INVESTING IN PRIVATE BUSINESSES

01 OVERVIEW

Private Equity is a popular source of financing for start-up ventures and businesses who want to avoid the red tape, regulatory burden, disclosure and costs associated with public markets. Accordingly, companies who do not generate enough internal cash from their operations will look to friends, family, and other external contacts to raise capital to fund their organization's growth. This can be a great opportunity for an investor to earn an extraordinary return by becoming involved with businesses at an early stage. While returns have traditionally outpaced those found in public markets, there are many additional factors to keep in mind before becoming an investor.

02 WHAT WILL YOU OWN AND HOW DO YOU GET PAID?

Traditionally, companies have the option of raising debt, a loan secured by cash flows and/or assets of the business; or, equity, which is proportional ownership of a corporation. However, there are no shortage of options which combine some aspects of the two. An investor needs to understand what they own in exchange for their money. Do you have a claim on any assets that can be sold in bankruptcy? Will you receive a regular income stream with limited opportunity for upside? Do you own equity with no downside protection but the potential to be richly rewarded for successful performance?

03 YOU ARE INVESTING IN MANAGEMENT

No matter how great the idea is, success will be determined by management's ability to execute. The road to success is littered with the shattered bones of incompetent management teams. To bring an idea from concept to profit takes a level of planning, focus, and execution that is often underappreciated. There are unlimited number of causes for failure, from under-estimating costs to over-estimating sales, and everything in between. That means that constant engagement with the entrepreneurs is essential to ensure that management is on-track and that they are responsible stewards of capital.

04 READ THE FINE PRINT

If a reputable company is pursuing equity funding, they should be able to provide a business plan, a pitch deck, financial statements, capitalization table, share subscription agreement and shareholders' agreement. The company should also make available its articles of incorporation and its set of bylaws. The roles and responsibilities of both the investor and investee need to be documented in advance of any money changing hands. In addition, some important features include the term of the deal (set-term or indefinite), exit strategy, liquidity provisions, payback structure, dilution protection, voting rights and the rights of other shareholders in relation to your share class.

05 KNOW YOUR RISKS

Investing in a small business is extremely risky. The investor should be prepared to lose everything. The fact that you are being contacted implies that the company does not have the cash flow to sustain their business. Also, it likely means that the organization has been turned down by other sources of capital. Always ask the question, "why me?". Investors are approached for their specialized knowledge or their chequebook. Investors in private businesses also sacrifice liquidity – there is no 'open market' through which shares can be traded for cash. Therefore, if you think you will need your capital in the near term, you will likely be out of luck. In fact, most business owners consider access to capital their biggest burden — so, you should expect to be asked to put more in before you get any out.