



Seven Key Questions

for Evaluating a Private Company



a white paper
brought to you by
The Knowledge Base
at carofin.com



Summary

The Private Investment Market, including all forms of private Alternative Investment, is now enormous. According to the WSJ¹, in 2017 the \$2.4 trillion-dollar volume of securities issuance in the private capital markets exceeded the \$2.1 trillion of issuance in public securities. Put another way, over 50% of all investment in newly issued securities now goes into a highly varied range of privately held companies and investment themes ... from an angel investment in a nascent business concept to a private equity acquisition of a generations-old family company. As a result, private investors are faced with a daunting array of factors when considering any alternative investment.

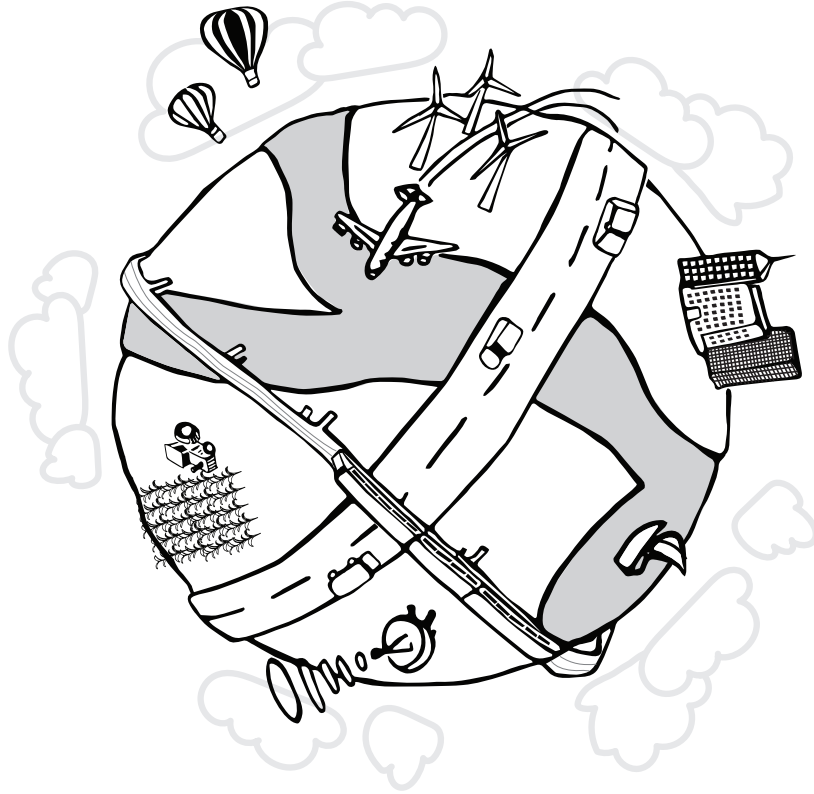
So, how can you efficiently, yet comprehensively, evaluate a given opportunity to determine whether it's the right investment for you?

We follow a framework which we call the "Seven Key Questions for Evaluating a Private Company."

- ① What does the Issuer do?
- ② "Who" is the Company?
- ③ In What Stage of Business is the Issuer, and is the Security Being Offered Appropriate?
- ④ Who are the Issuer's Customers?
- ⑤ How is the Product or Service Produced?
- ⑥ How Does the Company Make Money?
- ⑦ How Will Investors be Paid Back?

¹ Eaglesham, Jean and Jones, Coulter. *The Fuel Powering Corporate America: \$2.4 Trillion in Private Fundraising* The Wall Street Journal, April 3, 2018

After evaluating thousands of unique private companies and alternative investments over the past 20 years, Carolina Financial Securities, Carofin's parent company, has created this list of fundamental investment considerations for our use, and we are happy to make it available to you.



We feel these basic questions represent a “to the point” method for quickly sizing up the relative strengths and weaknesses of a given company (the “Issuer”) and the related investment opportunity.

Giving equal consideration to each of these subjects helps investors conduct a more comprehensive analysis. Too often, in our experience, one compelling element of an otherwise incomplete business plan, e.g., a large market opportunity, can excessively influence overall enthusiasm for an investment. Having reflected on each of these considerations, we’ve often found, helps to determine whether to remain interested in the investment and proceed with extensive due diligence (see Due Diligence”) or to “pass.”



The “Seven Questions”...

1 What does the Issuer do?

This may seem like a fairly obvious first question, but we’ve had many encounters (and wasted hundreds of hours) with potential Issuers where they simply could not succinctly communicate what they were doing as a business. Companies that don’t have a clear message can’t develop their businesses efficiently ... or consistently build investor value in the process.

RELATED QUESTIONS INCLUDE...

- » What is the nature of this product or service that is so compelling?
- » Is there a “disruptive technology” involved that is going to upend an existing and entrenched industry?
- » Has the entrepreneur found a cheaper way to deliver goods or services to a defined target market?
- » What are the differentiators making this a better mousetrap, and are they blatantly obvious to its target customer?
- » What are the barriers to entry to competition?

2 “Who” is the Company?

In other words, what is it about the Issuer’s senior management that makes them logical candidates to pursue the company’s primary business opportunity? Also ... are they on the same page with outside investors (you) wherein, if one side wins, all win.



Take it as a given that the success of the Issuer (and your potential for a successful investment) is more dependent upon the management skills, industry knowledge, work ethic and moral values of the company’s leaders than any other factor. If management isn’t right for the job, no magnitude of business opportunity, technological advantage or form of security is going to be enough to make up for management’s shortcomings ... you’ll likely lose money on that investment.

RELATED QUESTIONS INCLUDE...

- » Does the management team have prior business experience and success (preferably within a related industry), or is this their first rodeo?
- » Have they successfully operated a smaller business before, or have their careers been spent with larger corporations? Experiences and prior successes at larger companies, while relevant, are very different than within more resource-constrained, smaller enterprises that lack brand recognition or “big-brother” support.
- » Is the Issuer a “cash culture” (i.e., salary and cash bonus to management) versus an “equity culture,” where increasing equity value benefits both management and outside equity investors (again, you)?

- » What are the personal motivations behind the management team that make them the right fit?
- » Is their ownership of the company sufficient to keep them engaged despite the likely business challenges they'll face?
- » Are salaries, bonuses and stock options appropriate to the stage of the company, and are all the "Key" personnel properly motivated by their compensation package?
- » If it's a family business, how have existing or prospective family members been prepared to take over the reins, and what motivates them going forward?

3 In What Stage of Business is the Issuer, and is the Security Being Offered Appropriate?

A wise businessman once said, *"if you don't have a customer, you don't have a company."* As a potential investor, it's crucial for you to determine quickly whether the Issuer is trying to raise capital in a form that is appropriate to the stage of its business.

One investor's start-up venture investment is sometimes viewed by a founder as a pre-IPO opportunity. And many Issuers would rather issue debt securities to avoid diluting existing equity investors, reducing their stake in the company, even though the company is just not ready to take on debt obligations. A few basic financial "metrics" can quickly help you identify the stage of a given Issuer:

- » Is the company profitable? (If yes, maybe debt is appropriate.)
- » What is the Issuer's level of operating cash flow? If sufficiently positive, debt may be appropriate; if there isn't positive cash flow, this is probably a venture capital-stage equity investment.
- » Is the Issuer at least generating revenue? If not, it's certainly a venture investment.
- » Can the Issuer offer its assets as collateral for a debt investment?

XYZ Company, LLC Income Statement

For the Six Months Ended Dec. 31, 2017

“REVENUES” →

“EXPENSES” →

“GAINS OR LOSSES” →

Sales	1,000,000
Cost of goods sold	<u>- 750,000</u>
Gross Profit	250,000
Operating expenses	
Selling expenses	
Advertising expense	20,000
Commissions expense	<u>+ 50,000</u>
Administrative Expense	
Office supplies expense	35,000
Office equipment expense	<u>+ 25,000</u>
Total operating expense	130,000
Operating income	120,000
Non-operating or other	
Interest revenues	50,000
Gain on sale of investments	30,000
Interest expense	(5,000)
Loss from lawsuit	<u>+ 15,000</u>
Total non-operating	60,000
NET INCOME	\$180,000

INCOME STATEMENT: One important thing to remember about an income statement is that it represents a period of time (as does the cash flow statement). This contrasts with the balance sheet, which represents a single moment in time. Income statements should help investors and creditors determine the past financial performance of the enterprise, predict future performance, and assess the capability of generating future cash flows.

XYZ Company, LLC Statement of Cash Flows

For the Six Months Ended Dec. 31, 2017

OPERATIONS RELATED →

Cash Provided by Operating Activities

Net Income	180,000
Adjustments to reconcile Net Income to net cash provided by operations:	
Depreciation and Amortization	50,000
Decrease (Increase) in Current Assets	(30,000)
Increase (Decrease) in Current Liabilities	+ 25,000
Net Cash Provided by Operating Activities	225,000

INVESTMENT RELATED →

Cash Provided by Investing Activities

Capital Expenditures	(100,000)
Sale of Investments	+ 80,000
Net Cash Provided by Investing Activities	(20,000)

FINANCING RELATED →

Cash Provided by Financing Activities

Equity Issuance	10,000
Debt Issuance (Repayment), net	+ 90,000
Net Cash Provided by Financing Activities	100,000

NET CHANGE →

Net Increase (Decrease) in Cash	305,000
Beginning Cash Balance	250,000

ENDING CASH BALANCE	\$555,000
----------------------------	------------------

STATEMENT OF CASH FLOWS: A statement of cash flows is a financial statement that shows how changes in balance sheet accounts and income affect cash and cash equivalents, and it breaks the analysis down to operating, investing and financing activities. Simply put, the cash flow statement is concerned with the flow of cash in and out of the business. The statement captures both the current operating results and the accompanying changes in the balance sheet. As an analytical tool, the statement of cash flows is useful in determining the short-term viability of a company, particularly its ability to pay bills.

These financial metrics can affect the Issuer's valuation (for an equity investment). If a company is raising debt capital, they can indicate both whether debt is appropriate (you need cash flow to service debt payments) and what are appropriate interest rates and maturity.

DEBT INVESTMENTS: Issuers should be able to demonstrate historically sufficient operating cash flow before they issue a debt security or loan investment. Many investors seek current income from their debt investment. To attempt to avoid going through a legal process to get repaid, understanding the Issuer's credit profile is fundamental to the investment decision and eventual structure of the note or loan (i.e., interest rate, maturity, amortization, level of collateral, requirement for personal guarantees, etc.). As an aside, convertible debt (i.e., debt convertible into equity) may be appropriate in "bridging" between venture equity investments, so long as the convertible note investor expects to be converted eventually into equity.

EQUITY INVESTMENTS: Private (and, arguably, many public) equity valuations are highly subjective, but gauging the expected rate of equity valuation growth is a good place to spend time. Is this a high-growth, venture opportunity or a steady growth traditional business? Is there a visible path for realizing a future return of investment through any of the following events?

- » a private sale of the Issuer;
- » an Issuer recapitalization with other private investors; or
- » payment through Issuer distributions of profits.

IMPORTANTLY - Reviewing the Issuer's balance sheet will help to determine whether other investors have rights (Preferences) which are ahead of, or have preference to, the debt or equity investment that is being offered to you. If so, these investors are in a better position than you are to recover their invested capital if the company fails.

4 Who are the Issuer's Customers?

Customers, or a lack thereof. It's why businesses thrive or eventually fold. Every business plan *projects* the hockey stick revenue line, but can the company truly acquire and retain real, paying customers? We break down our thinking about customers in terms of *macro* and *micro* issues.



MACRO CONSIDERATIONS

- » What is a reasonable estimate of the aggregate market size for the company's product or service? Sure, there may be 7 billion people in the world with close to 14B legs, but how many of those individuals will stop what they're doing and switch to this company's brilliant new brand of pants? Realistically, it's usually a very small fraction of a targeted market that will ultimately adopt a new product or service.
- » What motivates customers within the target market to "pull the trigger" and make a purchase decision? Is a purchase motivated by "fear" (something bad will happen if not purchased) or "greed" (I'll be better off with this purchase)? An informed investor understands which, if either, is applicable to the Issuer's product or service. A fear sale, typically, is more urgent (which is good for the Issuer). Greed, however compelling, can be postponed more easily. Both are incredibly powerful catalysts for acquiring customers. However, if the company doesn't keenly understand its customers' motivations for purchasing a product or service and allocate marketing resources appropriately, these potential customers may remain on the sidelines indefinitely...



MICRO CONSIDERATIONS

- » What does the company's target list of near-term customers look like, and how aggressively is the Issuer managing this list?
- » Can you determine what these potential customers think about the company to gauge how hot these leads are?
- » What is the customer's process for purchasing the company's service or product (a single decision maker, a committee, internal capital allocation, seasonality, etc.)?
- » Is this a one-time purchase, or do customers come back repeatedly for the same product or service, e.g., a razor/razor blade model?
- » What are the sales or marketing channels for reaching potential or existing customers? Are there distributors, or is this a direct-to-consumer business?

5 How is the Product or Service Produced?

It's likely you'll never understand the process of creating the product or service to the same depth as the entrepreneur and other managers (that's why you are investing in them!). However, it is critical to have a fundamental grasp to evaluate an investment.

Considerations vary widely for service businesses versus product manufacturers and within each of these two broad categories, but, generally, a common sense, "bottom up" approach will serve you well. Asking "how, why, what and who" at each stage the "deliverable" is created can help investors get more than just the big picture. Following a "Due Diligence Checklist" is highly recommended (feel free to use Carofin's Due Diligence Checklist).

RELATED QUESTIONS INCLUDE...

- » If this is an earlier-stage business, execution at the pre-production stage is going to affect heavily the success or failure of the company.
- » Is capital being used to hire management, or is the team in place?
- » Can intellectual property (“IP”) be created and secured? Has another company gotten there already? IP can be a really great moat (barrier to entry for a competitor) and is almost always needed!
- » Do government regulations keep out most competition, or will these same regulations delay business and bleed the new company dry?
- » Is this a real estate venture that involves site selection (a “Green Field” project), or is this a new factory which will include extensive capital expenditure (CAPEX) up front? New construction involves a building timeline. Those of us who’ve built a new home can understand how construction timelines tend to slip ...
- » What do the production processes look like?
- » What are the “inputs,” their costs and sourcing considerations?
- » Is the production chain vulnerable to the operations of one or more third parties?
- » How strong is the relationship between critical vendors and suppliers?
- » What can a disrupt delivery of the “deliverable?”

6 How Does the Company Make Money?

As noted in Question #1 above, this may seem like an obvious issue, but, for some reason, investment “pitches” sometimes don’t review the inherent profitability of the business. Any entrepreneur and/or management team must understand and be guided by the “margins” of its business, and you should, too, before making an investment.

If Issuers can't fluently explain their financials in detail, starting with assumptions through to the "top and bottom lines," for both historical and projected, it's a "red flag"...

A good, relatively simple starting point is to review the Issuer's Gross Margin. For some businesses like grocery stores (retailing), it can be as low as 2%, but for others, like luxury goods, it can be over 90%.

$$\text{Gross Margin \%} = \left[\frac{(\text{Revenue} - \text{Cost of Goods Sold})}{\text{Revenue}} \right]$$

Identifying the Gross Margin of the Issuer will lead you to a deeper level of understanding, including:

- » How big does the business need to be to be profitable?
- » How much margin of error is there within the business plan to enable the company to reach cash flow sustainability (i.e., not need more investment to survive)?
- » How easily can it pay dividends to equity investors?
- » Can it borrow and repay debt?
- » How much internally generated cash is available for future CAPEX?
- » How much internally generated cash is available for marketing expenses?

The important points are:

- » operating margins and profitability expectations are important for any form of investment; and
- » if the Issuer isn't willing or able to review the financials, you should walk away.

7

How Will Investors be Paid Back?

Realizing a return of and return on your invested capital is, obviously, why you're making any investment. So, the Issuer should be able to provide a clear picture of how that's expected to happen, depending on whether it's a debt or equity investment.

DEBT INVESTMENTS: In the event of a loan or a Note, there will be a fixed schedule established for the payment of interest and a return of principal. The Note's Principal (your investment amount) will have a stated Maturity Date with principal being paid either over time (Amortization) or upon the Maturity Date (a Bullet Maturity). With such Current Income investments, investors should have a very clear understanding, from the outset, of the sources for repayment available to meet all the Note's interest and principal repayment obligations.

EQUITY INVESTMENTS: Equity investments, on the other hand, generally don't have fixed repayment dates, nor do they necessarily provide investors with a current return. Investment gains are derived from "buy low/sell higher" process which is, typically, very difficult to predict with accuracy.

When purchasing equity, investors should expect to be repaid at the time of a "liquidity event," that could be a sale of a company to a third party like a strategic buyer or a financial buyer, like a private equity fund. In some cases, investor capital is returned through projected cash flow distributions over time by the Issuer to its equity investors. In some, increasingly rare, cases, investors can achieve repayment of their initial investment through an Initial Public Offering, or "IPO," in which their private equity becomes registered as public equity and is free to trade on an exchange.

It's critical to remember that, unlike public investments, there is no secondary market where the investment can be sold efficiently to a third party. Investors should expect to "buy and hold" a private investment for the duration of its stated term with the potential underlying risk of losing their entire investment in the event of a loan default or company bankruptcy.

Conclusion

Alternative investment is, perhaps, the rawest form of capitalism, where an investor's funds directly contribute to the growth of a specific enterprise with the greatest impact.

For investors who take the time to understand the risks and rewards of Alternative Investments, they can benefit by both diversifying their portfolios while directly supporting free enterprise.

The above does not represent a comprehensive list. However, this framework has proven highly useful within Carofin for many years. We hope that you find it useful, and we welcome any comments or suggestions you may have for improving it.



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 Carofin, LLC, Member FINRA/SIPC. Carofin and Carolina Financial Securities are affiliated Broker-Dealers and subsidiaries of Carolina Financial Group, LLC. This material 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 in this material are available in every state and through every representative listed. For additional information, please contact Craig Gilmore at 828.393.0088 x 520 and/or cgilmore@carofin.com.

Private placements are high risk and illiquid investments. As with other investments, you can lose some or all your investment. Nothing in this material 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 material. 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.