CHAPTER

1 Keys to Successful Investing

We are all presented with numerous opportunities to invest in businesses. If you are a professional working for a venture capital or leveraged buyout firm, you are being bombarded with “opportunities” from professional money raisers known as *investment bankers*. If you are an “angel” investor, you are being flooded with new business plans from friends and business associates. In the introduction, we discussed how we all have biases toward everything, including what we like to invest in. Now we move from biases to gathering hard facts about the business, the industry, and the team running the business. This part of the investing process is know as *due diligence.*

This chapter starts the beginning of what venture capitalists (VCs) call the *due diligence process*. That is, it describes the steps that an investor should take in researching an investment opportunity. This is a detailed process that takes weeks—sometimes months—of work. It begins when an investor is confronted with a business proposal and must decide whether the idea warrants further investigation. If the investment does make it past this initial decision process (explained in this chapter), Chapters 2–8 go into further detail of the extent the due diligence process must take.

What Are the Basic Items to Look for in a Business Proposition?

There are six critical components to look for in this first stage of evaluation.

1. The Numbers Should Be Properly Presented

Everybody in the investment business lives and dies by "the numbers." This means that the investor cannot proceed without accurate figures on a company's past performance. Anything less than accurate and detailed (and in most cases, certified financial statements) will lead the investor into a business risk that is probably not worth the business opportunity. To repeat—no investor should make an investment without accurate historical figures.

In addition, current financial statements are an absolute must. All too often, investors are given financial statements that are ancient history. The older numbers do not reflect how the company is doing at that current moment. You should not accept any statements older than two months. Make sure the entrepreneur gives you current (either monthly or quarterly) interim financial statements, or don't invest. Any entrepreneur who sends you poorly prepared or stale financial statements does not deserve financing.

Another thing to look for is the entrepreneur's knowledge of the financials. You must make sure that your entrepreneur is able to explain the numbers in detail. If that cannot be done, it is a sure sign that the entrepreneur does not live and die by the numbers and, therefore, will be a poor match for you. As an investor, you must live and die by the numbers.

If an entrepreneur cannot produce accurate financial projections, he or she should hire an accountant to prepare them. However, even if hiring an accountant, the entrepreneur should still know most of the numbers by memory if he or she intends to live and die by the numbers. If you ask the entrepreneur about the financials and the answer is, "These financials were put together by my accountant and I cannot tell you why certain projections do certain things," the small business person does not understand the numbers. This is a clear sign that you will have problems in the future unless a new member of the team is brought in to handle that side of the business.

In addition, the entrepreneur must provide accurate and detailed projections for at least five years. As an investor, you cannot assess how much money you can make without good projections. An engineer was once asked for some projections on his small business, and the VC was told that he couldn't supply them because this involved "sheer speculation" and that engineers don't guess about things; they only report what is known. Needless to say, the VC did not invest in his company. Projections are important because they reflect the company's financial plan. A company without a financial plan is a company without direction.

Another point is that if the company has not reached the point where cash from sales is equal to expenses—the "breakeven"—the entrepreneur should provide you with a month-by-month financial analysis indicating when the company will reach breakeven. An investor needs to know when a company will finally reach cash flow breakeven and no longer require more investor money.

As investors, we prefer not to deal with entrepreneurs who do not understand the financial projections for their companies. A good entrepreneur must know the operating plan and the financial plan. A good manager has a deep appreciation of accounting. Managers know that, without accurate and timely information, a manager cannot manage a company. This sounds obvious, but many entrepreneurs are "concept people." An entrepreneur who lives by the numbers is the one you want to back.

2. The Deal Must Make Lots of Money

Usually, no one has to tell an entrepreneur that the projections must go up. Every set of projections that we have ever received from entrepreneurs has the infamous "bell curve," with everything on the income statement and balance sheet improving. If they didn't show improvement, no one would be interested in investing. Unless the projections go up significantly, no VC is going to be interested in investing. VCs look for a return on investment of at least 25 percent, and in many situations they expect to see as high as 50–100 percent return on investment per year.

When you look at the company's projections, you should be asking the question, What will the company be worth in three to five years? Using that projection and the earnings and cash flow of the business, one can put a value on the business at the end of that time period. Using that expected value of the company in the future, you can as the potential investor calculate how much of the company you will have to own in order to receive a return on investment that will compensate you for the risk. If the projections don't go up significantly, the investor will have to own a very large share of the small business in order to make a significant return. Years ago, a VC did this calculation on a potential investment, and it was determined that, to make the type of return that was commensurate with the risk, an investor would need to own 150 percent of the company. It was a nice little business on a slow growth pattern, but there was little possibility of a high return for an investor. Obviously, no one can own 150 percent of anything!

3. The Acid Test of a Deal Is Management

Recently, there was an industry seminar in which some very well known VCs were asked what attributes of a potential investment opportunity would indicate that the investment was going to be successful. There were ten slots on the blackboard, and within a minute, the first six slots were filled with some phrase that had the word *management* in it. Over and over again, VCs say that the acid test of any deal is its management. You may have heard a real estate executive say that a good real estate investment is based on the three attributes of good real estate: location, location, location. Well, in the venture capital world, the three attributes of a good venture capital deal are management, management, management.

But what exactly does good management mean? It is very easy for an investor to blame poor management for a loss, but the reverse is also true. You can make a lot of money when management is good. Well then, what management qualities should an investor look for? Here are a few.

Honesty and Integrity. One criterion that every investor uses to test management is honesty. If the entrepreneurial team is not honest, almost "honest to a fault," it is unlikely that the lender or VC will invest. One VC tells about touring a plant with a group of VCs and stopping for a moment to watch a lady at a drill press. He happened to ask her what she was making. She replied, "Oh, nothing. I was hired just for the day. I was told there were some big shots coming through and that I should look real busy." At that moment, management's credibility (and that of others in the plant) was gone. As a result of that one incident, the company never raised the money it needed. The news of its actions went flying through the venture capital community and killed all hopes of raising cash.

Experience. Every VC wants to back an entrepreneur who has extensive experience in the industry in which the business is operating. If the entrepreneur is a white-collar government worker who is going to buy a meat-packing plant, for example, the investor should have serious reservations about that person's qualifications for work in the industry. Would the entrepreneur know how to run a meat-packing plant? We remember one of the questions that a VC asked a man who owned a meat-packing plant when the VC was fresh out of business school and filled with a new concept called *management by objective* (MBO). The VC asked the owner whether he used MBO to run his plant. He was a fairly burly fellow, puffing on a big cigar, and he quickly informed the young VC, "No, I don't use MBO in my plant. I use MBI." "Oh," asked said the VC, "What is MBI?" This husky fellow replied, “management by intimidation.” This gruff entrepreneur knew how to work in his business. He knew that objectives were best left in the office and that MBO would not work inside his meat-packing plant. He had the experience necessary to operate the plant.

Achievement. Solid achievements in the entrepreneur’s background are a big plus. Every investor should look for achievements. The chances of success increase when the entrepreneur is an achiever. Look at the entrepreneur’s background. What did the entrepreneur achieve in college or in business? Achievers are what make the world go ’round.

During the 1950s, a social scientist studying achievers and nonachievers made some interesting discoveries about their backgrounds. The background factor having the highest correlation with the achievers was Eagle Scouts. The lowest correlation was between achievers and pipe smokers. There is a lesson here for anyone looking at an entrepreneur trying to raise money: Bet on high achievers. They have the spark that will light the fire. They want to win. They have achieved in the past and most likely will continue to achieve.

High Energy Level. What most investors look for in a management team is a high level of energy. Being an entrepreneur is tough. Every VC has the greatest respect for all entrepreneurs. Entrepreneurs work long hours. Most of us have worked only a few 70-hour weeks, and there are few people who like them. Your entrepreneur will have to be one who can accept the long hours and the grinding pace. Creating a great business is 1 percent inspiration and 99 percent perspiration.

Your entrepreneur must, therefore, be in good health and of sound mind. The entrepreneur’s health will be put to the test as the daily stress and physical exhaustion mount. Make sure your entrepreneur is a strong person with plenty of energy. The entrepreneur must have the energy to be successful. Good management will not only possess the strength to work long hours, but also will actually put in the long hours to make the business successful.

Motivation. Many entrepreneurs work long hours, week in and week out. So some of the questions a VC should ask an entrepreneur are, Why do you want to do all of this, knowing it is going to take time out of your life? Why is it you want to get involved in this difficult situation?

The wrong answer to this question is, "I want to be my own boss. My current boss doesn't understand me. I just want to get out on my own." Investors should not be solving the personal or psychological problems of entrepreneurs. The right answer to this question is, "It is a great opportunity for us both. If you will invest in the company, we can make a lot of money."

Of course, there are plenty of greedy people in the world who want to make money. But it is our experience that the winners are rarely just plain greedy! Business profits are a way of measuring one's success. Every achiever selects some standard to be measured by. A doctor measures success by the lives saved or the diseases cured, a clergyman measures success by the souls saved, and an inventor measures success by the useful inventions created. When one selects a business career, one accepts as the ultimate measure of success: a very strong, going concern with strong profitability for all parties at stake. You want to back an entrepreneur who measures success by profits.

4. The Situation Should Be Unique

One basic question every VC asks is, Why is this situation special? Every investor knows that in the business world, big businesses "beat up" little businesses. Therefore, if a small business is to survive, it must have something special, such as a patent, a proprietary process, a two-year lead time on the competition, or a good location (for example, in the case of a restaurant). What does the small business bring to the marketplace that will make people want to buy its product or service? The business must have something unique if it wants to win in the competitive environment.

At the same time, most VCs have an aversion to products that are *too* unique. The product or service should not be revolutionary; rather, it should be evolutionary. We suspect that most VCs would not have backed Edison's new invention, the electric light bulb, because it was too revolutionary. Revolutionary products change the way human beings live on Earth. As a result, they take many years to gain public acceptance, and the return on investment is stretched out over such a long period of time that the annualized return on investment is too low for most investors. VCs don't want to wait 20–25 years. Their normal time horizon is five to seven years. So the product cannot be revolutionary; it should be a follow-on product.

5. The Proposed Venture Should Be Oriented Toward the Market

Every successful business must take its direction from the marketplace it addresses. Emerson wrote, "If a man can…make a better mousetrap than his neighbor…the world will make a beaten path to his door." Obviously Emerson was not a venture capitalist! Good entrepreneurs do not introduce a product because it is a nifty product. They introduce a product because their analysis of the marketplace shows that a new product will sell and that there is a demand for the product.

Some people praise Henry Ford for creating mass production. He should be given more credit for his market analysis. He believed that the average person would purchase a cheap, stripped-down car if it were available. Instead, most cars were like the high-priced and beautifully made Stanley Steamer or Pierce Arrow. His market analysis concluded that people would buy a low-cost, shaking, rattling, "tin lizzie." That contraption made marketing history. It changed the way we live.

A good entrepreneur starts not with a product idea but with a vision of what the marketplace needs and wants. A market division entrepreneur loves the action of making sales. He or she is not in the lab to create a new product but to find a solution to a problem or to develop a product that people will want. Make sure you back a market-oriented company.

6. The Deal Must Have an Exit

The final element of a business proposition that every investor should look for is the exit. This refers to the way to get one's money back, or how to cash in on the investment. All VCs look at cash flow (sometimes known as EBITDA) and how the money will come back. VCs spend a great deal of time reviewing a business situation to make sure that they will get their money back, as well as turn a good profit. The event when a VC gets the investment back with a big capital gain is called a *liquidity event*.

There are only three basic ways to get your money out of a small business:

1. It can go public (this is one of the most common ways VCs reach liquidity).
2. A business in the same industry (a strategic buyer) or another investor group (a financial buyer) may want to buy the entire business, pay off its debts, and give the existing stockholders a good return on investment.
3. The company can simply buy out the VC by refinancing the company out of cash flow.

Although this last exit is an unusual way for VCs to make money, it happens more often than most VCs will tell you. The point here is this: Make sure there is a way out of the deal (a liquidity event) before you get into an investment.

It's Not an Investment, It's a Partnership

Every person who reads this book, and especially those who intend to put money into a small company, should be absolutely sure that the relationship between you, the investor, and the entrepreneur is a strong partnership—in reality, a "marriage." It must be a trusting relationship in which neither party is trying to get the upper hand. Both parties must be working together to make money. Therefore, every investor should get to know the management of the company before investing any money in it. We usually try to spend extra time with members of the management team so that we feel comfortable with them.

There is the story of the VC who was talking to a group that had three “Doc-in-the-Boxes.” This is slang for a medical delivery system. In place of a Jack-in-the-Box where one goes for a quick meal, you have a Doctor-in-the-Box, which refers to an accessible unit that provides quick, efficient, and cheap medical service. In this case, three individuals owned three Doc-in-the Boxes and wanted a large investment so they could continue to expand. After meeting with them for a full day and after being convinced that the VC should make the investment, the VC joined them for dinner. After a few drinks, they began to tell the VC how they really operated the business.

First they described (in their terms) how they were going to “screw” the IRS and not pay their taxes; then they described how they were going to “screw” their suppliers and not pay them, “screw” Medicare and Medicaid to get higher payments, and “screw” a few of their patients by overcharging them. The VC knew before that dinner was over that if the VC made the investment, someday in the future, one of those “screws” would have the VC’s name on it.

Prepare a Written Summary Before You Begin to Invest

We firmly believe that every investor should prepare a written summary before formally investigating the situation. A summary of one or two pages can crystallize your thinking about why this is such a great investment opportunity. It will also put in a concrete form what you want to discuss with your friends, your banker, your accountant, and others. All of them can help you to determine whether it is a good investment opportunity. After reading this book, you should be able to prepare such a summary. This summary should be a response to the following questions:

What Are You Investing In?

Here you are trying to define the entity that you are investing in. For example, specify whether it is a partnership, a subchapter S company, a limited liability company, or a corporate entity. Also, it's a good idea is to have the name, address, and telephone number of the business. It is also helpful to describe in ten words or less the type of company you are investing in. Describe the industry and describe its stage of development, such as a start-up. Try to pinpoint the kind of business you will be investing in. Often, this information does not appear in a conspicuous place on the proposal. Before you go any further, you should wade through the proposal to understand who and what you will be investing in. This information will also be handy in the future when you want to talk to the company's people.

Who Is Your Contact at the Business?

Many proposals list a number of contact people in the firm, but as an investor you need to know who you will be dealing with directly during the due diligence process and during the monitoring after you have invested in the company. Usually, it is the president of the company, although sometimes the vice president of finance will be your contact. Find out immediately who this person is and make sure you have a clear channel for gathering information from this person. If your initial contact is a broker, you should ask the broker to introduce you to the person who is going to be your contact at the business. Don't let all of the information filter through the broker. Get it from the "horse's mouth."

Summarize the Business Situation

Prepare a thumbnail sketch of the company's situation. Emphasize the strong points that draw you toward this investment. You should be able to do this in one paragraph, perhaps two. But it should be brief, and it should crystallize in your mind the business situation that you are getting involved with. If you cannot do this in a few words, ask yourself whether you really know what you are investing in.

Who Is the Management Team?

Although management is the most important section in the entire analysis, you don't need to cover entire backgrounds of the individuals involved in the investment you are considering. Do hit some of the highlights that make you want to invest, such as the entrepreneurs' experience, past achievements, and "go-power." Make sure you put down the names and the credentials of the top two or three people. You need to highlight in only two or three sentences what aspect of their backgrounds sets them apart from other management teams that you have seen and why their backgrounds are pertinent to this investment situation. Remember, you are investing in a team. If you don't have a good team at the top, it will be hard to win.

What Are They Selling?

In a very brief paragraph, describe the product or service the company is selling. State why the product or service is unique, and if it is not unique, explain why this product or service will succeed over other products and services that are offered by the competitors. You need not discuss the competition in detail, but it is important to differentiate the company in summary form from others in the industry. More than a paragraph here would be too much.

How Much Money Are They Raising and How Much Are You Considering Investing?

Every business proposal tells you how much money its principals are looking for, but the amount should not be expressed in ranges. For example, the business proposal should not say $5 million to $10 million. The company should know how much money it needs to do the job and should state that figure. In addition, you will want to know the type of money that the business is raising. Is it selling common stock, preferred stock, convertible debentures, subordinated debentures, or junior loans with warrants? What structure and format will be used in raising this money? You should know exactly what the deal involves on all levels of the balance sheet.

Is There Any Security for Your Investment?

Every banker looks for collateral when making a loan to a company. Even though you are an investor, your investment can be in the form of debt with collateral security (sometimes referred to as *second liens*). You may take a second mortgage on the assets of the business or you might have outside collateral, such as a mortgage on the person's house. Venture capital takes many forms, but whatever the form, your prime consideration should be how to lower your risk. Collateral is one way to lower your risk. However, most VCs who invest using stock, options, and warrants are the farthest down on the balance sheet and usually never see any type of collateral, which is why they demand such high returns.

How Will the Money Be Used?

The proposed use of proceeds is not always set out in great detail in the business plans. However, after investigating and discussing these plans with the entrepreneur, you should have a good idea of how he or she is going to spend the money. You should be able to state in one short paragraph where the money is going. You should not have to use such broad terms as *working capital*, but should be able to specify where the funds are to be used. A detailed explanation of sources and uses is essential.

What Is the Past Financial Performance?

In this section, you want to summarize the sales, earnings, assets, liabilities, and net worth of the company. In three or four columns, you should be able to sketch out where the company has been and what kinds of trends it is setting. You may be surprised by what you can learn by dredging through the business plan and placing these items in your summary.

What Are the Projections?

As a VC taking a long-range view of the situation, you should look at the five-year projections for the company. Even though the fifth year is highly speculative, it gives you a clear idea of how the company will grow and, in essence, how much money you stand to make if it meets the projected goals. Without a summary projection in the same format as the financial history, you will not be able to develop a basic understanding of the company.

A word from the wise: Always make your own projections and do it with your own model. We know how easy it is to use someone else's model, but don't. Building your own model will give you much deeper insights into the business than you can ever get from reviewing someone else's model. You need to look at the business from your own perspective.

How Will You Cash Out?

As we mentioned before, no venture capital company wants to remain a stockholder in a company forever. Every VC must realize the capital gains on the fund's investment in the business. Even though your horizon may be three to seven years, you must have a clear perception of how you are going to get out of the investment before you go into it. You should be able to state in three or four sentences how you plan to get out of this situation.

How Much Can You Make?

The expected profit is the final test of a promising business proposal. If you own a certain percentage of the company, what will it be worth when you cash it in? We like to set out in a tabular format the cash that we will be expected to be put into the company over the next seven years and the cash that we can expect to receive back. This format enables us to summarize clearly the cash in and cash out. There are probably a thousand ways to determine this, but we use a calculator that gives us internal rate of return. If a company can't show a strong internal rate of return and the situation entails all of the typical risks of a venture capital investment, it doesn't deserve any more of your time.

What Do You Like About This Situation?

List in point form three to five reasons for making the investment. What is it that you like about the situation and is compelling you to invest? If you can't express it now, you probably will never be able to do so.

What Do You Dislike About This Situation?

No investment opportunity is perfect. Every one of them seems to have some "warts." You should be able to explain those dislikes in three or four lines. You should know exactly what you don't like about the situation. If it goes bad, you will know what to avoid in the future.

What Does A Summary Look Like?

What follows is a useful summary format. This format is a composite of many that we have seen. The figures are based on an actual investment, but the numbers and names of the people involved have been changed. The investment made a tremendous amount of money for everyone.

Company

Electronic Press, Inc.

8888 Avenue of the Americas

New York, NY 10005

Telephone: (212) 555-1212

Contact: JB Entrepreneur, President

Type of Business

Online preparation of camera-ready copy and printing of materials requiring quick turnaround.

Company Summary

A new company has been formed to purchase the assets of an ailing printing company. The existing company is a quick-turnaround, standard printing company for company documents. The company's team will write computer programs to receive standard formatted information over the Internet and convert it to the format for printing. Then it will be sent back to the customer in camera-ready copy, ready for editing. This will continue back and forth until the customer is ready to print.

All existing customers will be serviced with the current business people until the new system is ready.

Management. JB Entrepreneur, president, has been in printing for 12 years. JB has worked in all phases of the business and has been working with computer programs to do this job for the past year. JB has a BA in accounting from a university in New York. JB is 32 years old.

Jim Operator, vice president and COO, has been in the computer field for eight years. He has been a programmer, systems analyst, and management consultant on computer applications. He has been working on a computer program to set type for one year. He has an engineering degree from a large Boston college. He is 31 years old.

As far as product/service and competition, Electronic Press will be continuing to offer conventional typesets and printing. Once the computer can be used to set type, the company will offer the customer five-hour turnaround or better for typesetting and printing. Customers can use the actual camera-ready copy for corrections and make corrections quickly.

Janet Accountant, vice president and CFO, has been with the company for six years and is responsible for the financial planning side of the business. She is a CPA and is age 28.

Funds Requested. $10 million in common stock for a 40 percent ownership.

Collateral. None.

Use of Proceeds. $2 million for new inventory purchases, $2 million to pay off accounts payable, and $6 million to carry the company's research and development budget to develop the computer program. The purchase price of the business is $16 million (or 6 × earnings before interest, taxes, depreciation, and amortization [EBITDA]): $2 million in cash; $4 million in a five-year, 8 percent note; and $10 million in equity.

Financial History.

Item	Actual 2 Years Ago ($)	Actual 1 Year Ago ($)	Actual Last Year ($)
Revenue	5,109,000	9,989,400	12,460,500
Net Loss	(70,000)	(43,100)	(11,600)
Assets	5,279,000	7,700,000	9,870,000
Liabilities	4,238,000	6,420,000	8,601,000
Net Worth	1,041,000	1,280,000	1,269,000

Financial Projections.

Item	Projected This Year ($)	Projected Next Year ($)	Projected 2 Years Out ($)
Revenue	18,000,000	26,000,000	42,000,000
Net Income	10,000	1,600,000	5,000,000
Assets	12,000,000	18,000,000	22,000,000
Liabilities	1,000,000	4,000,000	3,000,000
Net Worth	11,000,000	14,000,000	19,000,000

Exit. The company will go public in three years. If the company does not go public in five years, the investors can exchange their ownership for three times their investment and be paid out over three years.

A Second Summary

To give you more food for thought, here is a second summary (again, the information is disguised).

Company

TT5 Corporation
123 Main Street
McLean, Virginia 22101
Telephone: (703) 555-1212
Contact: JB Entrepreneur, Chairman

Type of Business

Manufacturer of switching gear for telephone equipment.

Company Summary

TT5 Corporation was founded three years ago by JB Entrepreneur, an individual with seven years' experience in the communication and switching-gear industry. The company's first product was a multipurpose switching unit attached to telephone systems that permits the buyer of the unit to use several low-cost telephone services. The company will reach profitability in one year, and estimates show that it will be very profitable in three years.

Management. JB Entrepreneur, with seven years' experience in manufacturing PBX and related equipment, founded the company and has served as president. He previously worked for a large communications network conglomerate and several other corporations in the communications field. He is a graduate of a

Boston technological university with a degree in electrical engineering and is 32 years old.

Joe Operator, vice president and COO, has been with the company for one year. He has 17 years of experience in the field of telephone equipment for businesses and related equipment. He has written two books on the subject and has been granted six patents for work in telecommunications. Currently, he guides the company in all of its marketing operations. He has an MBA degree from a large university in Maryland.

Jane Accountant, vice president and CFO, has been with the company for two years and has a work history in communications. She worked for two public companies for a total of six years and is a CPA.

Product/Service and Competition. TT5 Corporation manufactures a unique electrical switching box that can be adapted to all forms of PBX and telephone equipment. At present, no companies other than TT5 Corporation are in the business of manufacturing these add-on communication boxes. It is doubtful that anyone will enter the business in the next two years. If competitors do enter, TT5's patents should give it a monopoly on certain types of installations.

Funds Requested. $15 million convertible subordinated debentures at 13 percent cash interest; 5 percent noncash and convertible into 20 percent ownership of the company.

Collateral. Second secured interest in the assets of the business, subordinated to a local bank debt of $35 million.

Use of Proceeds. The company has currently outstripped its line of working capital at the bank, and its low equity base prevents the bank from increasing the line of credit beyond the current status. Initially, the company will use the $15 million to pay down the bank loan and negotiate a larger line of credit ($50 million) with the bank so that more working capital will be available to the company.

Financial History.

Item	Actual 2 Years Ago ($)	Actual 1 Year Ago ($)	Actual Last Year ($)
Revenue	100,000	450,000	2,450,000
Net Loss	(226,000)	(443,100)	(62,600)
Assets	443,000	1,002,000	10,200,000
Liabilities	232,000	1,402,000	9,876,000
Net Worth	211,000	(400,000)	324,000

Financial Projections.

Item	Projected This Year ($)	Projected Next Year ($)	Projected 2 Years Out ($)
Revenue	8,000,000	26,000,000	82,000,000
Net Income	1,000,000	3,600,000	15,000,000
Assets	19,000,000	28,000,000	32,000,000
Liabilities	15,000,000	23,000,000	23,000,000
Net Worth	4,000,000	5,000,000	9,000,000

Exit. The company will attempt a public offering on the basis of earnings in three years. If there is no public market and no prospect for a public market in the near future, the company will offer to buy back the stock owned by the fund.

What Makes It Exciting?

There are three reasons why such summaries excite the VC. First, the product is unique. As mentioned, the product is manufactured only by this company, and there appears to be no potential competition on the horizon. The second bit of information that is music to the VC's ears is the fact that the individuals have had previous experience in this area, as well as long experience in the industry. This background usually makes the VC more comfortable about the operation and about the prospects for the future. The crowning touch is the financial projections.

Not only has the company turned the corner from its actual financial statements, but it is now projecting strong earnings. Obviously, the VC will be led to believe that, in the years ahead, the company will go public or be sold to a large company. When the public offering occurs, the investor (as well as the entrepreneurs) will reap huge capital gains.

Whether or not you wish to use the format suggested here, you must try to summarize and crystallize your thoughts about why you are making this investment. If some nonmonetary items begin to creep into your thinking, it is the first sign that you are making a mistake.

For example, if you are making the investment to help a friend, why not just help him or her find a bank loan instead? Are you making the investment so that you will be famous and be recognized as the person who backed this great investment? You may turn out to be famous for backing a crazy idea that failed. Are you making the investment because the entrepreneur is the same race, religion, or sex? These are very poor barometers for success. Are you making the investment for some social goal? Why not make a cash gift to some charity instead? That will look better than an investment in a failed company. Are you investing so you can be on the board of directors? Being on the board of directors will carry some substantial liabilities beyond your investment—you might find out one day that the IRS is looking to the directors for past-due payroll taxes.

Finally, if you are making the investment because you will get some free merchandise, it would be much cheaper to go out and buy the products you want. Too many people have ended up losing a great deal of money this way, and the product has turned out to be far from free. In your summary, you should keep coming back to the key points; that is, good management, good profit potential, unique product or service, and great exit opportunity. If these things keep popping into your mind while you are writing the summary, you are on the right track.

Once you have finished your summary, you should show it to a few friends and let them read it. An accountant should definitely look at it, and so should your banker. Both are very conservative people and would probably advise you not to invest, but make sure they understand what you see in the business and why you are interested. If your summary churns up their desire to invest in the business, you know you are on the right trail.

Some Words about Franchising

Just because someone is starting a franchise that at first glance looks like the next great fast-food concept in your area, don't automatically jump at the idea. Franchising is just another means of operating a business. Before you invest in a franchise, you have to be sure that some very important characteristics are present.

Sound Concept

When you look into the history of a franchise, investigate the uniform franchise agreement that it must file in many of the states. In that filing, you will find the failure rate of the franchisor. If you discover that the number of failures exceeds 3 percent, the franchise that you are about to invest in is above the national average. You may want to read the entire uniform disclosure agreement to learn about the franchisor.

Well-Financed Franchisor

One of the things that you will be looking for when you review the uniform disclosure agreement is the financial statement of the franchisor. If the franchisor is not well financed and is living hand-to-mouth, it is not going to be able to give your franchisee a great deal of help. Study the franchisor as well as you do your franchisee. Unless the franchisor has the wherewithal to give a great deal of assistance to your franchisee, in all probability, the franchisee that you are investing in will fail.

How Does the Franchisor Make Money?

Every franchisor has an orientation in one direction or another toward the franchisee. By this we mean that the franchisor is either trying to make a great deal of money out of the franchising fee or it is content to break even on the franchise fee and make its long-term money on the royalties. It is by far better to select a franchisor that is oriented toward long-term royalty payments than one who is betting on a quick up-front fee from the franchisee. The franchise fee should not exceed the amount of the service that is being given to the franchisee. In good franchisor relationships, the franchisor charges a fee sufficient to cover its expenses for delivering the training and other assistance to the franchisee.

Good Relations

You may want to call a large number of the franchisees of the franchisor in question to see whether they are happy with their relationship with the franchisor. If after a few phone calls you find a group of unhappy franchisees, you may want to invest elsewhere. If the chain of franchisees is unhappy with their franchisor, in all probability, your franchise is not worth what you are being charged.

Summary—Quick Standards of Venture Capital Investing

Using some simple standards can help you make a quick decision to go forward or say no. People use various "quick-look" criteria when making decisions about venture capital investing. Although everybody has his or her own ideas about what to look for, here is some sound advice from individuals in the business:

1. Look for people who are hard-working and honest.
2. Look for a growth industry with strong growth opportunities.
3. Make sure the company has an adequate capital base.

Those three simple rules have helped us sort through hundreds of proposals and work on opportunities that make a great deal of money. If it passes this quick screening, move on to the next four criteria that the opportunity must pass.

First, is there a barrier to entry in the business? That is, each company has some kind of unique product or placement in the market that others are unable to have. It may be a proprietary situation or a patent. Each business has a competitive advantage, and you need to know how the business will defend its market.

Second, is the company leverageable? That is, the company is able to borrow money on the assets of the business so that it need not have an inordinate amount of equity capital in the business. Leverage is like buying stock on margin. You put up only part of the equity and the rest you borrow on the assets of the business. If a business is so risky that it cannot borrow money, it will have to use equity to grow. This is an expensive way to grow a business. At some point, it needs to be able to tap into the debt financing market.

Third, is the venture repeatable? That is, if you have only one location or one situation in which this business opportunity works, it is basically a one-time shot. Major venture capital firms look for things that can be done over and over again as a basis for a business. Repetition is a key trait of a good business. This concept has also led many VCs to conduct "roll ups" or "buy-and-build" strategies that we will mention later in the book.

Fourth, is the venture able to generate internal capital? The profits of a company must be great and its tax rate low if it is to generate its own capital to grow.

So, look at the cash flow being generated by the company. If it is strong, you probably have a winner. And if you are banking on a "growth" story, its ability to generate cash in the near future is essential.

These criteria are the keys to success. The harder you work at analyzing and learning as much as possible about your investment opportunity and the industry it operates in, the easier it will be to identify the keys to success in the investment.

Chapters 2–7 of this book explain in further detail the due diligence process of investigating a business. Obviously, investigating a new idea for a business is entirely different from investigating a business that is already thriving and needs growth capital. Do remember that you will have to adjust the questions you ask to the stage of development of the business in question.