Private Equity Investing

Valuation theory holds that a high risk investment has less value to an investor than an otherwise similar investment having lower risk. Possibly the best way that you, as a prospective investor, can reduce your risk, thus increasing value, is through a complete understanding of the investment factors. In order to understand the investment, you must research a business and its industry thoroughly. If George Carlin were an investment advisor, he might observe that the acronym for "Prospective Investor" is "PI," which, appropriately, is also the acronym for "Private Investigator."

Due Diligence and Research by Prospective Investors

As a prospective investor, you need to do your homework concerning potential investments. Think of how much time you spend picking through apples and oranges at the supermarket for a $5 purchase? How many pieces of fruit do you return to the bin before tossing one into the bag? When making a $5,000, $50,000 or $500,000 purchase of securities in an emerging private company, consider expending a proportionately larger amount of time in studying the company and its industry. Note that two minutes at the fruit stand equates to more than 300 hours for a $50,000 investment. You do not necessarily need to spend 300 hours, but this analogy demonstrates how absurd it is to rely upon inadequate investment research.

Venture Capitalists ("VCs") typically consider seriously only about 5% of the business plans that they receive. Following their example, plan to conduct an abbreviated review of at least 20 investment alternatives and, of these, expect to find only one that truly stands out as a promising investment candidate. Research that one company, its competition and its industry more thoroughly than the initial review, and only then, perhaps, make an investment. In the process, you may discover that a competitor has a much better product or other attribute, and you then invest in the competitor instead.

The respected and exceptionally successful investor, Warren Buffet, states frequently that he never invests in a business that he does not understand. You do not have to comprehend the theory behind a research project that is understood by only three PhDs in the world. However, you should be clear on the dynamics of an industry and the potential market (if any) for a product, and you must be aware if the vast majority of leading scientists do not believe that the theory can become a reality. Ask for commentary from a friend, colleague, professor or other person who is close to the industry. When Warren Buffet needs information on technology, he asks his good friend, Bill Gates. Rely on friends as one source of investment information, rather than "betting" blindfolded on their nebulous "tips."

Caveat Emptor

In certain ways, VCs perceive and analyze companies very conservatively. Unlike commercial bankers, VCs are willing to accept very high risks, hoping for considerable upside while making contingency plans for potential failures. You are the prospective buyer, so you should have the buyer's perspective. Consider that "high risk" is a euphemism for "a relatively high probability of losing most of your investment." High risk does not mean that you will earn a high return; a high risk investment is one that offers the potential for a high return, commensurate with the risk taken.

In the event that you hear whispers concerning a company's expectations, do not be surprised to see aggressive, "hockey stick" projections. Unlike public companies, most of these private companies have little to lose if they do not achieve their projections or expectations. You do have something to lose if you buy into such projections that a company fails to achieve. In your analysis, be conservative and consider the downside. It is a very realistic possibility that you could lose your entire investment. To minimize the overall impact of waning investments, a good rule-of-thumb is to allocate no more than 10% of your total assets in investments generally characterized as high risk, high volatility and negligible liquidity.

Money In – Impact of Use of Proceeds on Value

Check the "Use of Proceeds" section in the term sheet to ensure that your capital is being deployed for uses that are likely to create value, resulting in better returns on your investment. As examples of preferable uses, your invested capital might be utilized to acquire the requisite fixed assets for expanding manufacturing capacity or to facilitate further research and development on promising in-process technology. A little riskier scenario is when cash is used for a marketing campaign

designed to promote a recently proven prototype that is ready for market. Transaction costs are normal, but watch for excessive underwriting fees and commissions, finders' fees, professional advisory fees and stock or stock options to professional advisors.

This advice may sound obvious, but you should be wary. The proceeds from some equity offerings may be intended for large salaries to the founders (they already receive considerable compensation via capital appreciation on stock and stock equivalents held and granted). Consequently, after a year or so, your cash investment may be depleted, and the company may have acquired or built no additional assets. If such were the case, value would have been destroyed, and you are likely to incur a substantial loss of capital in a liquidation scenario.

In certain equity offerings, part or all of your investment will be used to buy-out existing shareholders. Your capital will not be used to expand the business. More importantly, you should be skeptical of an investment "opportunity" that seems to be so good, yet the existing shareholders, who know the company and its prospects very well, are selling not buying. Further, if the existing shareholders are the present founders and managers, they may have less of an incentive or vested interest in the success of the company.

Money Out – Exit Strategy

Part of the high return (if successful) from an investment in private companies compensates investors for the length of time without their money. VCs are comfortable being without their money for long periods of time, so long as an exit strategy does exist. Likewise, you should look for some planned exit strategy. Preferably, the targeted liquidity event will occur in less than four years. Do not expect liquidity in less than three years, otherwise you should seek a different investment medium than the private equity market. For pharmaceutical companies, with long R&D cycles and long FDA approval processes, the liquidity event may not occur for seven years or more. However, for other types of businesses, avoid investments with exit strategies requiring more than five years. Regardless, private equity is not a good reservoir for cash that is ear marked for near-term use or another investment, such as a down payment on a house.

As an example of an exit strategy, with its top engineers, a company may intend to develop a sophisticated technology during the next two years, and then sell the business and technology to a competitor that has good distribution channels but a low-quality product. As another example, the management team may plan to quadruple revenues in four years and then go public. Accordingly, you can expect to convert your investment back to cash sometime thereafter. Remember, you have allocated this portion of your portfolio to private companies with large potential, not large public companies with limited potential. Thus, you will generally want to roll your investment back into earlier stage companies.

Commentary on Risk Factors

You may frequently hear comments to the effect that the "Risk Factors" section of the term sheet is "just a bunch of boilerplate that our attorney and investment banker forced us to include, and its designed to convince everyone that they should never invest in any company." In actuality, the unadorned discussion of risk factors, along with any contingency plans, is a very important consideration for the investment analysis. Watch for companies that rely heavily upon three or fewer customers as sources for a majority of revenues. One lost customer could devastate the business. Companies having longer term contracts with customers encompass lower risk and consequently more value that otherwise similar investment alternatives, but you should also consider the possibility that contracts may not necessarily be renewed. Also, some contracts include a provision for early cancellation by either party. These characteristics are typically listed under "Risk Factors" in the term sheet and in the notes to the financial statements.

You should be concerned when an entrepreneur states that no competition exists for a product, if such is the case. Perhaps no competition exists because no market exists for the product, or because other companies have been unsuccessful in attempting to introduce the product. Also, developing a new market is extremely difficult, and, even if successful, the well-capitalized players may make a move on the market. Verbal claims such as "this investment is a no-brainer" or "there is no risk" should be a strong indication that you should avoid the investment; the entrepreneur is either unaware of potential risk factors or, worse, is attempting to gloss over or understate potential risk factors. Either way, you should be circumspect of investing in such a person, which brings us to the next topic.

Importance of a Strong Management Team

In effect, when you make an investment in emerging private companies, you are investing in management. A strong, credible, experienced management team is critical for operating and growing a successful company. Statistically, the vast majority of failures among entrepreneurial ventures occurs as a result of: (1) poor management and/or (2) managers and founders who have insufficient experience with respect to the product, business or industry in question. You should feel free to talk with senior

managers personally before committing capital to the company. In such discussions, not only do you obtain information regarding the company, you also gain insight into the managers themselves.

Commercial lenders consider management to be the most important criterion for assessing a potential borrower's credit worthiness. Similarly, VCs commonly cite that, when reviewing investment candidates, a critical consideration is the strength and depth of the management team. Not surprisingly, many VCs spend not less than a fifth of their time in recruiting managers for their portfolio companies. As an example of the importance of management, one VC invested in a company with a seemingly exciting product and a strong management team. The initial product failed, and the management team tried a succession of several unrelated products, each of which failed, until one finally succeeded. The VC had believed in the management team, even though successive plans, strategies and business models had failed.

Growth is a Significant Driver of Value

Most companies seeking financing are doing so because they are growth oriented, and most investors invest in higher risk private ventures because they seek the potential for high returns. Growth oriented companies, as emerging businesses, are not a good investment vehicle if you are interested in receiving dividends. These companies need to retain their earnings (if any) to support growth, which is the primary objective of the company and the investors (including you). Growth is a very important driver of value. Companies with a history of sustained rapid growth and those with high growth prospects can justify higher pricing than those with moderate or dubious growth expectations.

Other Drivers of Value and Market Pricing

Below is a list of factors that decrease the risk of the investment, decrease your required rate of return for the investment, and increase the market-based capitalization multiples applied to the company's financial measures. Thus, when present, these factors result in more value being attributed to the business.

- Significant brand recognition, at least regionally;
- Profitable with strong margins;
- Low earnings volatility;
- Robust and sustainable growth;
- More mature and larger;
- Capable of a near-term liquidity event;
- Diversified customer base;
- Numerous suppliers;
- New equipment / well-maintained equipment;
- Patents, copyrights, and licenses;
- Trained and assembled workforce;
- Talented / seasoned management team;
- Experienced board of directors, including outside directors; and
- Board of advisors with subject experience e.g., scientists and medical doctors for a pharmaceutical or life sciences company.

Value Indicated from Previous Rounds of Financing

Several sections of the term sheet address previous rounds of financing for a given company. You should analyze this information in an effort to ascertain the earlier valuations for the company as implied by these financings, as well as the implicit pricing mechanism utilized. Use caution when evaluating the pricing in transactions between affiliated parties, since such transactions are not necessarily representative of value. Value generally increases as a function of the growth in revenues, cash flows, earnings, book values or some other important financial measure for a company, depending on its industry and stage of development.

For companies involved in the development of technology, look for derailed R&D efforts for which value was inadvertently destroyed. "Back to the drawing board" means back to negligible value. Alternatively, if a given R&D project requires a finite amount of time and money, and the research efforts are on target, investors can expect at least $1 of value created for each $1 of their cash "burned" to advance that research project. Be wary of multiples of 1.5x to 3x the cash investment. The ratio of value created to capital investment can be higher, but prospective investors should become increasingly wary, and the company should have a compelling "story," such as the potential for a major technological break-through, a very large prospective market or other auspicious news concerning the prospects for the technology.

Contact Steven Kam, ASA, at kam@cogentvaluation.com for additional information or questions.