farm to plate

STRENGTHENING VERMONT'S FOOD SYSTEM

Seeding the Future with Convertible Debt:

How *High Mowing Organic Seeds* used convertible debt to plan wisely for its future and keep fueling its growth

Prepared By:
Carrie Abels

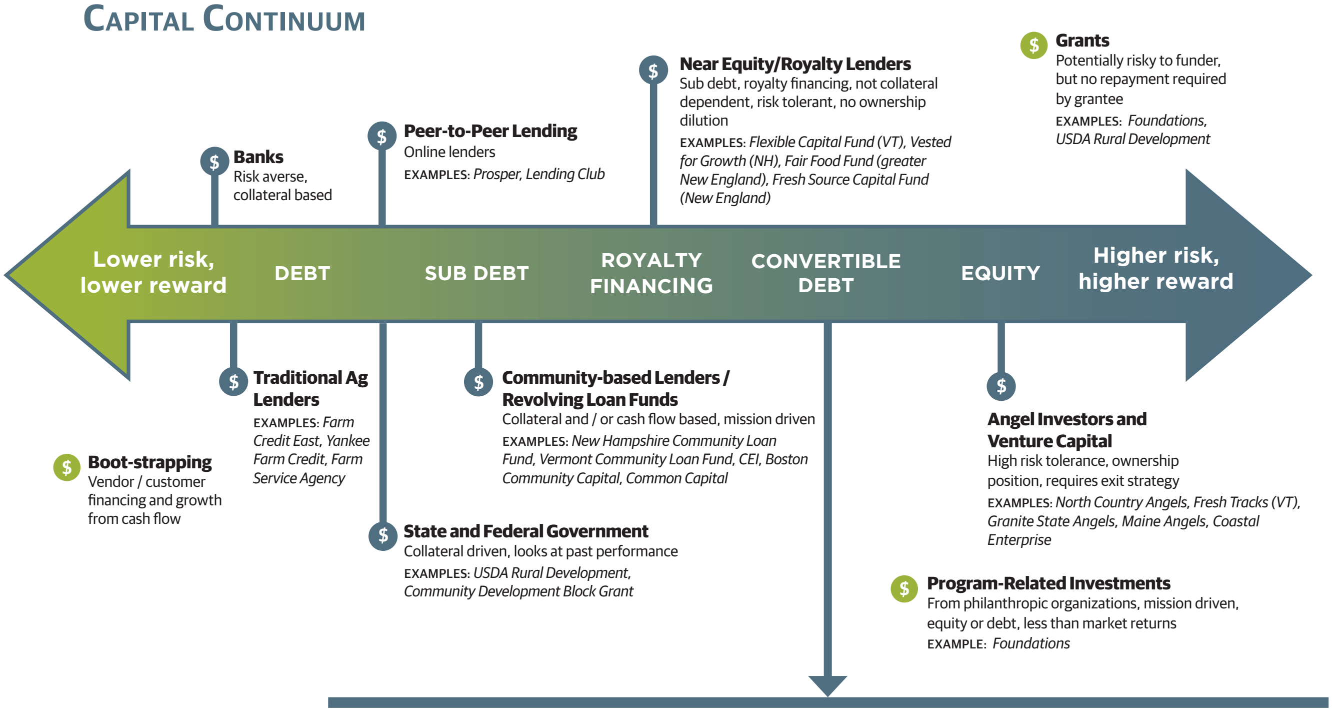
HIGH MOWING Organic Seeds

FINANCING CROSS-CUTTING TEAM

Key Messages

- A wide variety of financing options across the **capital continuum** are available to assist with the capital needs of Vermont's food system businesses. However, navigating through the multitude of financing options can be overwhelming.
- The *Financing Cross-Cutting Team* of the *Farm to Plate Network* convened a series of panels that illuminated financing options that different food system businesses have used—***High Mowing Organic Seeds*** and convertible debt, ***Bread & Butter Farm*** and a complex farmland deal, ***Liz Lovely Cookies*** and royalty financing, and ***Aqua Vitae*** and convertible debt.
- These Financing Case Studies help to fulfill *Goal 20* of the *Farm to Plate Strategic Plan* by exemplifying how different businesses have found the right match of capital.

Capital Continuum



High Mowing Organic Seeds | www.highmowingseeds.com | Wolcott, Vermont

Started in 1996 | >600 varieties of vegetable, fruit, herb, and flower seed

Note: *We recognize that there have been other capital providers involved in High Mowing's launch and growth. However, for purposes of this case study, we have listed only those funders and resources that were involved in this specific convertible debt deal.*

All Photos: High Mowing Organic Seeds

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Tom Stearns launched ***High Mowing Organic Seeds*** in 1996 without knowing much about business financing. To him, a loan was always just a loan. He took out a few of them after starting up his organic seed company and obtained a line of credit from a local bank. For a while those simple loans, along with a few small grants and strong sales, were enough to propel his company forward at a rapid rate.

Photo Credit: High Mowing Organic Seeds.

Tom Stearns juggling lettuce in High Mowing's trials field.

But in 2007, Tom felt that he and his Wolcott, Vermont staff were playing "constant catchup." Sales were catapulting year over year, going from $35,000 in 2000 to $900,000 just seven years later, but ***High Mowing*** was only barely staying ahead of the growing demand for organic seeds. The company needed cash to secure organic seed stock, build new offices and storage facilities, and hire more people.

"I felt we needed free money for 5 years, to grow out of gangly teenager stage," Tom recalls. "We needed to invest in who we were becoming a year or two down the road, not just six months down the road."

"I FELT WE NEEDED FREE MONEY FOR 5 YEARS, TO GROW OUT OF GANGLY TEENAGER STAGE," TOM RECALLS. "WE NEEDED TO INVEST IN WHO WE WERE BECOMING A YEAR OR TWO DOWN THE ROAD, NOT JUST SIX MONTHS DOWN THE ROAD."

When Tom and his business partner Meredith Martin Davis learned about "convertible debt," they sensed that this alternative model of financing would be attractive to socially conscious investors—individuals and foundations who might want to make a relatively high-risk loan to a worthwhile business, but whose jitters could be tempered by having the option to "convert" their loan into equity after a certain amount of time.

So Tom and Meredith put in motion the necessary legal steps to introduce a $700,000 convertible debt offering and ended up raising just over $1 million. Because interest in the offering was so strong, Tom was able to turn away investors who were highly focused on the option to convert (something that doesn't always happen in convertible debt deals). He naturally wanted to retain complete control over the company. The investors he ended up with had no interest in seeing ***High Mowing*** sold for their own profit. In the end, they would become close and loyal allies of the company.

High Mowing Organic Seeds spinner rack.

Photo Credit: High Mowing Organic Seeds.

Why did High Mowing and the investors choose convertible debt?

A **convertible debt** instrument gives lenders the choice to either collect their principal and accrued interest at the end of a fixed amount of time (called "terming out") or to "convert" their investment into shares of the company instead. This allows lenders to become involved with the running of the company should its finances be poor at the time of the conversion opportunity, or—if the business is sold or encounters massive growth—allows them to capitalize on a hard-to-pass up equity opportunity.

Because entrepreneurs in convertible debt deals aren't required to go through a complex valuation process in which they must make detailed forecasts, their business is evaluated as it is at the time of the deal. This makes convertible debt rather high-risk for the investor, but that risk is offset by the chance to eventually become an equity investor.

For his part, Tom wanted 5 years to go by before investors were paid back, so he could grow his business without having to chase capital all the time, and so he could minimize any risk that he'd have to sell his beloved company or take it public in order to pay back investors.

"It was like getting a million dollars and pushing 'pause' on having to do anything about it and then getting to grow the business to where it is now," Tom recalls.

With Meredith promoted to general manager in 2007, Tom had enough time to educate himself about convertible debt. He sought the guidance of Eli Moulton of ***Merritt, Merritt & Moulton***, a Burlington law firm that works with growth and start-up companies. Eli wrote up the documents that would be necessary to satisfy financial regulators.

"THE FUNKIER [THE DEAL] IS, THE MORE YOU NEED SOMETHING THAT HAS WEIGHT BEHIND IT, ALL THE LEGALESE, EVERY 'I' DOTTED, EVERY 'T' CROSSED," TOM SAYS.

How did High Mowing structure its convertible debt offering?

Convertible debt deals can be structured in many different ways (and regulations are often changing, making it even more imperative that business owners obtain legal guidance). The ***High Mowing*** offering was notable for its length of time—5 years—and had the following characteristics:

- **Flexibility for the investor:** An investor could lend money to ***High Mowing*** knowing they had no interest in converting that loan to equity, but at least they would have the option.
- **Opportunity for engagement:** Tom promised to send detailed company updates to his investors every six months so they'd be comfortable with their eventual decision on conversion.
- **Opportunity to make a difference:** While investors had to wait longer than the usual 1 or 2 years for the return on their loan, they knew they were giving ***High Mowing*** enough time to thrive and make a positive impact.

High Mowing's minimum investment was $25,000 (though the threshold was lowered for a few people). Interest would accrue for 5 years at 6%. At the end of 2012, investors would have a choice: they could receive their accrued interest and then receive regular principal repayments for 5 years, or they could receive shares in the company. (If every investor converted, they'd collectively own 26% of the company.)

"A LOT OF ENTREPRENEURS MAY BE SUCCESSFUL IN RAISING THEIR CAPITAL, BUT IF THEY DON'T REACH OUT AND PROVIDE THAT REPORTING, THEY'RE LESS LIKELY TO HAVE INVESTORS SUPPORT THEM IN THE FUTURE." —ELI MOULTON

The $1 million offering ended up attracting 14 individuals and 3 foundations. All but two of the individuals were accredited investors. Six were tapped by two socially-responsible investment firms and the rest were found by Tom through what he calls "extreme networking."

One of the investors was the ***Castanea Foundation***, a private, nonprofit Vermont foundation that had been looking to make more program-related investments, or PRI's—investments in for-profit companies whose mission is in alignment with a foundation, and which allows a foundation to re-deploy newly earned dollars towards its philanthropic ends.

Another institution that entered the deal was ***Clean Yield***, a money management firm based in Norwich, Vermont, focused on high net-worth individuals interested in making a social impact. The company wasn't as interested in the conversion option as it was in the 5-year length of the note. It felt that this amount of time would allow their investors to get to know Tom, and would allow ***High Mowing*** to scale up in a measured and healthy way.

What happened at the time of conversion?

Because Tom had no intention of selling ***High Mowing Organic Seeds*** back in 2007—a fact he stated repeatedly—and because he had pretty much hand-picked his investors, it was unlikely that they would want to convert (barring a turn for the worse in the company).

And indeed, at the end of 2012, none of the 17 investors sought stock in ***High Mowing***. The company was healthy, it was growing, it didn't need saving, and Tom still didn't want to sell it.

But only half of the money was paid back as it was originally structured to be paid pack. In 2012, ***High Mowing*** proposed three new options. Investors could: extend their loan by accepting a 10-year principal payback period; roll their interest check into their principal and re-invest for another 5 years; or donate their accrued interest to the company's education fund. Roughly half of the money was rolled into the 10-year payback period at 3%.

Attorney Eli Moulton says Tom's excellent communication with his investors gave many of them the trust to sign on for more. "A lot of entrepreneurs may be successful in raising their capital," Eli says, "but if they don't reach out and provide that reporting, they're less likely to have investors support them in the future."

A number of investors were also pleased by the increasing role of Meredith Martin Davis and the fact that Tom had been working with an advisory board to identify areas of the business that required expertise beyond Tom's own skills. "It comes down to the mission [of the company] but the people, too, and the trust that they can complete the work," says Stacy Burnstein, program manager at the ***Castanea Foundation***.

Trials field, late summer. Photo Credit: High Mowing Organic Seeds.

How things are today

It turns out that all of ***High Mowing's*** needs back in 2007 were met by the convertible debt offering. ***High Mowing*** hired new staff, bought seed and built new storage areas. The company grew 400% larger in sales and profitability over those 5 years and, by the end of its 2012-2013 fiscal year, ***High Mowing*** was reporting $4 million in sales (compared with $900,000 before the convertible debt).

"We're profitable enough to fuel our own growth now," Tom says. As of this writing (mid-2014) ***High Mowing*** didn't have any immediate creative financing needs like the convertible debt arrangement, and the company is very thankful for their relationships with several banks that they rely heavily on for an annual line of credit. But Tom knows a bunch of people he can turn to if the company requires more outside sources of growth—his investors (and potential new ones) who believe in what ***High Mowing*** is doing, want the company to remain independent and locally-owned, and don't just want to sell the company down the road.

"I WASN'T SURE THOSE KINDS OF PEOPLE WERE OUT THERE," TOM SAYS, "BUT NOW I'VE GAINED A WHOLE LOT OF CONFIDENCE THAT THEY ARE."

Resources

Merritt & Merritt & Moulton
http://merritt-merritt.com
60 Lake Street, 2nd Floor
Burlington, VT 05402

Clean Yield
http://cleanyield.com
16 Beaver Meadow Road
Norwich, VT 05055

Castanea Foundation
www.castaneafoundation.org
100 State Street, Suite 510
Montpelier, VT 05601

Definitions

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 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.

Convertible Debt: Instruments that are essentially asset-backed loans that can require the business owner to give up some future equity (ownership) in the business if the lender wishes to convert the debt to an equity position in the company.

Convertible Equity: A form of financing that gives investors the right to preferred stock once a triggering event occurs.

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).

Investment Clubs and Networks: A formal investment club is a group of people who pool their money to make investments. Usually, investment clubs are organized as partnerships and, after the members study different investments, the group decides to buy or sell based on a majority vote of the members. Club meetings may be educational and each member may actively participate in investment decisions. For the SEC definition, visit *www.sec.gov/investor/pubs/invclub.htm*. There are also informal investment networks that can organize around making connections between entrepreneurs and investors.

Peer-to-Peer Lending: The practice of lending money to unrelated individuals, or "peers," without going through a traditional financial intermediary such as a bank or other traditional financial institution. This lending takes place online on peer-to-peer lending companies' websites using various different lending platforms and credit checking tools. Two recent peer-to-peer lending portals have been approved in the State of Vermont for small business loans up to $35,000: Prosper (*www.prosper.com*) and Lending Club (*www.lendingclub.com*).

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.

Accredited Investor: Term used by the Securities and Exchange Commission (SEC) under Regulation D to refer to investors who are financially sophisticated and have a reduced need for the protection provided by certain government filings. Accredited investors include individuals, banks, insurance companies, employee benefit plans, and trusts.

*Definitions from *www.investopedia.com*, *www.businessdictionary.com*, and *www.sec.gov/answers/accred.htm*.