



# Primary Investment Considerations, OR First Principles

As basic (but essential) as it gets...



a white paper  
brought to you by  
The Knowledge Base  
at [carofin.com](http://carofin.com)



**carofin**

CONNECTING ENGAGED INVESTORS  
WITH WORTHY COMPANIES  
[WWW.CAROFIN.COM](http://WWW.CAROFIN.COM)



# Summary

Investment analysis can be highly challenging. Each Issuer of securities (the company seeking your investment) differs in significant ways from others, and it's easy to miss “the forest” for a few particularly compelling “trees.” Therefore, it is essential that you apply a consistent approach to your analysis that first identifies the fundamental rationale for an enterprise, before digging into the many other considerations which are also important when considering a potential investment.

Following the leads of Investor icons (e.g., Charles Munger, Carl Icahn), Carofin and its affiliates use a First Principles-based approach to each company we encounter. It guides us as we initially determine whether we want to represent the business as a Placement Agent (for offering private equity or debt securities), and then as we introduce private investment opportunities to our investors.

First Principles is a framework for getting to know the fundamental “Why’s” behind a given business. Once understood, an Investor is in a much better position to consider the many other important factors (the “What’s”) which can affect an investment’s performance.

We hope this helps you better evaluate investments you may be considering.



# Defining First Principles

The fundamental concepts or assumptions on which a theory, system, or method is based. “I think we have to start again and go right back to first principles.”<sup>1</sup>

While often used in scientific research, a First Principles approach to investment analysis is guided by the following questions:

- » **The Opportunity** - What primary business opportunity is the Issuer addressing?
- » **The Challenge** - What stands in the way of it (or any other company) realizing the opportunity?
- » **The Solution** - What is the Issuer’s solution(s) to the challenge(s)?

This approach may seem overly simplistic, but, all too often, an investment opportunity is presented emphasizing the sizzle over the steak. If the meat is no good, it doesn’t matter how you flavor it.

## First Principles, Its Origins and Application to Investing.

The concept of First Principles is over 2,000 years old. Aristotle is first credited with the concept, so this approach has withstood the test of time.

*“In every systematic inquiry (methodos) where there are first principles, or causes, or elements, knowledge and science result from acquiring knowledge of these; for we think we know something just in case we acquire knowledge of the primary causes, the primary first principles, all the way to the elements.”<sup>2</sup>*

He connected an idea to fundamental underlying knowledge, defining First Principles as ***“the first basis from which a thing is known.”***<sup>3</sup>

In other words, a First Principle is a basic assumption that cannot be reduced any further. Reasoning by *First Principles* removes the impurity of assumptions and conventions, allowing you to see where reasoning by analogy might lead you astray.

Financial markets consistently provide us with examples of what can happen when a *First Principle* analysis is not used. With the benefit of hindsight, we can see how the great “crashes” involved:

1. Less discerning Investors following a hot market trend into unrealistic company valuations (remember Warren Buffet’s “irrational exuberance” market call in the late 1990’s?);
2. Business realities asserting themselves when investment returns could not be produced by the underlying business activity; and
3. Grossly over-valued investments that ultimately result in major losses for the last Investors to “get in on the action.”

Of course, the opposite can occur after a market has over-corrected. More disciplined Investors, recognizing good buying opportunities, start to invest at overly depressed prices (such as public stock investment opportunities in early 2009).

#### Footnotes

1. Carofin would like to recognize Farnam Street’s *First Principles: The Building Block of True Knowledge*, for its influence on this White Paper.
2. Aristotle, *Physics* 184a10–21
3. Aristotle, *Metaphysics* 1013a14-15

# Private Investment & First Principles

Investment in private companies, because each is so unique and represents a “buy and hold” investment, is particularly well-suited to a First Principles analytical discipline. Private investments, by their nature, are usually not correlated to public market valuations and volatility. They perform for the Investors when the Issuer simply achieves its business objectives and generates greater profits.



## 1 The Opportunity

To start - What is the primary business **opportunity** being pursued? Generally it is tied to a fundamental societal need (food, clothing, shelter, security, healthcare, etc.) and should be clearly discernable. Identifying the fundamental opportunity may seem overly simplistic, but that's the nature of a First Principles-based analysis.

Sometimes, Carofin is approached by an entrepreneur with a *solution looking for a problem*. We see many cases where some entrepreneur or technologist has come up with what seems to be a great idea, but it's not clear what opportunity it addresses. An early stage company – with limited resources -- must always be laser-focused on a single business opportunity. Such a focus helps prioritize all other decisions, such as product development, employee hiring, capital expenditure, etc.

### CONSIDER, TOO, THESE ADDITIONAL ASPECTS:

- » Why does the opportunity exist?
- » How urgent is the need to address it?
- » Who does the opportunity most affect (i.e., who is the customer)?

## 2 The Challenge(s)

Every opportunity faces **challenges**, whether growing crops, providing cybersecurity solutions, or repairing commercial aircraft. Every opportunity also has unique challenges -- independent of any company addressing it.

A business must address these inherent challenges, or it will not be successful.

**FULLY UNDERSTANDING CHALLENGES FROM SEVERAL PERSPECTIVES IS IMPORTANT:**

- » What is the nature of the challenge – technological, skill-based, capital-intensive, or management-related?
- » Is the challenge broadly understood or obscure?
- » Did the challenge recently occur, or does it have a long history?
- » How are other businesses, if any, addressing the challenge?

### 3 The Solution

Assuming the challenge has been identified, the business needs to be providing a viable solution. Ideally, the solution is relatively simple (usually the simpler, the better), but it may be, by its nature, highly complex.

**A PROSPECTIVE INVESTOR SHOULD ASK THE FOLLOWING QUESTIONS:**

- » What's needed to deliver the solution (capex, technology development, regulatory approval, staff training, third-party resources)?
- » How did the company arrive at its solution?
- » Is this solution proprietary?
- » Are there “barriers to entry” that deter competition and, possibly, enable higher margin and longer-term profitability?

Over the years, we've listened to many a struggling entrepreneur complain that their customers “*don't get it,*” and, so, the business isn't making its sales projections. That's a red flag. The business needs to deliver a solution that is readily desired. The best solutions are ones customers **can't live without** (sometimes literally).

# Conclusion

A First Principals-approach to investment analysis provides Investors with a simple framework - a process for understanding the **why's** of a business - from which to base all other discoveries about the securities Issuer.

In another Carofin white paper, "[Seven Key Questions for Evaluating a Private Company](#)," we present a guideline for quickly and comprehensively understanding the fundamental **"what's"** of a company and the securities it is offering to Investors. If you missed it, you can read it here. You can also find guidelines for conducting comprehensive due diligence in Carofin's "[Due Diligence" and Investments: What do I Really Need to Know.](#)"

Carofin is committed to improving investment standards for the Alternative Investment community, and we hope that you find this information helpful. Please tell us your experiences so we can share them with others.



**As always, please reach out to schedule a call if you have questions. (828.393.5401)**



**And, if you are ready to consider investing in our alternative investments, please click here.**

Securities offered through Carolina Financial Securities, Member FINRA/SIPC. Carolina Financial Securities is affiliated with Carolina Financial Group, LLC. This site is published for residents of the United States only. Representatives may only conduct business with residents of the states and jurisdictions in which they are properly registered. Therefore, a response to a request for information may be delayed until appropriate registration is obtained or exemption from registration is determined. Not all services referenced on this site are available in every state and through every advisor listed. For additional information, please contact Craig Gilmore at 828.393.0088 x 520 and/or [cgilmore@carofin.com](mailto:cgilmore@carofin.com).

Private placements are high risk and illiquid investments. As with other investments, you can lose some or all of your investment. Nothing on this website should be interpreted to state or imply that past results are an indication of future performance nor should it be interpreted that FINRA, the SEC or any other securities regulator approves of any of these securities. Additionally, there are no warranties expressed or implied as to accuracy, completeness, or results obtained from any information provided in this website. Investing in private securities transactions bears risk, in part due to the following factors: there is no secondary market for the securities; there is credit risk; where there is collateral as security for the investment, its value may be impaired if it is sold.