Five Elements

of Private Investing

By Bruce Roberts

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

carofin
MEANINGFUL INVESTMENTS
VITAL CAPITAL

Summary

Private investing can be rewarding...but it's always challenging. There are so many offerings to choose from, but each one is very different from the other. Therefore, investors need to apply an analytical approach to each private investment that is consistent and effective, while also efficient. You can't digest all the various details of a given opportunity at once, but you can organize your review by focusing on the key factors which determine whether a given investment is right for you – or otherwise merits further analysis.

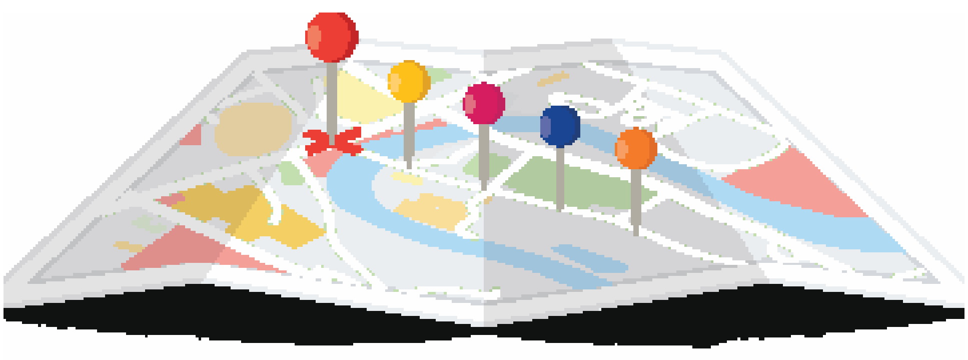
This material presents a "first pass" framework with which to quickly obtain a fundamental understanding of a private security offering. It does this by prioritizing five areas of influence on the investment's structure and eventual outcome – what we are calling the "Five Elements" (the "Elements").

The Elements, once understood, then establish a platform for more in-depth research – a full "due diligence" investigation. Investment analysis involves a journey where a relatively obscure, under-weighted detail can ultimately derail the investment's performance. But getting too granular too quickly in the evaluation process can also lead to a missing of the "forest for the trees." Elements is about making sure an investor first achieves an adequate understanding of the forest.

The order followed during the investor's analysis is also important. With Elements, an understanding of the private offering builds, step-by-step, as each Element is addressed. Since each of the Five Elements

interrelates, reviewing these topics in order enables the investor to gain an appreciation for how each pertains to the totality of the investment as an understanding of the investment unfolds.
The analysis should, therefore, follow this simple sequence:

1. Purpose – Why is this capital being raised?
2. Issuer – Who is issuing the security?
3. Security – What type of investment is being offered?
4. Repayment – What determines the success of the investment?
5. Risks – What can go wrong?



1 Purpose

Understanding a financing's purpose – **the "why" of a securities offering** – provides the underlying context for each of the other Elements while also helping to reconcile whether what's being presented to the investor makes sense.

An early understanding of the Purpose of the underlying financing often enables investors to immediately determine whether they wish to keep exploring the investment opportunity. For example, does the investor want to be associated with the underlying business of the Issuer such as cannabis or alcohol production?

Identifying what the cash proceeds from the offering are to be used for also paints a clear picture of the offering's Purpose. Is it for short-term working capital needs or for longer-term business development? Are the funds supporting organic growth or to make an acquisition? Will the proceeds build the business or be used to make distributions to existing investors?

RELATED QUESTIONS

- How will the offering proceeds (the cash raised) be used?
- What will be accomplished with this capital?
- How does this financing and related activities further the Issuer's mission?
- Why raise the capital now?
- What kind of security structure does the Purpose suggest is most appropriate (e.g., debt or equity, long-term or short-term investment)?

2 Issuer

The party carrying the financial obligations of the security is called the Issuer. It's vitally important to assess the basic nature of the Issuer, its owners and senior management since, collectively, they will have the greatest impact on the security's performance. If you don't understand who the Issuer is, you're not making an investment. You're gambling...

RELATED QUESTIONS

- **Senior Management** – Who is leading the company and what are their qualifications and limitations?
- **Ownership** – Who are the existing shareholders, how is ownership held, is it concentrated and what are their motivations?

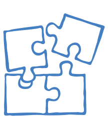
- **Stage of Business** – Venture (pre-operating cash flow) or more established (positive EBITDA, profitable). Without positive cash flow, it's impossible to service debt without selling assets or raising new capital. The stage of the business should be reflected in the investors' potential return on investment (ROI).
- **Industry** – Each industry necessitates vastly different operational considerations, capitalization and investment risks.
- **Form of Incorporation** – Is the issuer a taxable entity (C corporation) or a pass-through for tax purposes (such as a Limited Liability Company or an S corporation).

- **Operating Company or Single Purpose Vehicle (SPV)** – Is the issuer an operating company with a business plan, dedicated employees and fixed operating expenses or is it an SPV that has been created to enable a financing structure benefiting other third-parties (which isn't necessarily a bad thing)?

- **Structure of Company** – Is the investment in a holding company or at the operating company level where tangible assets, direct customer relationships and specific revenue generating business activities are carried out?

3 Security

A security is a form of financial asset held by an investor. Securities are "issued" by legal entities, such as corporations, to raise capital, for purchase by investors typically expecting to profit from the exchange.



Typically, a security is either in the form of debt or equity. Since each represents a very different obligation by the Issuer, it's important to determine, early on, what type of security is being offered for investment.

Examples of securities include indebtedness (in the form of a Promissory Note) or ownership (equity in the form of shares or units), each of which is assigned a monetary value. For the security holder, it represents an investment with rights of ownership.

DEBT QUESTIONS

- **Maturity** – Short-term (<1 year to repayment) or longer-term, amortizing principal or paid upon the maturity date?
- **Amount** – How much capital is being raised?
- **Interest Rate** – What is the annual interest and how often is it paid?
- **Seniority** – Is it senior debt or junior debt (subordinated in liquidation preference to senior)?
- **Collateral** – Are specific assets pledged toward repayment of this indebtedness (secured debt)?

EQUITY QUESTIONS

- **Class** – Are preferred or common shares being offered? This determines liquidation priority relative to outstanding equity securities.
- **Amount** – How much capital is being raised?
- **Valuation** – What's the implied value of the issuer and, therefore, what portion of the company's ownership is being sold?
- **Dividend** – Is there a specific dividend and how is it to be paid?
- **Return on Investment (ROI)**– What is expected?

4 Repayment

Once you know the type of security that is being offered, it's important to understand how the investment, with its projected return to investors, will be paid by the Issuer.

Debt securities are generally repaid from the operating cash flow generated by the company's ongoing business. Equity securities, on the other hand, are typically repaid through some event such as the sale of the company or by registering equity with the S.E.C., listing on a stock exchange and through subsequent sales on the open market.

DEBT QUESTIONS

- **Operating Cash Flow** - Is the company currently generating sufficient cash flow from its operations to pay the additional interest and principal associated with the new note?
- **Pre-existing Indebtedness** – Are there other lenders with senior claims to this cash flow and any of the company's assets?
- **Covenants** – Are there existing financial and other covenants governing the business which affect its ability to service existing debt, if any, as well as the new debt?

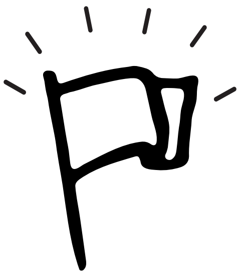
EQUITY QUESTIONS

- Increasing Equity Value – Does it come from cash flow, asset appreciation, customer growth, intellectual property – what is the primary value driver?

» **Business Focus** – Are the company's activities being managed to increase equity value for shareholders or for cash distributions to management and other insiders?

» **Liquidity Event** – What is/are the most likely events that enable the equity holders to sell their shares, what level of business activity will make this possible and when can this be expected?

5 Risk Assessment



Every security involves the risk that it will not perform as expected for the investor. Conducting your Elements investment analysis as suggested above should highlight the major risks inherent to the security being offered, but there are other risks which can present themselves over the course of the investment. Major categories of risk include:

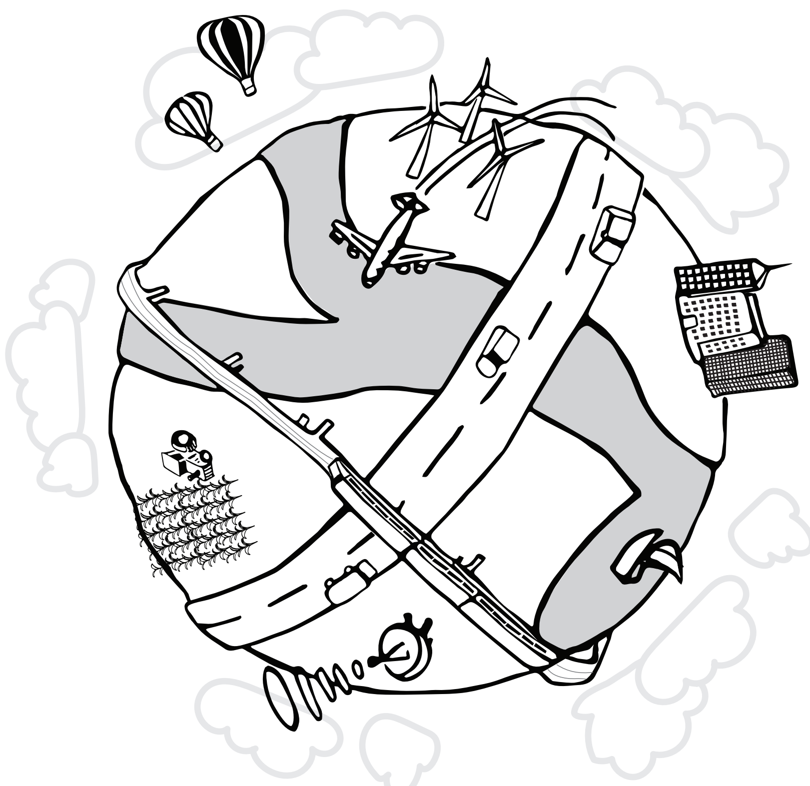
» **Investment-related Risks** – Specific to the security being offered (as above).

» **Industry-related Risks** – Risks inherent to the Issuer's broader industry (e.g., agriculture, consumer products, real estate, oil & gas, etc.).

» **Macro-Economic Risks** – General economic risks which may affect the specific industry directly or indirectly.

» **Management-related Risks** – The performance of key personnel, the overall reliance upon personnel performance.

- **Management-related Risks** – The performance of key personnel, the overall reliance upon personnel performance.
- **Regulatory Risk** – The potential for adverse regulatory actions affecting an industry or specific to the issuer.
- **Offering-related Risks** – The accuracy of issuer representations, and the manner that the security is offered to investors.
- **Tax-related Risks** – Future tax rulings and their impact on income recognition, risk of IRS audit, etc.



Conclusion

As they say in Economics 101, ***there is no free lunch!*** Investment income is generally "earned" by investors through thoughtful investment analysis, consistently applied to investments – before they are funded by the investor.

Though the Five Elements are not all-encompassing, they guide an abbreviated process, early in the analysis process, for determining whether the commitment of time and other resources is justified for a more in-depth and time-consuming investigation. However, the Elements will provide essential context for the many other facts and details a deeper due diligence process will uncover (see Carofin's Due Diligence Guidelines).

Carofin has created an extensive library of investor-oriented material within its Knowledge Base. We provide it to aid investors with their private investment analysis. The following White Papers should help you evaluate debt and equity private investments:

- Private Investing the "Right" Way
- Seven Key Questions for Evaluating a Private Company

Our library of material in our Knowledge Base is continually expanding, so we invite to you to visit it regularly as you consider new private investments.

Improving investment standards for the Alternative Investment community is an important goal of Carofin. Please tell us your experiences so we can share them with others.

As always, call us if you have questions.

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

If you like reading these papers and want to stay current, please "Follow us" on LinkedIn.

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.