NC 27704
(919) 220-8065

Jerry Powell
Editor-in-Chief
Resource Recycling
P.O. Box 10540
Portland, OR 97210
(503) 227-1319

Kathleen Powell
National Marketing Director
Equipment Leasing Corporation
8777 E. Via De Ventura, Ste 396
Scottsdale, AZ 85258
(602) 443-8984

Ira Rubenstei
President
HRST, Inc.
1223 Peoples Ave.
Troy, NY 12180
(518) 276-8458

I. INTRODUCTION

OVERVIEW

Many promising recycling related companies, whether they focus on collection, processing, distribution, manufacturing, or retailing, face a similar problem: difficulty accessing growth capital. Companies need capital to grow, fund research, verify promising technologies, commercialize products, expand production, or for other business opportunities.

Yet recycling related businesses often find that conventional banks are unwilling to extend sufficient lines of credit because companies lack an "adequate track record" (i.e. at least three recent years of profitable operations). Even when a business possesses the requisite track record, conventional banks often site their own inexperience or price and regulatory uncertainties, associated with the recycling industry, to explain why they can't extend credit.

At the same time, recycling related businesses often find that their efforts to obtain equity capital from private individual investors and venture capitalists is very time consuming, expensive and often not very successful. Unfortunately, many equity investors do not understand the industry and are wary of the industry's cyclical pricing characteristics, shifting regulatory environments, and general poor financial performance.

Nonetheless, many recycling companies can be financed and can find the capital they need to support their business through a variety of non-traditional finance sources.

WHAT THIS PRIMER DOES

The purpose of this primer is to introduce recycling companies to non-traditional finance sources and methods, which may assist them in the capitalization of their business. To the extent possible, the primer uses non-technical language. The primer is divided into two major sections:

Section I: Finance Basics and

Section II: Non-Traditional Finance Tools

Section I outlines the critical concepts necessary to understand the fundamentals of financing and presents some basic business development concepts. It concludes by presenting a simple model for business finance that lays out many of the finance tools most appropriate for different stages of a company's development.

Section II provides more detailed information on a variety of non-traditional finance tools that a recycling company may use. This information includes a brief description of the tool, how it works, typical terms, advantages and limitations, and an illustration of use. Suggestions on how to get started and references for many of the tools described are provided in Appendix A.

SECTION I: FINANCE BASICS

It is important for proper financial planning that management of recycling companies have a good understanding of the broad categories of capital sources available, and that they be able to identify the types of capital best suited to their particular business today and in the future. This section will provide the reader with an overview of the general types of capital options available and a general understanding of the types of capital most appropriate for different types of businesses in different stages of development. This Section covers the following:

A. Capital Sources: Traditional Equity, Traditional Debt, and Non-Traditional Financing

B. Business Capitalization: A Road Map of Financing Options

A. CAPITAL SOURCES

The capital marketplace essentially uses two key principles to guide investment decisions:

- Risk - measurable probability of losing or not gaining value on a security or capital investment and

- Return - the expected or necessary Return on Investment (ROI) that a capital investment is expected to provide to an investor to compensate for the risk associated with that capital investment.

Generally speaking, there are three categories of capital investment options: traditional equity, traditional debt, and non-traditional financing capital sources. Traditional equity sources are willing to assume relatively higher levels of risk and expect relatively higher rates of return. Traditional debt capital sources typically assume a low level of risk and require relatively lo rates of return. Non-traditional financing sources, in general, are designed to accept moderate levels of risk for moderate levels of return.

I.A.1 TRADITIONAL EQUITY

Equity investors invest to participate in a company's future value. Equity investors literally "buy" ownership in a company, in exchange for the opportunity to sell that ownership at a later time when the company's value has increased. Generally speaking, a company has three groups of equity sources to potentially tap: Friends, Family & Founders; Professional Early Stage Investors; and Later Stage Investors.

Friends, Family & Founders: Most businesses, rapid growth or otherwise, begin with equity placed by the firm's founders, partners, friends, relatives, business associates, and other non-professional investors who have personal connections to a company's founders. Such investment is usually made in businesses at early stages of capitalization.

Founders invest "sweat equity", personal time, energy, and credit, to get a business started. They typically make direct investments by tapping personal savings, credit cards, home mortgages, small bank loans, loans from friends and relatives, or through loan guarantees. Other wealthy non-professional investors will make direct investments of $5,000 to $250,000 per investor, often based upon the personal character of and their relationship with the founders.

Professional Early Stage Investors: Professional early stage investors include most high net-worth individuals, or "Angels" and some specialized venture capital firms. It may also include potential corporate joint ventures or strategic partners. Such investors are usually looking to place anywhere from $250,000 to $5,000,000 in capital. They typically expect returns ranging from 30-100% per year, and want to be able to exit from the company (i.e. able to sell their ownership) within 3-5 years.

This group is important because many early stage companies, particularly rapid growth companies with large research and development, fixed capital, or marketing needs, will often need to seek outside professional early stage investors to infuse larger sums of capital and to provide guidance to the firm.

Later Stage Investors: The later stage investor pool consists largely of venture capital firms and institutional investors often recruited by investment bankers. However, in recent years it has expanded to include pension firms and mutual funds. Later stage investors are usually looking to place at least $2 million in companies. They often seek a minimum, 30% annual ROI and typically want to liquidate their stock within 3 years.

Rapid growth companies, well into the startup or 1st expansion stages, will often require even larger sums of outside capital to further expand their marketing efforts, launch new products, open new plants, etc. Later stage investors can be particularly helpful in financing these types of endeavors.

I.A.2 TRADITIONAL DEBT

Traditional debt is usually provided by individuals or from commercial banking institutions. Traditional debt capital targets a fixed and immediate rate of return and is designed to incur little risk. Debt capital is primarily concerned with reclaiming the loan plus some profit, and will generally require the company to offer collateral in case the company is unable to repay the loan in the prescribed manner. Further, the size of the fee or the interest rate is assigned based upon the perceived risk that the recipient will default on the loan.

Traditional sources of debt capital typically base their decision to lend upon the following "Four C's" of credit:

- <u>Capacity</u> - the borrower's ability to pay back the loan demonstrated through a resume highlighting the necessary skills to run a successful business;

- <u>Capital</u> - the individual's or company's net worth;

- Character or Credit - the demonstrated desire to meet or fulfill responsibilities based on references and prior debt-repayment records and

- Collateral - the borrower's ability to pledge suitable assets to secure a loan.

Individual Debt: Individual debt comes in several forms: personal savings, credit cards, and family loans. These types of "non-secured" debt usually don't rely on hard assets for collateral, but upon the character and credit record of the individual borrower. The amount of capital available for individual debt is typically small and is usually limited to an individual's net worth. Interest rates can range widely from zero to over 20% depending upon the source.

Commercial Debt: Commercial banks, credit unions, community development financial institutions (CDFIs), and similar banking institutions will often lend to individuals or companies that they consider a very low and acceptable risk. Acceptable risk generally translates to possessing sufficient, existing, hard collateral like real estate, and a sound historical financial track record, within an industry about which the bank feels knowledgeable. Such banks typically lend relatively small amounts of capital (usually from $5,000 to $2 million) to startup and expansion stage businesses at rates of 8-15% per year.

Loans are usually made in the form of term loans, home equity loans or second mortgages for individuals, or in business loans or lines of credit. Virtually all firms seeking bank loans will be required to offer collateral items such as an individual's house, a piece of equipment, land, or other fixed and hard assets. The lender places a lien on these assets and can sell them to recoup losses in the event the borrower defaults on the loan.

I.A.3. NON-TRADITIONAL FINANCE

There is a range of non-traditional finance sources that individuals in certain circumstances may be able to tap into to start and grow their businesses. This type of capital is also referred to as "transitional capital." These include asset-based financing, leasing, partnership financing, and government financing. An overview of these sources is presented below. A more detailed discussion can be found in Section II of this Primer.

Asset-Based Financing: Asset-based lending firms, factors, and purchase order finance companies provide debt capital that is based primarily on a company's ability to produce, and is less concerned with a firm's historical track record and existing hard assets. (See Section II for a complete description.) Accordingly, asset-based finance companies are often willing to loan to viable, revenue generating companies that are considered unacceptable by commercial banks.

Such sources place capital based upon assets such as accounts receivables, inventory, purchase orders, and production equipment. They typically lend capital at interest rates of 10-25% per year and make placements of $50,000 to $5 million in capital, per company.

Lease Financing: Leasing entities finance equipment and other hard assets for companies based primarily upon the value of the equipment obtained through the lease finance. Leases can be arranged by third parties or by equipment manufacturers. Companies pursue leases as a way to essentially rent equipment which they are unable or unwilling to purchase outright. Leasing may also provide a company with certain tax benefits.

Lease rates and fees range typically from 12% to 20% per year. At the end of the lease, the leased equipment either becomes the property of the company, or it is returned to the leasing entity.

Partnership Financing: Companies can partner with other companies to gain a wide variety of direct and indirect capital. Options include customer/supplier credit, licensing, franchising, and project financing. Each of these options essentially finances a company in part, by leveraging the resources of other companies either to reduce costs, increase revenues, or to increase the amount of capital available.

The terms and conditions of partnership financing cannot be easily generalized, as they vary widely from case to case. In general, the monetary cost of capital in partnership financing is comparatively low. As a result of teaming up with another entity, however, a company may need to make certain sacrifices in terms of strategic control and or business decisions.

Government Financing: Many government agencies, from the federal to the local, offer programs to foster a jurisdiction's economic development or the attainment of an agency's goals. Such "mission-based financing" programs typically link funding or financing to an enterprise's ability to facilitate the attainment of agency or public goals. These programs may have many manifestations, including loan guarantees and grants, but also include revolving lines of credit, direct loans, tax incentives, and municipal or industrial bonds.

Federal, state and local governments often have the ability to make financing available, to small businesses, at lower interest rates and/or in greater quantities than commercial banks are willing to provide. For example, the Federal government may provide loan guarantees to leverage bank loans to small businesses, often at better terms, by sharing the bank's lending risk. The Small Business Administration (SBA) is the leading source of loan guarantees for small businesses of any nature. Other federal agencies and many state and local economic development authorities also provide loans and loan guarantees.

Many government entities also provide select companies with grants to offset research and development, technology verification, startup, and even some expansion expenses. In some cases, grants may be available to recycling related businesses, particularly through federal government programs such as the Small Business Innovative Research (SBIR), the Department of Energy's National Industrial Competitiveness Through Energy, Environment, and Economics (NICE3), and the Strategic Transfer of Technology Research (STTR). Detailed information on these and other federal grant programs is provided in section II.C.b.

I.B. BUSINESS CAPITALIZATION: A MAP FOR FINANCE OPTIONS

Successful capitalization requires an understanding of how different types of capital sources can meet a company's needs at different points in the company's development. With this understanding, a company can effectively map out the types of capital that will be available to it currently and in the future.

This section first describes factors that capital sources consider when assessing whether or not to invest in or make loans to a company. These factors include the company's type, its growth stage, and its planned use of funds. Simply put, different kinds of capital are available for different business types, different growth stages, and different uses. This section also presents the types of capital that are available at different points in a company's development.

I.B.1 FACTORS TO CONSIDER

The type and amount of capital available to a recycling (or any other) company is driven by the following factors:

- Business Type;
- Business Growth Stage;
- Investment Risks and
- Capital Uses.

Business Type: Capital sources usually categorize businesses into two types: "High Growth" and "Steady Growth." The vast majority of recycling companies are considered "Steady Growth" businesses. Indeed, relatively few companies truly have "High Growth Potential". Characteristics of each type of business are provided in Table 1.

Table 1. Basic Characteristics of Business Types

"High Growth Business"	"Steady Growth Business"
• Serious prospects for growth exceeding 35% per year. • "Home-run" potential within specific niche markets. • Proprietary technology that provides significant solutions to customer problems. • Aggressive business model with potential to move company to national and international markets. • Well rounded and sophisticated management team. • Could be extremely profitable in next 3-7 years.	• Limited growth potential (sales growing by less than 20% per year). • Typical in highly localized or very "mature" markets. • Not aggressively seeking growth opportunities. • Not conducting significant R&D. • Stable management team. • Often are well established, family run businesses.

Business Growth Stages: Another critical factor in determining the appropriateness of a capital source is a company's current growth stage. While terms will differ among business development professionals, five distinct growth stages can be identified:

Early Stage	• Embryonic • Seed • Startup
Expansion Stage	• First Stage Expansion • Second Stage Expansion

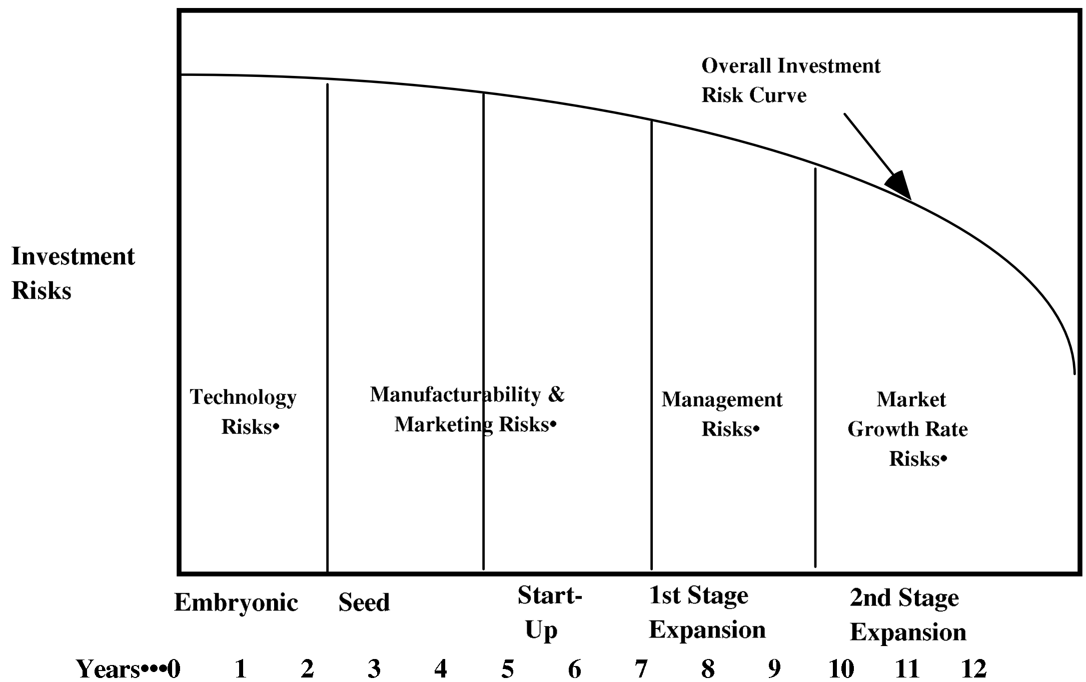
An overview of the characteristics and financial status, and investment risk factors for early and expansion stage businesses is described below.

Table 2. Basic Characteristics of Early Stage Businesses

	Business Characteristics	Financial Characteristics
Embryonic	• Enterprise forms. • Conducts R&D to demonstrate proof of concept. • Files for initial patents. • Writes early business plan describing next 2 rounds of financing. • Typically lasts 1-2 years.	• No assets or sales. • No operating history.
Seed	• Builds a prototype. • Initiates serious market research. • Hires initial management team. • Formulates a business growth strategy. • Often lasts 2-3 more years, until initial sales.	• Minimal assets. • No revenues. • Losing money. • Very modest financial track record.
Startup	• Builds and operates a pilot plant. • Makes initial sales. • Small customer base. • Improves manufacturing efficiency. • Refines product delivery and feedstock acquisition strategies. • Can last several years, until firm achieves stable and growing sales and profitability.	• Minimal (but real) product sales. • Not profitable. • Still potentially losing money. • Modest but growing assets.
First Stage Expansion	• Growing sales and customer base. • Builds and operates first full scale commercial plant. • Develops or acquires additional technologies. • Rounds out management team. • Can conclude rapidly or last an additional 2 years after startup.	• Increasing customer base and sales. • Builds and operates facility expansions. • Initiating a roll out strategy and constructing new plants. • Can take several years to successfully execute full expansion strategy at which time the company is ready to "go public" or be acquired. • Is at or near profitability. • Typical revenues of $1-5 million.
Second Stage Expansion	• Sound financial track record • More assets than liabilities.	• Rapidly growing product revenues. • Revenues exceed $5 million. • Profitable. • Strong balance sheet.

Investment Risks: From the perspective of a capital investor, different business stages translate into different types and degrees of risk. In general, overall risk declines as the company matures. Lower risk in turn increases a firm's ability to access capital and its ability to negotiate more favorable terms. Table 3 offers a graphic description of overall risk and of the major risks at each corresponding stage of development. A more detailed layout of the types of risks capital investors consider, at each stage of development, is presented in Table 4 on the following page.

Table 3. Overall Investment Risk and Main Risk at Corresponding Development Stag



Source: Mark Clevey. MERRA. Ann Arbor, MI 1998

Table 4. Different Types of Risk Capital Investors Consider

	Technology Risks	Manufacturing Risks	Market Risks	Management Risks
Embryonic	Will it work as predicted? Will a patent be attainable? How much R&D is necessary?	Can fluctuations in the volume, quality and price of the feedstock or product be stabilized or otherwise compensated?	Does the company provide a solution for a real market need?	Does management have the ability to successfully commercialize the technology, product or service?
Seed	Will the prototype perform as expected?	Will the production process be reliable and reasonably cost-effective? Will a process for production be created?	Are there customers for the product?	Does management have the ability to identify a market niche and to grow the company as a business?
StartUp	Does the technology work as well in the field as in the lab?	Is the production process actually reliable and are costs decreasing?	Does a profitable market exist? Can the firm efficiently sell increasingly more product to real, paying customers.	Does management have the ability to successfully penetrate the firm's market niche?
1st Stage Expansion	Is technology sufficiently protected to eliminate threat from copycat competitors?	Can production be easily replicated and can further economies of scale be gained?		Is team capable of building a large and profitable company?
2nd Stage Expansion	Is this the best technology to serve the company's customers? Are there better technologies available?	Can production be modified to further lower costs and/or create new products?	Is the market growing fast enough to build a large company within a five year time horizon?	Is management capable of operating multiple facilities and achieving global growth?

Typical Capital Uses: Capital is usually invested or loaned based in part upon how the capital will be used. Accordingly, it is important to understand how capital uses differ depending upon a company's business type and stage of development. An overview of different capital uses at different development stages is shown on the following page.

Table 5. Overview of Different Capital Uses

	Rapid Growth	Steady Growth
Embryonic	• Research and development. • Raise seed round of capital.	• Concept research.
Seed	• Research and development. • Building prototype and pilot. • Hiring initial management. • Market research. • Legal assistance. • Writing business plan. • Raising startup capital.	• Writing business plan. • Raising startup capital. • Confirming market assumptions. • Legal assistance.
Startup	• Operating and refining pilot. • Equipment, facilities and inventory. • Working capital for better management, more staff, marketing and sales, and raising capital.	• Starting business. • Hiring management and staff. • Securing working capital. • Equipment and facilities. • Inventory.
1st & 2nd Stage Expansion	• Additional production capacity. • Marketing and sales. • Working capital. • Facilities, equipment & inventory.	• Working capital. • Facilities, equipment & inventory.

I.B.2 A CAPITALIZATION ROAD MAP

A company's capitalization prospects depend, in part, upon management's ability to clearly answer the following questions:

1) Is the company a "High Growth" or “Steady Growth" business?

2) What is the company's current stage of growth?

3) What risks do capital investors face with the company?

4) How will the capital be used?

As a company's growth stage and the capital sources available are compared, a road map of traditional equity, traditional debt and non-traditional finance can be constructed over a company's growth cycle.

Table 6. Business Capitalization Road Map

	Embryonic	Seed	Startup	1st Expansion	2nd Expansion
Traditional Equity					
	•-----	Friends, Family, Founders	-----•		
		•-----	Early Stage Investors	-----•	
			•-----	Later Stage Investors	-----•
Traditional Debt					
	•-----	Individual Debt	-----•		
			•-----	Commercial Debt	-----•
Non-Trad. Finance*					
Asset-Based Finance			•-----	Purchase Order Finance	-----•
			•-----	Factors	-----•
			•-----	Asset-Based Lenders	-----•
Leasing			•-----	Manufacturer Leasing	-----•
			•-----	Third Party Leasing	-----•
Partnership Finance		•-----		Supplier/Customer Credits	-----•
			•-----	Licensing	-----•
			•-----	Joint Ventures	-----•
				•-----	Franchising -----•
Government Finance	•-----	SBIR, STTC, NIST	-----•		
		•-----		SBA Loan Guarantees	-----•
			•-----	NICE3 -----•	
			•-----	State/Local Sources	-----•

* See Section II for further discussion of non-traditional financing tools.

With this road map in mind, management should be able to select which types of capital can most likely be sourced to meet a company's financing needs at different stages in the company's development.

A summary of preferred investment factors for equity, traditional debt and non-traditional financing options are shown below, along with the typical expected rates of return, the correlating investment amounts, and the degree of accessibility for these different types of capital.

Table 7. Typically Preferred Investment Factors for Traditional Equity, Traditional Debt, and Non-Traditional Financing (Except Government Finance)

	Traditional Equity	**Traditional Debt**	**Non-Traditional**
Primary Objectives of Capital Sources	Long term capital gains	Income stream	To loan more capital
Preferred Type of Business	High Growth Potential	High Growth Potential Steady Growth Businesses	High Growth Potential Steady Growth Businesses
Preferred Business Growth Stage	Embryonic Seed Startup 1st Stage Expansion 2nd Stage Expansion	Startup 1st Stage Expansion 2nd Stage Expansion	Startup 1st Stage Expansion 2nd Stage Expansion
Preferred Expected Rates of Return	30% plus per year	8-20% per year	10-25% per year
Preferred Amounts of Capital Invested	$5,000 to $10+ million	$3,000 to $3 million	$50,000 to $5 million
Degree of Accessibility	Moderate to Difficult	Moderate (If track record is sufficient)	Easy to Moderate (If market risk is minimized)
Risk to Mitigate	Technology Risk Manufacturing Risk Management Risk	Management Risk Market Risk Market Growth Risk	Market Risk Market Growth Risk

At this point, company management should have a clearer understanding of the following:

- The most appropriate type of capital for their business, currently and
- Whether or not non-traditional financing is currently a viable option for their business.

This concludes the general overview of traditional equity, traditional debt, and non-traditional finance options. The following section will further explore the options available to those seeking non-traditional financing and will explain various tools that can be used to attain this type of capital.

Exploring popular magazines like *Inc., Fortune, Barron's,* or other trade journals will provide you with a sense of what the competition is doing and what other industries may be interested in your technology. Contacting potentially interested industry trade associations may be the best step after that. An experienced franchising consultant will be able to provide you with additional information and self-diagnostic material to help you decide if franchising will work for your company. To locate such an expert or for additional information on franchising contact the International Franchise Association on-line at (*www.franchise.org*) or at:

International Franchise Association
1350 New York Avenue, NW
Suite 900
Washington, DC 20005-4709
(202) 628-8000.

Lastly, if the company is in a position to roll-out production facilities and is considering project development finance, there are many avenues to consider. If the company has an established relationship with a law or engineering firm, they may be able to provide initial consultations. Other sources of leads include trade associations that represent a company's interests. The periodical *Recycling Today,* annually publishes a supplementary Equipment and Services Buyer's Guide, which provides listings and contact information for many recycling related associations. The EPA's Office of Solid Waste and Emergency Response also maintains a listing of recycling trade associations, although, these organizations are typically oriented towards municipal solid waste recycling.

Suggested Reading

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