Understanding Private Securities

By Bruce Roberts

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Summary

This material has been prepared to help investors understand the types of securities which are most commonly issued in private placement financings – in particular, debt and equity securities.

To best understand the differences between them, we have emphasized:

- What each type of security represents as an obligation of its Issuer;
- What this means for investors;
- How each is structured to generate investment returns for the investor.

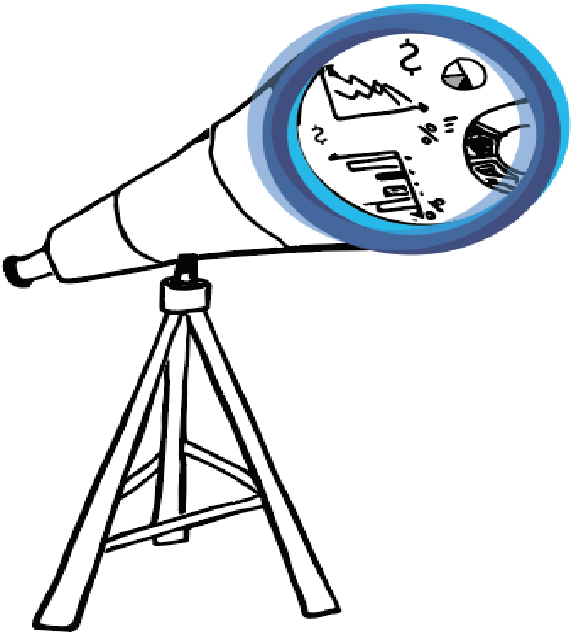
As background, we first review basic financial concepts which underpin the use of securities to finance a business:

- What is a Security?
- What is a Private Placement?
- What is a Balance Sheet?

Afterward, the major securities structures are described within the debt and equity categories, as well as for certain hybrid structures. We take particular care to explain where a type of security falls within the Issuer's balance sheet (within the "capital stack"). This determines its liquidation priority or "preference," or how investors in each type of security will be treated in the event that a company discontinues its operations and must liquidate its assets.

Risk is an essential concept for investors to grasp. It goes to the heart of each investment's analysis. What are the risks associated with the investment, and what is the investor's tolerance for risk? For the same company, some types of securities are inherently safer than others – say, its senior secured debt (safer) versus its common stock (much less safe).

Carofin's primary objective herein is to help investors select the "right" private investments to meet their goals and other objectives. Selecting the right form of security, debt or equity, is, therefore, essential to successful investing.



What's a Security?

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

Examples of securities include any proof of ownership (equity) or indebtedness (loans, often in the form of promissory notes) that has been assigned a monetary value. For the security holder, it represents an investment with rights of ownership. In general, it's safe to assume that if a business is borrowing from non-bank third parties, the activity falls under U.S. securities laws.

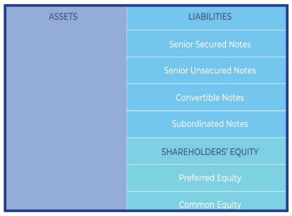
What's a Private Placement?

"Private Placements" are discrete offerings of securities that are not publicly registered with the U.S. Securities and Exchange Commission (the S.E.C.) before being made available to investors. Therefore, the information provided by Issuers to investors is not available publicly through advertisements or news stories.

Private placements must be conducted using a "manner of offering" authorized within the Securities Act of 1933 and with issuance guidelines specified in S.E.C. regulations – primarily Regulation D. Importantly, these laws and regulations do not specify the type of security being sold by the Issuer – only the manner in which it is being offered to investors (again, very discreetly in the case of traditional private placements).

A Private Placement can, therefore, involve virtually any type of security, including debt (such as Promissory Notes) or equity interests (e.g., common stock, preferred stock or membership interests in a Limited Liability Company), as described below.

What's a Balance Sheet?



To understand investment securities, you need to also attain a very basic understanding of financial accounting (what's taught during the first few days of an

Accounting 101 class) – in particular, the role of a Balance Sheet in the financial management of a business.

The balance sheet is a "snapshot" taken at a specific moment of a company's Assets (what it owns), Liabilities (what it owes to others) and Shareholders' Equity (the value left after repaying all of its liabilities). Importantly, a Balance Sheet reflects the financial condition of a business when it is compiled. If a balance sheet is old, many things probably have changed with the business, so, it must be updated to reflect the current financial condition of the company.

It is essential that the Balance Sheet "balances" – that the aggregate values assigned to the Assets of the company equal the sum of all recorded Liabilities amounts plus values assigned to Shareholders' Equity.

Elements of a Balance Sheet

ASSETS	LIABILITIES
	Senior Secured Notes
	Senior Unsecured Notes
	Convertible Notes
	Subordinated Notes
	SHAREHOLDERS' EQUITY
	Preferred Equity
	Common Equity

ASSETS

A company's assets are what the company owns.   Asset are listed on the Balance Sheet in order of the life cycle of the asset.

Short-Term Assets are listed above Long-Term Assets. These include Current Assets, such as cash, Inventory, and Accounts Receivable (payments customers owe the business). Long-Term Assets exist longer than one year and include investments (including securities if they are owned), Property, Plant and Equipment ("PP&E"), Intangible Assets and others. Some may have a corresponding liability on the right side of the balance sheet because they "collateralize" the repayment obligation of some of the company's indebtedness. Personal examples would be your home and car (assets) if you financed their purchases with debt.

LIABILITIES

This lists the financial obligations of the company, including loans and promissory Notes. Current Liabilities[1] are short-term liabilities (less than one year) and are listed first. Long-Term Liabilities[2] are listed below current liabilities on the balance sheet.   Debt securities issued by companies can be either short-term or long-term, depending on the amount of time remaining until they mature.

SHAREHOLDERS' OR OWNERS' EQUITY

Shareholders' Equity represents the Net Equity the owners have in the business assets. It includes all Paid-in Capital (funds put into the business as an equity investment) plus or minus the Net Income generated over the life of the company. All equity in the form of stocks (for corporations), Membership Interests (for Limited Liability Companies) and Partnership Interests are considered securities.   Equity can be either Preferred or Common. Common stock is subordinate to Preferred Shares in liquidation priority when the company or its assets is sold.

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1 e.g., payroll or Accounts Payable as well as Notes Payable maturing in less than one year

2 e.g., mortgages, Notes Payable with maturities due in greater than one year

THE “TERM SHEET”
A guide to understanding each security

Private investing is absolutely a world where the “devil is in the details,” and investors must be committed to understanding the nuances of each security they are seriously considering – before they commit their capital. It’s not enough just to know whether the investment is simply debt or equity – what type of debt, what type of equity?

Term sheets, also called a Summary of Terms, provide a line-item review of a security. They must be available for investors’ review, early-on in their consideration of the investment. These documents, while not normally in the form of an executable contract, provide an essential roadmap. They guide investors to an understanding of the security being offered and every important, and often unique, feature that is associated with it.

Investors should carefully read the Term Sheet, all offering documents and all closing documents associated with each private investment they are considering. Carofin also strongly encourages investors to retain legal counsel specializing in private finance to provide objective interpretation and advice regarding each investment.

Debt, by its nature, has very different terms than equity. Below are links to typical term sheets for debt and equity investments:

- Private Lending Term Sheet: Typical Terms and Conditions
- Private Equity Term Sheet: Typical Terms and Conditions

Each private investment is contractually represented within its closing documents. These agreements between the issuer and the investor provide the legally binding language associated with each element of the term sheets. Commonly used closing documents for debt and for equity private security offerings are reviewed in the following Carofin article:

[Closing Documentation for Private Placement Investments]

IMPORTANTLY - It's also essential for potential investors to understand where the rights associated with a newly issued security fall relative to those of the Issuer's other outstanding securities. Some securities, and, by extension, their investors may have rights that remain superior to the newly issued securities.

Notes, Equity & Hybrid Securities ... An Introduction

Securities structured as Notes are Liabilities (indebtedness) of the company (the "Issuer"). Therefore, interest payment and Note principal repayment obligations are ahead in Liquidation Preference[1] to obligations due to Equity holders (see below). If a company's assets are liquidated, voluntarily or otherwise, cash proceeds are first used to repay Noteholders.

Notes typically only receive their stated interest rate and have a date specified when the principal is to be repaid. Noteholders do not participate in the profits of the business unless they are convertible into equity (see Convertible Notes below) or are accompanied by equity warrants of the Issuer.

Conversely, equity securities are "junior" in preference to all liabilities. Equity investors generally participate in the profits of the company, with preferred equity participating ahead of common equity (see below).

For more risk-averse investors, an Issuer's debt securities are safer investments than the same Issuer's equity securities.

On the other hand, if your investment priority is to generate greater profits – and you are willing to accept more risk – an equity investment has the potential to generate greater returns.

1 What gets paid first when a company or its assets is sold – Preference

Profits from equity investments can be realized by investors in several ways:

- Dividend distributions from operating profits;
- Proceed distributions if the company is sold; and/or
- A sale of publicly registered stock after the company "publicly registers" its private equity with the S.E.C.

A Convertible Note, a hybrid security, is a debt investment that can be converted into equity. For venture-stage companies, Convertible Notes are often used for a smaller "bridge" financings

DEBT SECURITIES (OR NOTES)

Debt securities are usually expressed in the form of a Promissory Note (or Note) that is accompanied by a Loan and Security Agreement. It includes details relating to the Issuer's obligations for the Note. The Principal is specified, along with the "interest" it pays to investors, the name of the investor owning the Note, its maturity date (when all Note principal repayment becomes due) and the major provisions protecting the Investor.

The Principal of the Note is the amount invested by the investor and is usually repaid by the Issuer to the investor in one of two ways: upon the maturity date of the Note or through an "amortization" schedule involving smaller, scheduled Principal payments made over the life of the Note.

Investor income from debt securities is generated through interest payments made by the Issuer, typically monthly or quarterly. The interest (also called the Interest Rate) is specified on an annualized basis (x% / year), and the amount due at any point is normally calculated as (actual # of days since the last interest payment) / (365 days). The interest can be a "fixed" rate for the life of the loan, or it can change periodically. "Floating-rate" loans are calculated as a fixed "spread" to some daily-changing public bank rate index – normally the Prime Rate or LIBOR.

Unless a common equity warrant also comes with the Note or it is convertible into the equity of the Issuer (see Convertible Notes below), the income received by investors from the interest payments represents the only form of income they will receive from the investment.

A major consideration for debt securities is whether they are “collateralized” (also indicated as “secured”). Collateral can be real property (land, buildings), equipment or, for short-term Notes, cash balances, accounts receivable and inventories.

If a Note is secured, the Note holder has a claim on the value of specific assets through a “liquidation” of the collateral if the Issuer otherwise cannot pay the interest and/or principal when it is due. Making this claim is called “foreclosure.” To be enforceable, a state filing specifying this claim under Uniform Commercial Code regulations (a “UCC”) must have been made beforehand, usually as part of the closing process at the time of the debt investment.

There are five principal types of debt securities:

- Senior Secured Notes,
- Senior Unsecured Notes,
- Subordinated Notes,
- Revenue-share Notes, and
- Convertible Notes.

The differences between them relate primarily to their “seniority” for Issuer interest and principal payments, their “preference” in a company liquidation scenario, how the return of invested capital is made by the Issuer and whether the Note is convertible into equity securities of the Issuer.

SENIOR SECURED NOTES

Senior secured debt is the most senior security of any Issuer. Therefore, it is first in line to be repaid, either through normal operations or through the liquidation of the Issuer's assets if its business fails.

Note that repayment terms vary with senior secured Notes. Some can be interest-only for its term with a "bullet" payment – or full repayment of principal – only at maturity; others will repay principal and interest along the way in accordance with an amortization schedule. There are many variations, and it's important to understand this basic strutural aspect of the Note.

The illustration on the following page provides the following:

1. An abbreviated Summary of Terms for senior Notes;
2. Where these Notes are found in a company's balance sheet;
3. Where they rank in terms of liquidation preference (within the "capital stack"); and
4. The timing for principal and interest payments over the course of the investment.

SENIOR SECURED NOTES

SENIOR SECURED NOTES

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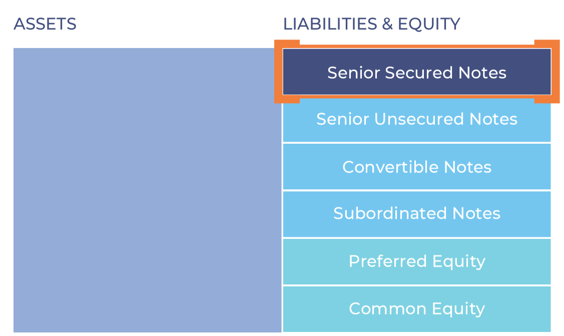
SUMMARY OF TERMS

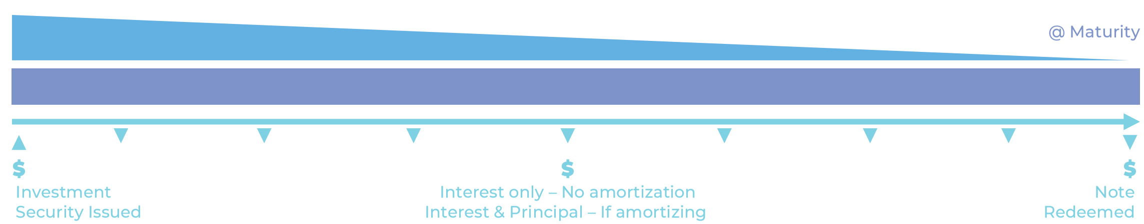
SECURITY TYPE:	Note (Issuer liability)
ISSUANCE AMOUNT:	Set at issuance
INTEREST RATE:	Set at issuance, paid monthly or quarterly
MATURITY:	Set at issuance
AMORTIZATION:	Typically either paid incrementally over time or all at maturity
CREDIT ENHANCEMENTS:	Collateral, possibly guarantees
OTHER TERMS:	Issuer representations and various financial covenants

ISSUER BALANCE SHEET



LIQUIDATION PREFERENCE

SECURITY'S PROJECTED CASH FLOW



SENIOR UNSECURED NOTES

Refers to lending arrangements to companies as evidenced by a Promissory Note and Loan Agreement, but, unlike a senior secured Note, there is no supporting collateral. If there is no senior secured indebtedness, this is the most senior security of the Issuer and, therefore, is first in line to be repaid if its business fails. Otherwise, senior unsecured Notes are repaid after senior secured Notes have been satisfied.

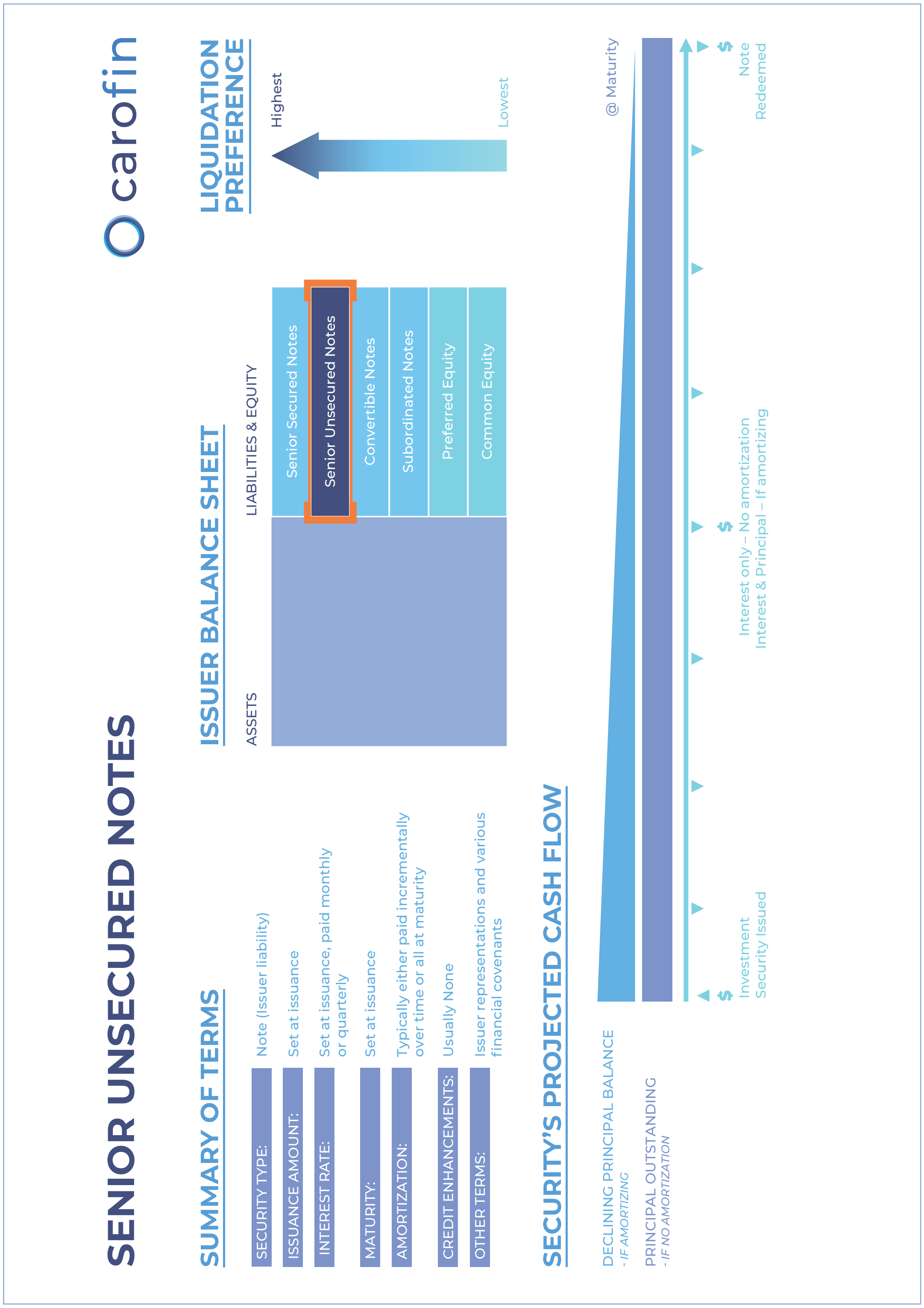
Once again, the following illustration (and all succeeding ones) indicates where the security falls in the capital stack, where it falls in liquidation preference, and typical terms and conditions.

SUBORDINATED NOTES

(“Sub-Debt” or “Mezzanine Financing”)

A form of cash-flow lending (i.e., unsecured) which is “subordinate” to senior debt in liquidation preference. In other words, if the Issuer defaults, holders of Subordinated Notes are repaid only after all senior debt repayment obligations have been met. Subordinated notes are still repaid before distributions are made to holder of any form of equity.

SENIOR UNSECURED NOTES



SUBORDINATED NOTES

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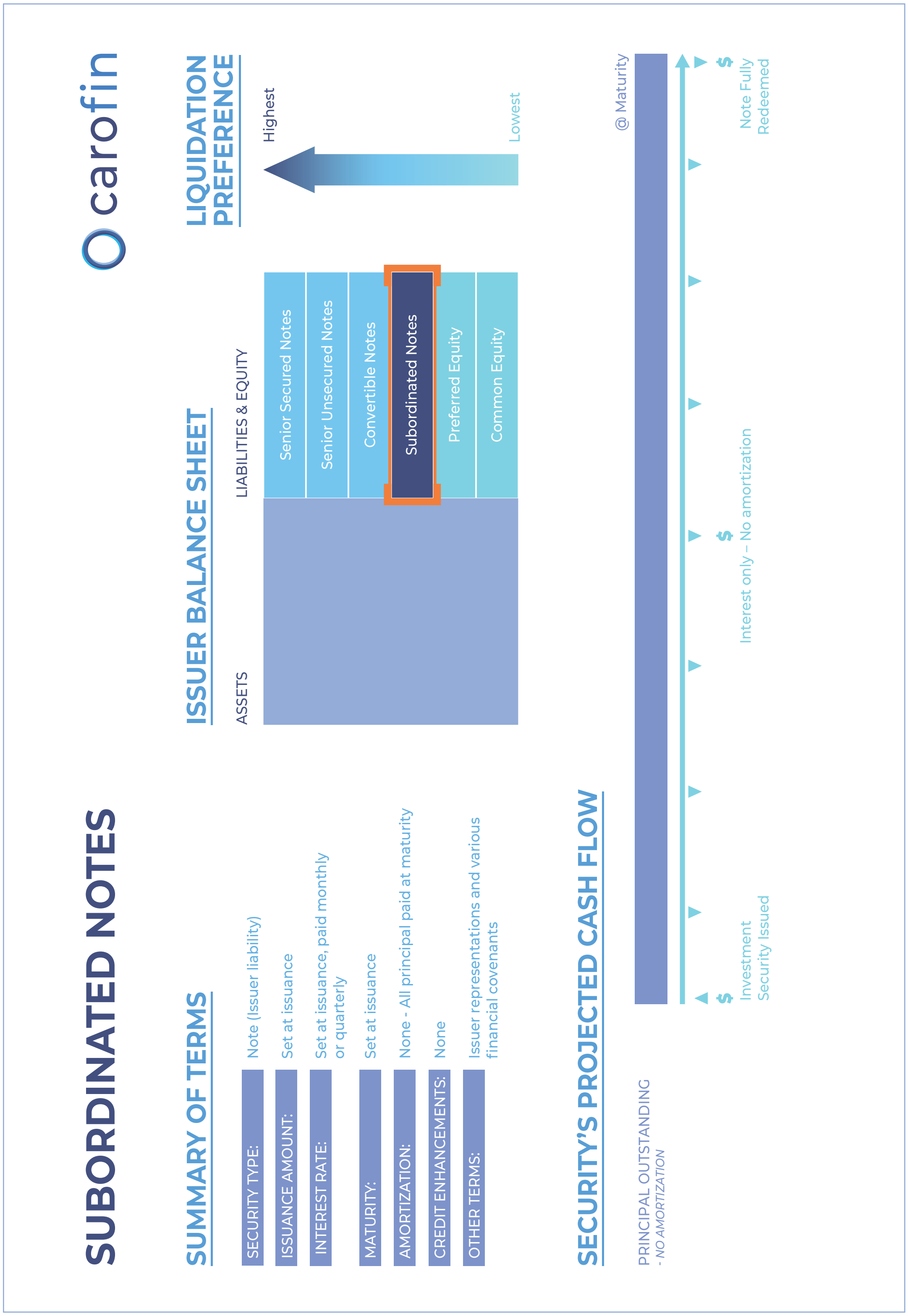


REVENUE ROYALTY NOTES

A debt investment wherein the current return and principal repayment are each tied to Issuer payments. These are a fixed percentage of the Issuer's gross revenues – up to a capped amount (e.g., 1.5x the original principal amount). If the Issuer's sales grow faster, the capped return is reached more quickly and the IRR is higher. If the sales growth is slower, it will take more time to reach the capped return (or return), and the IRR is lower. If the capped return is not repaid by the maturity date, any additional amounts due to reach the capped return become due and payable.

Unlike other types of debt or distributions from private equity investments, payments received from Royalty Notes are not tied to the Company's available operating cash flow or profitability. In contrast to other forms of debt, Issuers avoid fixed-charge covenants[1] associated with traditional form of lending.

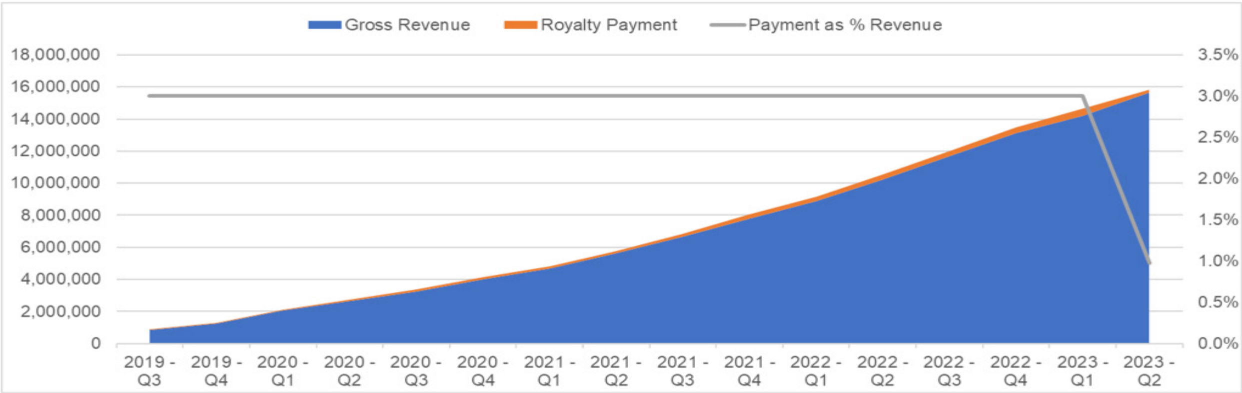
Revenue Royalty Notes afford private investors the opportunity to collect current income with a return on investment (ROI) that is generally higher than other forms of senior debt and even approaches private equity returns. For more information, see Carofin's White Paper "*Revenue Royalty Notes*."

SUMMARY OF TERMS

Type of Security: Note (Issuer liability)
Issuance Amount: Set at issuance
Interest Rate: None
Revenue Royalty Rate: Expressed as a fixed percentage of gross revenue, or royalty; likely 1-8%
Return Cap: Expressed as a multiple of the principal amount of the loan, e.g., 1.3x - 2x
Maturity: Set at issuance
Amortization: Typically, either paid incrementally or fully at maturity
Credit Enhancements: None – Typically unsecured
Other Terms: Issuer representations and various financial covenants

1 The fixed-charge coverage ratio measures a firm's ability to cover its fixed charges, such as debt payments,

Royalty Note Payment Illustration



CONVERTIBLE NOTES

Convertible Notes are hybrid securities that afford investors the liquidation priority of debt. But they also enable investors to convert into the Issuer's equity security should the company's value grow between the time of investment and a liquidity event.

There are two ways that a Convertible Note can be repaid, as illustrated below – either in the form of equity, should the company's value have risen, or as a Note with principal and accrued interest.

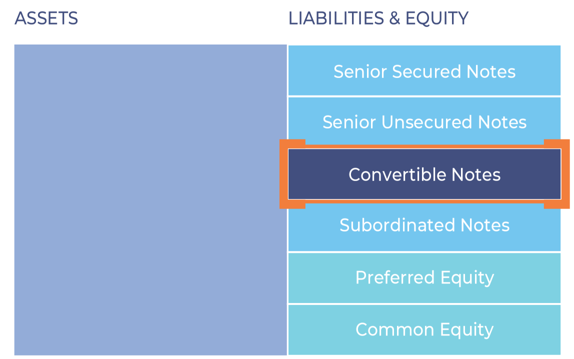
CONVERTIBLE NOTES

CONVERTIBLE NOTES

SUMMARY OF TERMS

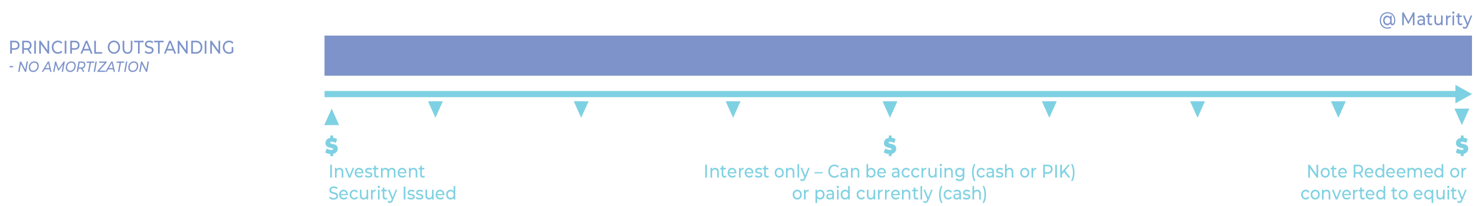
SECURITY TYPE:	Note (Issuer liability, initially)
ISSUANCE AMOUNT:	Set at issuance
INTEREST RATE:	Set at issuance, paid monthly or quarterly, accrual cash or paid-in-kind (PIK)
MATURITY:	Set at issuance
CONVERSION:	Automatic conversion to equity, preferred or common upon certain events
AMORTIZATION:	None - Principal paid at maturity
CREDIT ENHANCEMENTS:	None - Typically unsecured
OTHER TERMS:	Issuer representations and various financial covenants

ISSUER BALANCE SHEET

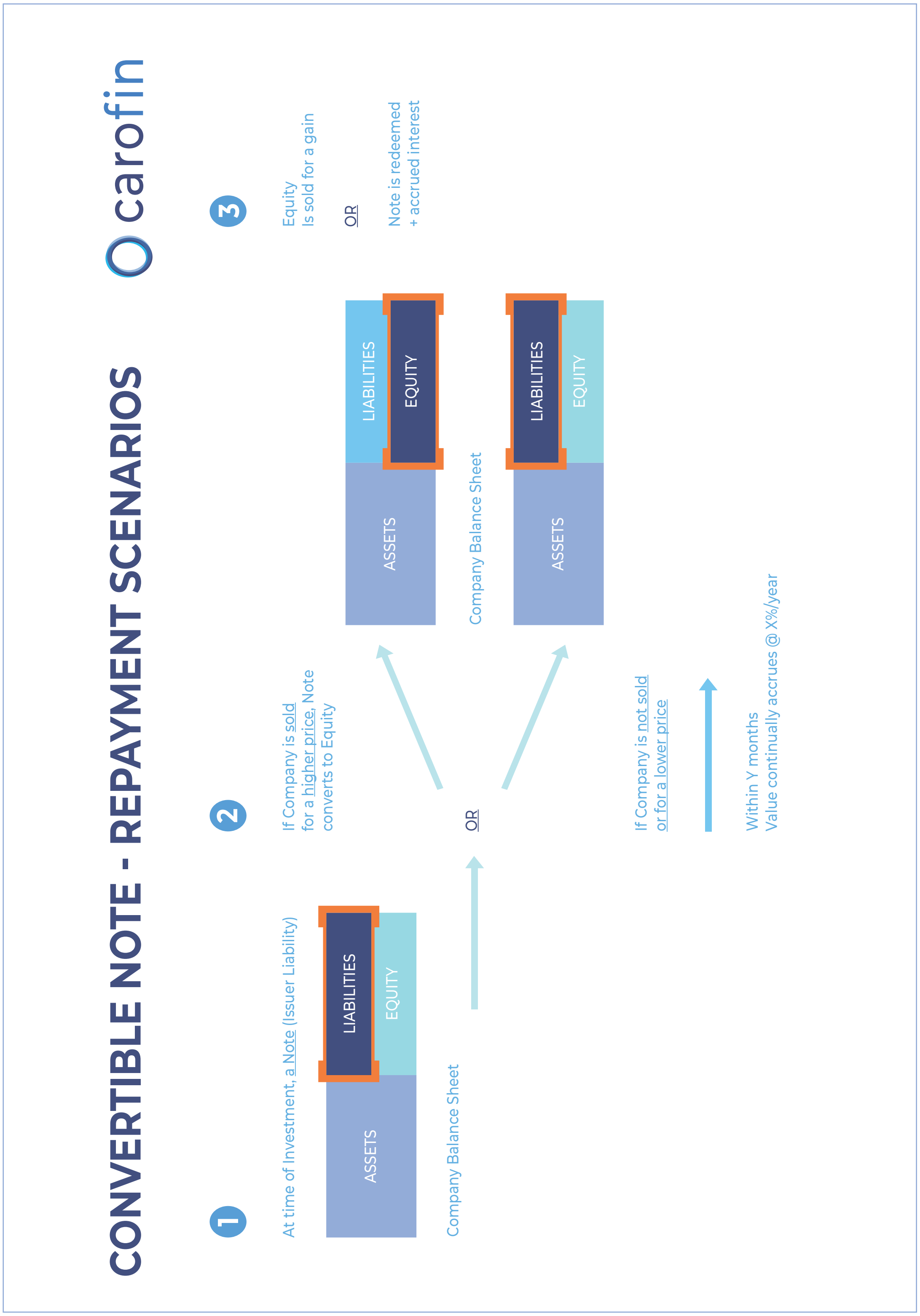


LIQUIDATION PREFERENCE

SECURITY'S PROJECTED CASH FLOW



CONVERTIBLE NOTES



EQUITY SECURITIES

As noted above, equity securities represent an equity ownership in the business and, as such, investment gains are usually achieved through an increase in the value of the equity (i.e., share price appreciation, usually a "capital gain" for tax purposes) and also through distributions of Issuer after-tax profits (ordinary income for tax purposes).

As the overall value of the company increases, an equity investment should rise in value proportionately to the investor's ownership in the business. However, within the equity securities of an Issuer, there can be several "classes" of equity, each having unique rights when it's time for a distribution of cash proceeds resulting from a sale of the Issuer.

One might wonder why there are different types of equity securities. There are several answers:

- Preferred shares have less investment risk than common shares;
- Younger, often unprofitable companies are riskier than more mature, perhaps profitable companies, and this added protection is necessary to attract investment.

The following equity structures are commonly issued in conjunction with private placements.

PARTICIPATING PREFERRED EQUITY

Participating preferred stock has become a standard form of investment for earlier-stage companies (venture capital). It is the most senior form of equity capital and, upon liquidation, can receive up to three types of distribution:

- **Preferred dividends:** Any accrued and unpaid dividends up to the time of a liquidity event are paid first;
- **Preferred return of capital:** Next, all the investors' originally invested capital is repaid. For successful investments, this feature provides an additional return of invested capital;
- **Pro-rata participation on an as-converted basis:** If there are any amounts left to be distributed to common equity holders, it is also disbursed to participating preferred investors pro-rata to the number of common shares they now hold.

CONVERTIBLE PREFERRED EQUITY

This type of preferred equity is an "either/or" form of investment. At the time of conversion, the convertible preferred may convert either into common equity or remain as preferred equity (see the illustration below). If the company's value has increased, investors will benefit more by converting into common equity. Investors choose the source of redemption that returns the most to them either by:

- Selecting accumulated preferred dividends and a preferred return of invested capital. Any accrued and unpaid dividends up to the time of a liquidity event are first paid PLUS all the investors' originally invested capital;

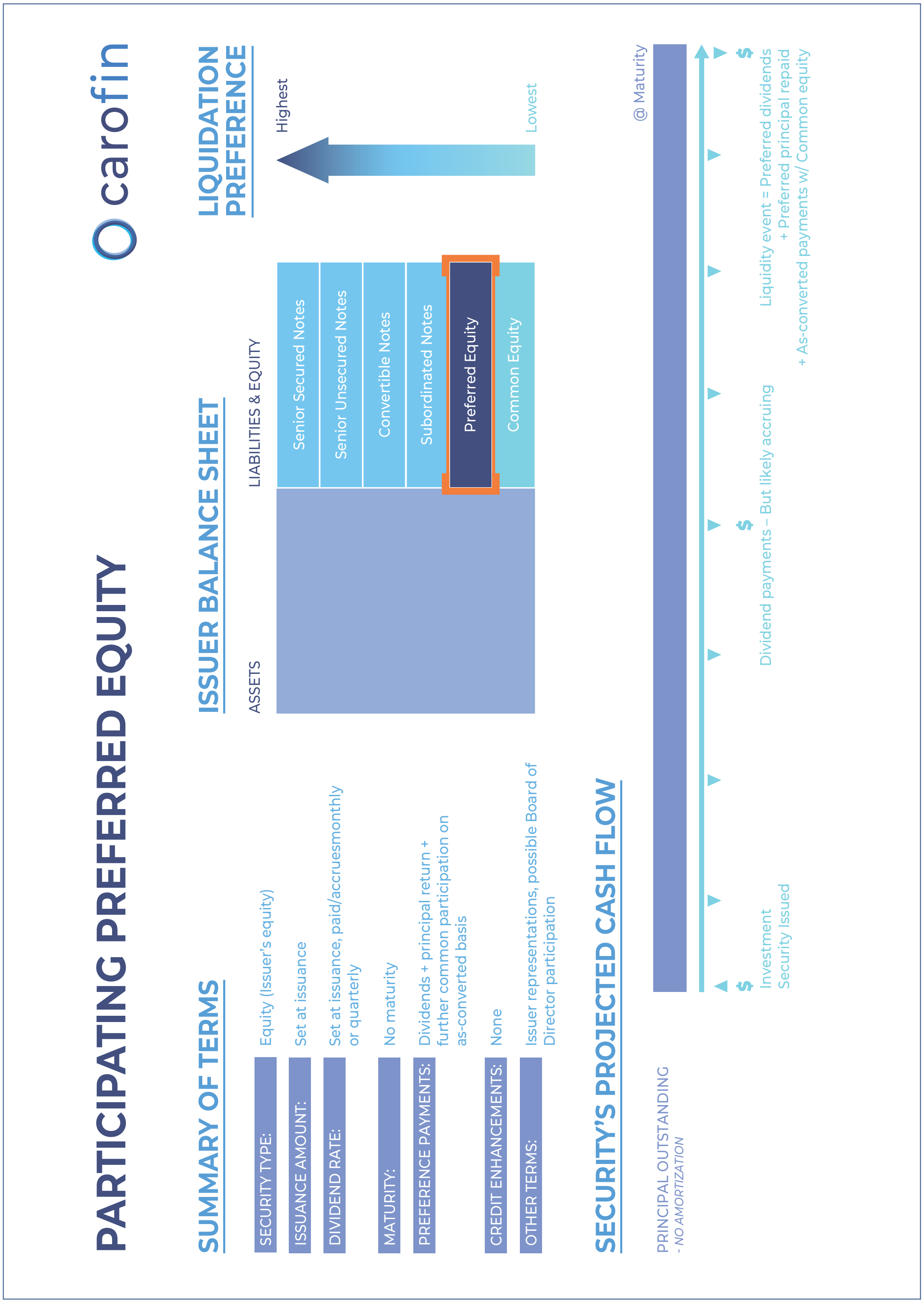
OR

- Converting to a number of common equity based upon the originally invested capital. Accrued dividends may or may not be payable in the form of cash or shares depending on what what was established for the security when it was issued.

COMMON EQUITY

The most junior security on an Issuer's balance sheet. Holders of common equity receive, pro-rata, remaining amounts after all creditors and preferred equity holders have been satisfied.

PARTICIPATING PREFERRED EQUITY



CONVERTIBLE PREFERRED EQUITY

CONVERTIBLE PREFERRED EQUITY

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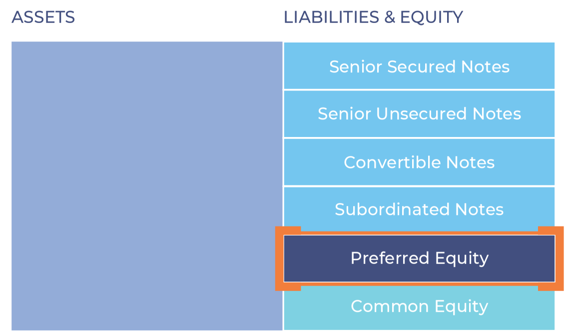
SUMMARY OF TERMS

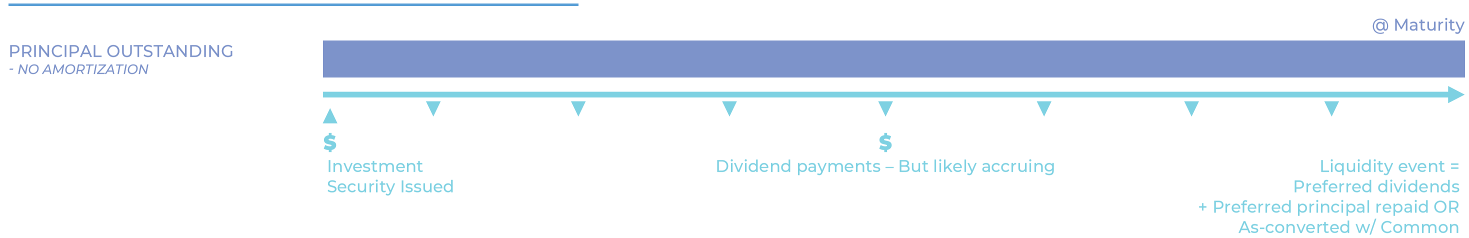
SECURITY TYPE:	Equity (Issuer's equity)
ISSUANCE AMOUNT:	Set at issuance
DIVIDEND RATE:	Set at issuance, paid/accrues monthly or quarterly, usually as a payment-in-kind (PIK)
MATURITY:	No maturity
PREFERENCE PAYMENTS:	Investor receives higher of Liquidation preference (Accrued Dividends + principal) or participation on as-converted basis
CREDIT ENHANCEMENTS:	None
OTHER TERMS:	Issuer representations, possible Board of Director participation

ISSUER BALANCE SHEET



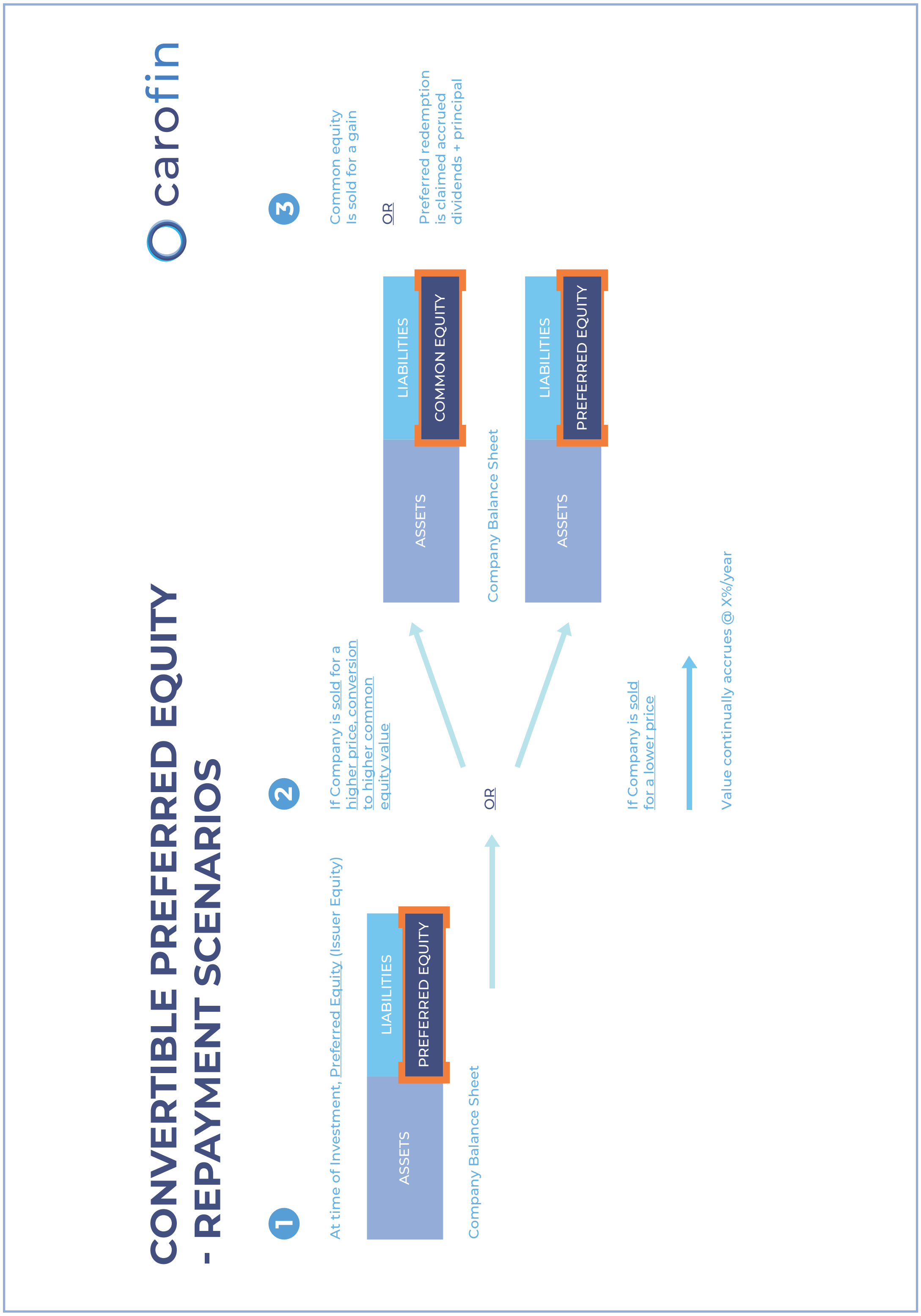
LIQUIDATION PREFERENCE

SECURITY'S PROJECTED CASH FLOW

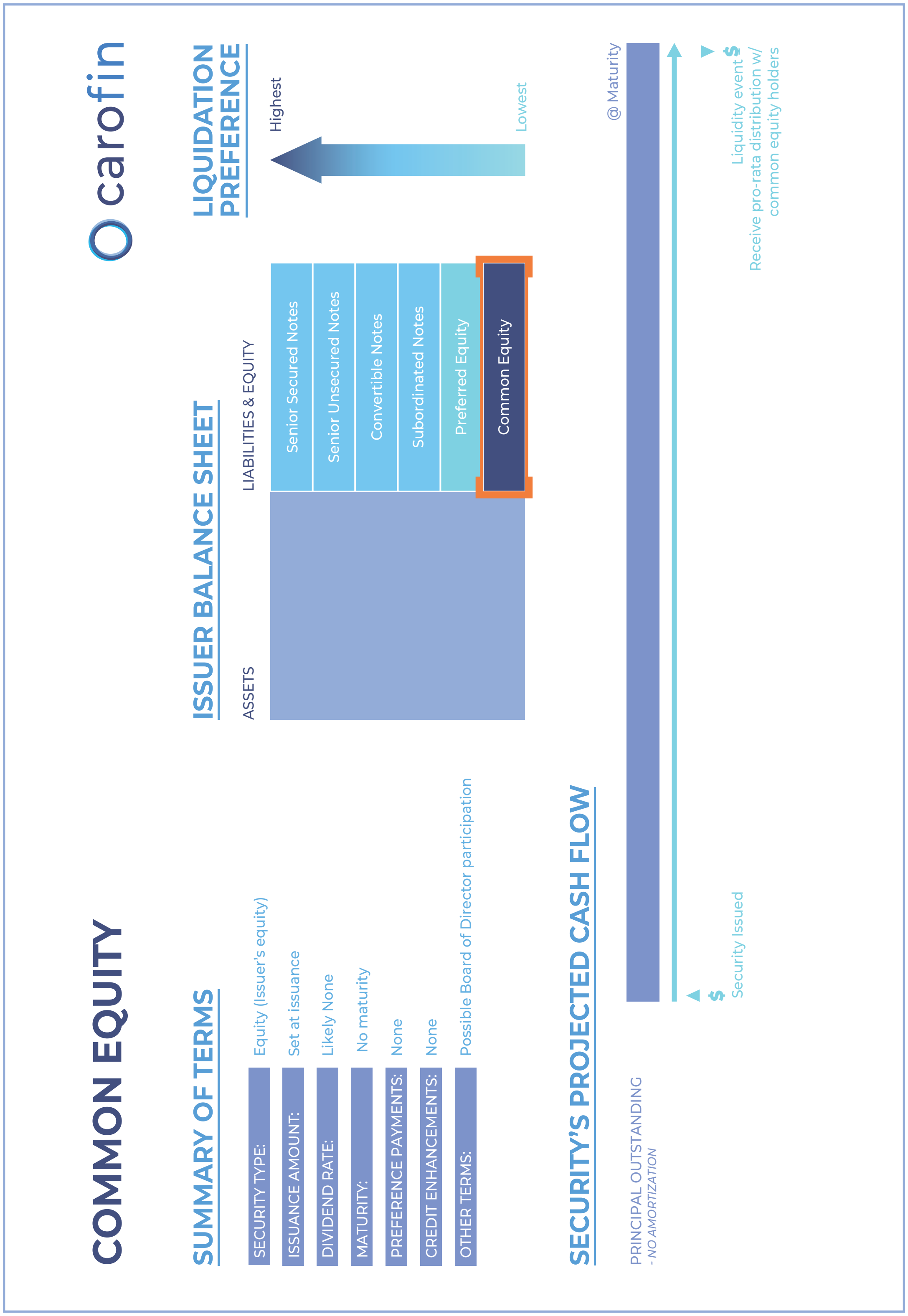


CONVERTIBLE PREFERRED EQUITY

Repayment Scenarios



COMMON EQUITY



Conclusion

This material was created to help private investors better understand the fundamental characteristics of the securities they are most likely to encounter in private offerings. There are notable differences between them that suggest varying levels of risk and return.

Appropriate rates of return can be found in Carofin's *Alternative Investments and their ROI's*. This material does not touch on corporate analysis, which is explained in several White Papers available in the Carofin Knowledge Base including:

- *Primary Investment Considerations, or First Principles*
- *Investing in Private Debt: How can I be prepared?*
- *Seven Key Questions for Evaluating a Private Company*
- *Nine Leaps of Faith – 9 Key Questions for Evaluating Venture-Stage Investments*

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.

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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.