Investing in Private Companies — A Perspective

(i.e. Ten Ways to Lose Your Money)

We are frequently asked to look at private equity and venture capital investment opportunities on behalf of our clients and offer our advice on whether a particular investment is appropriate. More often than not, the so-called "opportunity" comes from a good friend or a trusted professional, and saying no is not the most comfortable or easiest response. The grim statistics on private investing bear out the highly speculative nature of this type of investment. Yet, the "this deal is different" syndrome and the unending quest to be part of "the next Google or Facebook," as unlikely as that may be, makes the task of vetting a private investment opportunity for a good client or friend a bit more challenging. It is also true that some people are just lucky, and a business proposition that seems to make no sense at all becomes a big winner — think Netflix. In fact, many (maybe most) very successful companies looked like very bad business propositions when they got their start.

There are all kinds of ways to evaluate a private company, and this is an effort to provide a framework that can serve as a starting point in that process. It consists of a series of questions we pose to identify potential issues (i.e. red flags) as we analyze the private placement memorandum or business plan and, based on the responses to those questions, we spend more or less time on the most important issues — Is this a good business? Is it valued properly? These latter two questions are the most critical, and answering them takes a lot of work, but if one or more of the red flags are present, it is seldom worth spending the time to resolve those issues. It is certainly not worth the effort to do real due diligence without a clear understanding of the heightened risk of the investment and good reasons to move forward notwithstanding the identified concerns. With the caution of "there are always exceptions," here are the top 10 red flags we look for:

1. The People Are the people first rate, reliable, and successful? Every company needs to be led and managed by its key people. The old adage "you can't do good deals with bad people" (attributed to legendary St. Louis investment banker Elliot Stein) is rule number one. If you don't know the key people, make sure you know someone you can rely on who does. Values, integrity, and ethics are not just important, they are essential—check the people out thoroughly. All companies experience challenges, and you need to be able to rely on the key people to make the right decisions when the need arises.

2. Expertise of the People This is what is called the Predictive Evidence Test. What is their track record in similar endeavors? What is it about the background or skill sets of the people involved in this business that makes it likely they will succeed at the task at hand? Have they done anything like this before? Have they ever failed (having experienced prior failures can be positive)? How does their prior experience and expertise match the specific needs of the proposed venture? Creating a viable new business is very difficult for experienced

people and for the inexperienced, highly unlikely.

Matching talent with the task at hand is far from an exact science, and outliers abound. The effort is all the more complex because successful companies require all kinds of talents at different stages of development. The story of Mark Zuckerberg and the founding of Facebook is a great case in point.

3. Third Party Validation Are there really knowledgeable people (other than the promoters) who think this is a good idea? The validation can come from an investor, a supplier, or potential customer. The key question is whether there is someone in the mix who is in the position to know a great deal more about the business proposition than you do and who has made a material commitment to its success, preferably by investing money or material time (opportunity cost). Be very wary of validations by peripheral parties (i.e., people who have no material stake in the outcome), such as an advisor with no skin in the game or, even worse, an intermediary who is compensated for raising capital from you.

4. Stake in the Outcome Are the financial interests of the promoters aligned with those of the investors? This is an inquiry to see to what extent, if any, the promoters are on the same side of the table as the investors. Do they have material money (relative to their worth) at risk? Do they benefit from success or failure on the same terms as the investors? Is this all they are doing? Do they have any conflicts of interests with the business or with their other business interests? How will they address them?

5. Expert Advisors Do they have recognized lawyers, accountants, board members, scientific advisors, etc., and are they being used properly? Are the offering materials thorough and competently prepared? Starting a business and raising capital requires a lot of professional help; if done improperly, the capital plan may be flawed and doom the company from the very start. Cutting corners on paying for the advice of experts is evidence of poor judgment. Properly using qualified legal, financial, and accounting talent is indispensable.

6. Quality of Existing Investors Are they credible, and are they a source of third-party validation? Money is money, but at some point, the nature of the investor base of a company becomes important. Angel investors can play a critical role in the early stages of business formation, but as a company grows, it is important to graduate to more sophisticated and reliable financial support. The biggest danger of not having the appropriate investor base is that valuation of the company can easily get out of line with reality (institutions, despite the difficulty of working with them, can provide a market test of the valuation), and it may be difficult to raise the follow-on capital necessary to enable the company to grow. The risk of substantial dilution is very significant the longer credible investors are not involved.

7. Time Constraints Is there a rush to raise the money? Raising capital takes time because rational investors need to perform the due diligence necessary to evaluate the soundness of an investment proposition. Sophisticated investors do not take people's word for it — they seek out expertise and advice from sources that are unaffiliated with the proposed venture to validate assumptions and verify factual matters. A thorough evaluation of an offering takes time.

8. Financial Information Have the proponents of the venture provided the necessary financial information (and related assumptions) by which to evaluate the financial risk of the venture? For start-ups, the information will be largely made up of projections; existing businesses need to provide historical data that is audited or otherwise easy to validate. The quality (both in terms of clarity and thoroughness) and reasonableness of the

information is a good indicator of the caliber of the proponents of the venture.

9. Valuation Is the business properly valued? This is a critical question and really can't be answered without extensive diligence and time-consuming financial analysis. However, it is remarkable how many private deals are marketed (especially to individual investors) without the information needed to determine the pre-money valuation or with valuation metrics that are unreasonable (i.e., out—of-line, on their face). This is often the case with follow-on investment opportunities involving companies that have raised several prior rounds of capital over a number of years. There is little reason to do the extensive work necessary to investigate and determine the proper valuation of an enterprise if the proposed terms are clearly off the mark. Again, this reflects poorly on the judgment of the promoters.

10. The Business Is this the kind of business that can provide returns commensurate with the risks? This is a big picture question (a sort of Peter Lynch approach): **given the risks and the illiquidity of any private company investment, why is the proposed investment superior to an investment that one can make in any number of existing public companies doing the same thing or something very similar (with a track record of success, comprehensive disclosure, audited financials, an independent board, etc.) and with market liquidity?** Is the proposed venture unique in any way? Does it have a real competitive advantage that is sustainable? At what point is the business self-funding? Another question to ask yourself, "Is this business idea really new, or is it just new to me?" A group of experienced investment professionals can easily recite lists of bad business ideas that, like clockwork, are recycled among unsophisticated investors as the "next new thing" — restaurants and entertainment concepts, health clubs, energy conversion/environmental stories, commodity manufacturing businesses, consumer product fads, businesses that would not exist without a government subsidy, new retail concepts, vacant land plays, distressed this or that, companies with "secret technology," medical or technology "breakthroughs" coming from unrecognizable sources, etc.

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If, after a thorough evaluation, the proposed business proposition seems to be a good one, we ask our client to consider the following question: "compared to what?" If, as is often the case, this is the only deal our client has looked at seriously because he or she is not in the deal business, it is highly likely that there are other, better investment opportunities that can be accessed with modest effort. We remind our client that "this deal found you, you did not find it — are you sure that you don't want to do some comparison shopping just to see what else is out there?"

It is critical that our client has realistic expectations when investing in this space. The odds of success are very low under the best of circumstances even for the professional investor and funds that specialize in private investing. They are dramatically lower for the amateur investor.

A word of caution is called for — no one likes to work with "negative people"—it isn't much fun and is contrary to our wiring as humans. We all want to believe that we have discovered the next new thing and a big (low-risk) return is around the corner, etc. We also all are prone to confirmation bias—the tendency to seek out others who will validate our ability to pick a winner. When vetting private investment opportunities, we also need to acknowledge that the evaluation of private investment opportunities is not just an inexact science; it is not science at all—it is about judgment that only comes from years of experience evaluating business ventures. Success can come from very surprising places—sometimes a business plan that doesn't work out (if well

funded) can lead to a later success (the story of Uber entrepreneur Bob Brooks, the founder of Brooks Fiber, is a great case in point). The odds of avoiding a disaster are, however, very much in your favor if you take a pass on transactions with too many red flags. But, then again, some people are just plain lucky!

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