What's a Good Deal?

Reflections on Evaluating Direct Private Investment Opportunities

By Bruce Roberts

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Summary –

After Carofin's* 25+ years of evaluating, financing, supporting and tracking 100+ investment outcomes, I find it amusing when someone points to a successful transaction and suggests that it was somehow always destined to be a "good deal."

I wish it were that easy …

A good deal is simply one that works … in hindsight. It delivered a compelling return.

The investment may or may not have followed its originally projected path (it probably didn't!), but it succeeded – one way or another. Chances are either management did something herculean or luck played a role (i.e., when preparation met opportunity). But its investors mostly will remember, simply, that it worked.

Of course, if it didn't look good in the beginning, you wouldn't have invested! But don't all your investments initially look that way?

Success is never assured. Challenges arise in any business, and, typically, when they are least expected and the business is most vulnerable.

So, I suggest you check the following fundamentals (some of the biggest items to look for) as you screen private debt and equity investments.

I also share some of my horror stories to temper your confidence particularly with direct private investments (DPI), Carofin's stock-in-trade.

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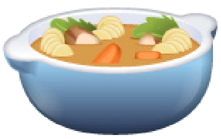
What Supports Success ... What I now look for in a company

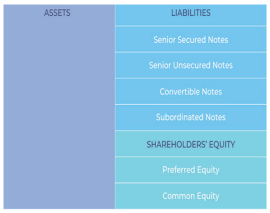


Decades into direct private investments (with successes and failures to draw from), I have reduced the "soup" of incredients to look for in a prospective company into five primary ingredients.

1. Strong Senior Management
2. Customers & Sales
3. Financial Management
4. Scale
5. A "Craig"

1 **Strong senior management:** As the saying goes, "I'll take an A management team with a C business plan over a C management team with an A business plan." I have backed proven winners (tireless, innovative, experienced, honest and fair, with excellent management skills) and have rarely been disappointed. I have also supported outstanding business opportunities with (what turned out to be) poor management and seen most of them languish ... or worse.

2 **Customers & Sales:** Another saying goes, "If you don't have a customer, you don't have a company." Nothing delivers like a happy and growing customer base – third parties spending their hard-earned $$$ to buy products or use a service from the business needing your capital to grow even faster.



3. **Financial management:** Small to medium businesses (SMB) almost always underinvest in financial management. If so, they (and you as an investor) are "flying blind" for as long as you hold the investment. Look for entrepreneurs who talk in terms of gross margins and cost-efficiency and have real-time data to back it up. Beware of the founder who says that they have a CFO who handles the financial stuff. CEOs must understand and live with their numbers.

   Businesses survive because they not only deliver a valuable product or service but do so at a price point that produces profits. Companies must actively use P&L's, budgets and balance sheets to guide them, and the data producing these reports must be both current and accurate.

4. **Scale:** Any early stage or smaller business faces two sets of challenges. The first is making a product and delivering it profitably to customers. The second is achieving the first while trying to stay on top of the financial management, HR requirements, basic administration, regulatory requirements, etc. which are inherent to that business.

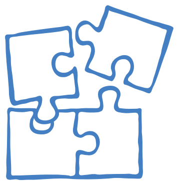
   The more established the business, with a critical mass of actual business activity (again, customers), the more likely it is to have adequate resources (in-house or outsourced). These can help make sure peripheral "snakes in the grass" won't bring down the business – like a call from your friendly regulator or tax authority.

5. **A "Craig":** CEOs cannot do it all. Even if they could, they cannot both mind every detail while also looking over the horizon for business opportunities or potential challenges.

   I have been so fortunate having a business partner for the past 15 years, Craig Gilmore. While not a banker or in sales, he excels at minding the myriad of details inherent to an investment banking business. He also continually evolves technology-supported solutions, enabling us to operate with increasing efficiency and confidence. We couldn't make it without Craig. Are there "Craigs" within each of your DPI?

Unexpected challenges ... Some of my misadventures

I've encountered challenges with many companies I've financed over the years, some of which you can't make up. Here are a few to help you think a bit more critically...

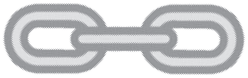


- **Management incompetence:** A business won't make it if senior management is not up to the task. Not all people are equal in this regard. Some have the skills, but most don't.

  One of the most consistent traits of the poor managers I've met is insecurity. Insecure individuals micro-manage their staff and are over-guarded about information reflecting the performance of the business. They do not engender the best performance from their employees.

  Good managers, on the other hand, know their own strengths and weaknesses, surrounding themselves with talented people to complement them. They let their staff do their jobs, empowering them and inviting their creativity. Look critically at the people, as individuals, in the business, not just the business plan.

- **Financial blindness:** As noted above, competent staff should constantly update data into financial management systems customized to support the business. Otherwise, a business really doesn't know how it is performing. Somewhere along the way, it will crash. Furthermore, the CEO must listen to the financial staff and respect their input. They may recommend a more conservative use of cash or note a trend line pointing to needing another round of financing (i.e., the funds which come after yours...).



- **Employees, vendors & supply chains:** Every business relies both upon its employees and on other businesses to perform its intended purpose. In a post COVID world, employees, both yours and those of your vendors, are becoming very hard to come by.

  Furthermore, supply chains are being challenged like never before. This was not the case pre-COVID. But now, before investing, you must consider the effect stretched delivery times, particularly from overseas suppliers, will have on business plans.

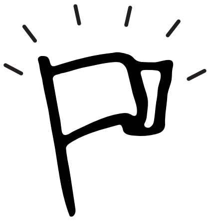
Competitors: Every business has competitors, and you must understand the playing field. Who else on the planet wants (or already has) the same customers as the business you are evaluating, and what will they do to get them or keep them?

I have seen big companies sling lawsuits at smaller companies – not because they were justified, but because the larger companies could afford to create spurious legal roadblocks for a cash-constrained competitor. Also, slander now knows no limitations, particularly in today's media-frenzied / social media world.

The businesses you invest in must be knowledgeable about and realistically appreciate their competitors, or those competitors will eat their lunch.

Government: Regulatory creep is a reality. Increasingly, almost any business is constrained in this regard, and you need to understand just how fundamental regulatory compliance and oversight is to the conduct of the business.

It's certainly fundamental to mine, the securities industry. You cannot raise capital from investors for issuers of securities (and be paid for it) if you are not a member of FINRA, which reports to the SEC. If we get it wrong, we're out of business. So, we must always be prepared to defend every action, particularly in this digital audit-trail world we all live in. Regulators always have 20/20 hindsight and "no harm, no foul" is a thing of the past.



Fraud: Going from the bad to the ugly. If you have not lived through a fraud, you haven't lived through a fraud. Where money is moving around, bad characters will show up. We have seen many of them, and we've avoided most, but not all…

Be on your guard, and don't feel the least bit hesitant to "trust … but VERIFY." Trust your common sense.

Multiple parties (both within and outside the company) should continuously scrutinize critical financial information within the business. If this is not apparent, be careful. Fraudsters survive in the dark; they can't stand up to the light.

Conclusion

The preceding isn't an exhaustive list. But I hope it spurs you to stand back from the information presented in a Private Placement Memorandum and begin looking for other factors essential to any business success.

So, what's a "good deal?" One that worked.

In the early days, does it check all the positives noted above while avoiding the challenges? Probably not completely, though some challenges are particularly toxic – they can't be fixed (like fraud).

Just like the people who conceive and run them, the perfect business doesn't exist. Nor is there a company that follows its business plan with complete precision. Success demands persistence, "listening" to results and adapting.

But, by acknowledging the above, by risk-weighting what you discover during your analysis / due diligence, and by creating a DPI portfolio that isn't too exposed to any one investment, direct investments may make significant contributions to your investment portfolio's overall returns. Expect some drama and adventure along the way...

Good luck!

Carofin offers direct private investments that reflect our firm's 25 years of experience across 200+ transactions. If you would like to consider participating, we welcome a discussion with one of our registered representatives at a time of your convenience.*

**Carofin and affiliates*

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For more information about Direct Private Investments, please see Carofin's Knowledge Base.

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5 Elements of Private Investing

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