Alternative Investments & Their ROI's

What should I be getting from these investments?

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Summary

In a world where stock prices and bond yields can be easily found on your phone, 24/7, you may be surprised how challenging it is to confirm whether the terms of a private placement securities offering are fair. Given that the private securities markets (over $2.4 trillion/year raised in the U.S.[1]) are now larger than the public markets, this is particularly perplexing – but it doesn't have to be.

This White Paper addresses direct investment in private placements (not fund investments) and the return on investment (ROI) investors should expect.

THE PRICING OF PRIVATE SECURITIES IS OBSCURED BY SEVERAL FACTORS:

- They're private. Private placements can't be advertised; they are discrete offerings;
- Each is unique (start-up to more established businesses, technology-based to traditional industries, highly structured securities, etc.);
- Third-party analysis common to public securities doesn't exist for private investing (credit ratings for debt, equity research for stocks)
- Pricing norms for a given class of securities are the province of narrowly-focused private funds – they don't often share this information with individual investors.
- Even professional investors in this market are somewhat "siloed," typically investing only in a certain class of security (venture capital, subordinated debt, etc.).

Footnotes

[1] *Wall Street Journal, April 2018*

Carofin and its affiliates have conducted 200+ private placements, offering the full range of private debt and equity securities, for over 20 years. We address the continuum of private offerings — from senior secured debt to early-stage venture capital — and the typical ranges of ROI's appropriate to each.

THIS WHITE PAPER PROVIDES:

- A framework for considering investment returns across the major categories of private investment, and
- Our assessment of the range of returns which should be offered to you from each.

To get a solid grasp of this topic, we'll first review ways to look at ROI and, then, provide some basics regarding private placements. Next we'll contrast public to private securities markets and, finally, give you some ranges of ROI's for the various categories of securities.

What follows is a bit dry in places, but this is where your investment dollar meets the major private placement roads ...

Ways to look at Return on Investment

First things first … let's make sure that, when we're talking about a Return on Investment (ROI, return or yield), we're saying the same thing. Applying the right math consistently is essential. It's also important to prioritize the type of return which best reflects the terms of the investment (particularly short-term vs. long-term investments).

Calculating investment returns can be simple — or challenging — depending on the type of ROI being considered. While you don't need to memorize the mathematic equation for an Internal Rate of Return (IRR), you should understand the underlying differences between an IRR and alternative methods for determining the yield on a particular investment.

While IRR is the standard against which returns are measured by investment professionals, other measures have their place, since you "can't eat" an IRR (see below). Here are the most common ways to measure investment returns, starting with the easiest and finishing with IRR.

- **Cash-on-cash Return** — As the name suggests, this is a money-in / money-back calculation with no allowance for the time the capital is committed to the investment. You simply divide the money you eventually get back (Principal plus any additional form of cash or other consideration) by the amount of money you invested (the Principal). Cash-on-cash returns are expressed as a multiple of the principal (e.g., "I got back 5.5X" or "I made 5.5 times my money").
- **Simple interest return or geometric average** — Again, it's easy to calculate. You take the total investment income (only the income) over the life of the investment, divide this figure by the principal invested and then divide this result by the total term of the investment (years or fraction of years). This is expressed as an annualized percentage rate, such as 14.2%.

  Straight line calculations (simple interest returns) are useful for estimating what an investment delivers over a short period (less than one year). They

Financial terms used herein are more fully defined in the Carofin's Glossary of Investment Terms aren't adequate for multi-year investments given "time value of money" considerations. For example: Are the returns received early on, consistently over the life of the investment (through the notes' interest payments) or at the end of your holding period (a capital gain of longer than one year)? When is the principal you invested actually returned - over time (amortization for debt investments) or as a note's bullet maturity or a stock's redemption at the end of the investment? These considerations make IRR the best standard of measurement for most longer-term investments.

- **Internal Rate of Return (IRR)** — IRR should be the form of yield you use to evaluate private investments (with a few caveats below) because IRR's account for the timing of the returns you receive, which vary significantly from one private investment to another.

  While it sounds a bit theoretical, an IRR is a...

  > *Discount rate (an annualized percentage) at which the net present value of costs of the investment equals the net present value of the benefits of the investment.*

  Put another way, it's a way to contrast what you may receive in the future versus doing nothing ("staying in cash").

HERE'S THE MATH! THE FORMULA FOR CALCULATING AN IRR IS:

$$\sum_{t=0}^{T} \frac{CF_t}{(1+IRR)^t} = 0$$

Where:

T = Holding Period

t = Each period

CFt = Cash Flow for each period

IRR = Internal Rate of Return

Fortunately, we have spreadsheets and calculators to run this calculation. Calculating an IRR long-hand is an iterative process where multiple calculation cycles are required to get you ever closer to the IRR, but probably not to an exact figure. It's a question of the accuracy required — three significant digits usually suffice for most investments.

Importantly … you should know (most people don't) that this calculation assumes that the "reinvestment rate" for returns received during the investment period also equals the IRR. However, for a higher yielding investment (say, greater than 10%), this probably is unlikely, so the IRR calculation isn't perfect. But it's still arguably the best ROI measure there is. If you really want to become an expert, read the investment classic, "Inside the Yield Book" by Liebowitz, Homer, Kogelman and Bova.

Another very important note … IRR's can be deceptive, since an IRR much better reflects risk/return for longer investment periods than for very short ones. For example:

- A 2 percent return, achieved through a cash payment over a 30-day investment, is a 24% IRR (again, IRR's are reported on an annualized basis) — but it's still only a 2% cash-on-cash return.
- You took 100% of the risk in making the investment but only made a 2% cash-on-cash return!
- Contrast that to a one-year investment with the same monthly returns (12 in total) where you took the same 100% risk upfront but actually received a 24% cash-on-cash return.

Hereafter, we'll use IRR when contrasting the yields on various investments, but always also consider the term of the investment to assure that IRR is the best ROI measure to use.

What is a Private Security?

Just to be sure we're clear when talking about a private placement or private offering ...

Private placements are offerings of securities that are exempt from the public registration requirements of the Securities and Exchange Commission (SEC). The Federal law authorizing private placements is Section 4(a)(2) of the Securities Act of 1933. For more information, please see "*What is a Private Placement*."

Private investments are traditionally offered in a non-public manner (i.e., without public advertising) and sold only to larger Investors such as private investment funds and insurance companies. With the JOBS Act of 2012, a growing number of individual investors are beginning to participate in the private market (hence this white paper).

Virtually any type of security can be offered through a private placement, including debt (such as Promissory Notes) or equity interests (e.g., common stock, preferred stock or membership interests in a Limited Liability Company). Investment in privately placed securities offers Investors a significantly expanded universe of investment alternatives.

Contrasting the Public Markets to Private Investment

Public securities markets have evolved in ways facilitating both the initial issuance of publicly registered securities and their subsequent "secondary trading" while they are outstanding. The most well-known exchanges for public stocks include the New York Stock Exchange and NASDAQ for U.S. equities and the institutional "bond markets" for government and corporate debt in its many forms (e.g., bills, notes and bonds).

Public securities are traded on a secondary basis after they have been issued; private investments are not. In order to facilitate an active secondary market, some infrastructure is essential:

- **Financial Accounting Standards** — Financial figures must be used in an accurate and consistent manner by issuers for investors to then conduct their analysis. Audited financials (following a GAAP standard in the U.S.) are required for publicly registered securities — audits are not required for private placements. Though some private issuers produce audited, or, at least, "reviewed" financial statements, many do not.
- **A highly regulated system** — Everyone must play by some rules. Issuance, trading and ongoing disclosures to investors are tightly controlled and well defined for public securities — it is much less so for private placements (though they are still subject to U.S federal and state regulation and oversight with respect to fraud).
- **Market makers** — Financial institutions (broker-dealers) buy and sell public securities, thereby creating a secondary market for the security after its initial issuance. Market makers are critical to public markets but generally do not exist for private placements.

THIRD-PARTY ANALYSIS AND VALUATION

For public stocks, this includes equity research from securities houses with buy/sell/hold recommendations. For public debt, rating agencies (e.g., Moody's, S&P, Fitch) publish "Investment Grade" or "Non-Investment Grade" ("junk or high yield") designations. While fundamental to the public markets, these forms of analysis are rare for private securities. With so many safeguards supporting public security investment, why would an investor consider private placements? There are quite a few reasons:

- **Higher returns** — Because they have much less liquidity, privately securities usually offer higher returns to investors than their publicly registered equivalents.
- **Less competition among investors** — With many discrete and smaller private placements, there are fewer investors at the table for most offerings. As a result, private investors are in a much stronger position to dictate new-issue pricing (i.e. the interest rate for notes, valuation for equity).
- **Less public market correlation** — Returns achieved from private placements are relatively "inelastic" relative to public market volatility (i.e., they don't move in lock-step with each other). Private new-issue pricing is negotiated between investors and issuers in a manner largely removed from prevailing interest rates or equity market valuations.
- **Absolute returns** — Private investments are made with an expectation that a specific return (an "absolute return") will be achieved, regardless of future public market conditions. Private security performance is directly tied to the fundamental financial performance of the issuer and to the structure of the security it issues — yields aren't tied to public market indices.
- **Better matching of security terms to investor needs** —Some investors need current income; some prioritize capital gains. The variety of issuance terms found in private placements offers investors a chance to better match what they need from their investments, including optimizing the tax treatment of the returns.
- **Potentially greater financial disclosure** — Though historical financial statements may or may not be audited, the issuer is able to disclose its financial projections and a lot of other detailed information, thus providing investors a deeper view of its expected performance. In general, investor disclosures for private offerings should be much more extensive than what a public issuer is allowed to reveal under S.E.C. regulations.

Private Investments are Often Highly Structured

Many privately placed securities are highly structured, meaning they contain numerous investment terms which can affect the performance of the investment in unexpected ways relative to common public security structures. All such terms are specified within the appropriate documentation for each security at the time of issuance.

Most of the time these terms advantage investors, but careful evaluation is needed to fully understand the risks and projected ROI's. For example:

- Equity dividends typically accrue when not paid currently, but they may accrue on a compounding basis or with no compounding. Compounding makes a significant difference to the realized cash-on-cash return over longer periods (like 5 years or more for a venture investment!).
- Debt investments may pay currently or accrue for a period, but does the accrued interest compound?
- How is principal repaid for a debt security — through mortgage-style amortization, after a period of interest-only payments or only at maturity?
- Do detachable equity warrants come as part of an equity or debt investment? Can they be put to the issuer at some date? What is the exercise price of any warrants?

The complexity and varied nature of private security structures further points to IRR's, in most cases, as the best way to compare one investment alternative to another.

Private Investments Categories & Typical Returns

Like public securities, private placements generally fall into two broad categories: equity and debt. We break each of these into their most commonly encountered forms: venture capital and "Private Equity" for private equity (yes...it's used interchangeably) and senior debt and subordinated debt for private debt.

VENTURE CAPITAL ("VC" – EQUITY INVESTMENTS)

- **Security Description** – An equity investment in a private company that **isn't consistently generating positive operating cashflow**.

For a venture-stage company to survive, it must either:

1. Build a business that generates operating cash flow, or
2. Raise more capital in the future to fund further losses (representing another form of liquidity risk for earlier investors).

Though companies from many industries issue VC, information technology and life sciences are the most frequently represented. However, any company that isn't consistently generating positive cash flow should be considered venture for risk/return evaluation purposes.

- **Valuation Considerations** – This a world where capital raising by smaller companies is often very difficult, and investors more often dictate company valuations.

  A good rule of thumb for early stage VC (*see the Carofin White Paper* – "*Nine Leaps of Faith - 9 Key Questions for Evaluating Venture Stage Investments*") is to expect at least: **60%+ IRR** = 10x return on investment in 5 years (a "10 bagger").

  Companies that are later-stage ventures (later-stage VC) still require a relatively high projected ROI because they are still very risky. We recommend that the lowest expected return you should accept is: **35%+ IRR** =

4.5x return over 5 years.

Because VC investment is so risky, you must assume that many of your venture investments will fail. By requiring a very high projected return for each VC investment you make, you hope to still have a compelling overall return when your total portfolio is evaluated relative to other investment asset classes. A 35% IRR is a common target for venture capital fund portfolios.

PRIVATE EQUITY (“PE” – EQUITY INVESTMENTS)

- **Security Description** – This is a bit confusing – while the term can refer to any equity investment that is made privately, Private Equity Funds (“PE Firms”) invest only in companies with **positive EBITDA** (earnings before interest, taxes, depreciation and amortization). This is the world of leveraged buyouts, recapitalizations, acquisitions, etc.
- **Valuation Considerations** – Illiquidity alone suggests that expectations are still relatively high, but, since so much capital is currently available for this type of investment by PE Firms, private equity investors face a more competitive environment than do VC Firms, particularly for larger transactions.

Here’s our take on the PE market (as of September 2019):

Issuer EBITDA	IRR Expectation	Pricing Rationale
< $2,000,000	Around 35%	Much like later-stage VC. An inefficient market with sporadic demand
$2,000,000 - $10,000,000	25%+	Many “middle-market” PE Firms are active in this market, so it has more competitive pricing
$10,000,000+	20%+	Highly competitive among PE Firms

So, even in the PE world, there can be competition among investors for a given offering, but there are still floors in terms of the absolute returns required by PE Firms.

SENIOR DEBT (LOANS & NOTES -- DEBT INVESTMENTS)

- **Security Description** – Senior debt is the most senior form of security a company can issue. Investors in this class of security are first in line to be repaid by the issuer. Repayment comes either from the issuer's operating cash flow or from funds raised through the liquidation of Issuer's assets in case the business fails.
  - These loans and notes are often collateralized by assets of the issuer (making it senior secured notes), but sometimes not for companies with stronger operating histories (senior unsecured notes).
  - Companies which privately issue senior debt **often can't obtain less expensive bank loans.** Nevertheless, if they have adequate cash flow to service a private loan, borrowing represents a lower cost of capital than issuing equity.
- **Interest Rate Considerations** – The size and credit strength of the issuer will dramatically affect the interest rate it can command because so much capital has been assembled by "non-banks" (private debt funds of different descriptions). Like private equity, the bigger the enterprise, the lower the return the issuer typically needs to offer investors.

As of September 2019, we view private senior debt market as follows:

Issuer EBITDA	IRR Expectation	Pricing Rationale
< $2,000,000	9% to 16%	Greatly affected by asset quality (for use as collateral), nature of revenue/earnings, and financial covenant strength
$2,000,000 to $5,000,000	8% to 12%+	Depends on asset quality, nature of revenue/earnings and financial covenant strength
$5,000,000+	7% to 10%	Highly competitive among PE Firms

IMPORTANTLY - While lenders to smaller companies can often demand interest rates above 16%, Carofin believes there is a limit to the amount of "current pay" interest a smart investor should expect an issuer to pay. With usurious interest rates, an issuer default becomes much more probable. If more yield is justified for the risk at hand, equity warrants, or a revenue share (for certain fast-growing companies), is a more appropriate way to achieve it.

SUBORDINATED DEBT ("SUB-DEBT" OR "MEZZANINE FINANCING" – DEBT INVESTMENTS)

- **Security Description** – Cash-flow lending that is typically unsecured and **junior to senior debt in liquidation** preference. In other words, if the issuer's wheels come off and funds are raised through a sale of the issuer's assets, investors in sub debt are second in line, or "subordinated," to senior debt for repayment purposes. However, until they are fully repaid, they are still ahead of equity investors in the company.
- **Interest Rate Considerations** – Like senior debt, the size and credit strength of the Issuer will dramatically affect the returns investors can expect.

The total return (again, the IRR) for this type of lending is usually achieved through a combination of an interest rate, which the Issuer pays currently, and value derived from a detachable equity warrant. The interest rate portion of the return usually falls in the 10% to 14% range. The equity warrants, with their put option to the issuer, is sized, priced and timed to add 5% +/- in annualized return to the lender's IRR.

We currently see sub debt pricing as follows:

Issuer EBITDA	IRR Expectation	Pricing Rationale
< $2,000,000	16% to 25%	Historically achieved in all mezzanine lending -- now only for smaller companies
$2,000,000 - $5,000,000	12% to 18%+	An abundance of lender supply and a low interest rate environment has pushed down rates
$5,000,000+	10% to 15%	Highly competitive among mezzanine lenders

Conclusion

The stage of the issuer, the type of security it issues, and investor competition for a given investment opportunity will ultimately drive what's available to investors from a private placement. Like any other asset purchase (a house, car, etc.), a security's valuation or interest rate will be driven by what investors are willing to accept.

For larger Issuers, institutional capital abounds, and expected ROI are, ironically perhaps, much lower than for smaller Issuers. It is estimated that over $1 trillion of "dry powder" is now sitting in private investment funds, and the economies of managing a larger fund suggest that they must invest in relatively large transactions – hence the competition among investors.

Limited size offerings (less than $5,000,000) by smaller companies represent a much less efficient market. Because they have fewer, easily sourced financing options, higher projected returns should be required by investors in these smaller deals.

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.

Financial terms used herein are more fully defined in the Carofin's Glossary of Investment Terms

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