

How The Rich Get Richer With Quiet Private Investments

By David A. Kekich

How to spot the next Microsoft before Wall Street discovers it... and how to invest in it at founders' prices!

The book that shows you overnight, the proven step-by-step success formula of how to avoid mistakes and disasters - while investing like a venture capital pro.

Inside, David Kekich reveals...

- **Where to uncover the very best private investment opportunities!**
- **What you need to know about the 15 characteristics of the absolutely perfect deal!**
- **How one simple phone call can save you weeks of work and hundreds of thousands of dollars!**
- **A comprehensive list of 23 red flags which could signal trouble ahead!**
- **The 7 crucial key marketing questions you must ask before investing in any deal!**
- **Lawyers: When they can help you and how they can hurt you... even your own lawyer!**
- **The single most important management function in every early-stage company... and how to make certain it succeeds!**
- **How to turn your "paper profits" into cold, hard cash!**
- **9 good reasons to walk away from a deal - no matter how good it looks!**
- **The eight critical questions you must ask every potential partner before you invest a dime!**
- **An unusual, almost totally unknown tool which can make your investment decisions automatic!**
- **The 7 most important traits to look for when evaluating management!**
- **... and much more!**

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By David A. Kekich

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PREFACE

Imagine the chance to discover and work with the most creative minds on the planet. Imagine the possibility of discovering the next Bill Gates. Imagine the opportunity to profit along side of him from day one.

Welcome to the exciting and profitable world of venture capital. Unknown to the general investing public, private investing is exactly how the really big money is made in America.

Most people never even think about investing in private companies. Most of what we hear and read about are listed stocks, bonds, mutual funds, hard assets and real estate. But a select few think differently. I know. I'm one of them. And there are others you heard of, including Bill Gates, Warren Buffet and George Soros. They're all billionaires. And they're all invested in the private market. In fact, just about every self-made multimillionaire (and billionaire) you read about in the financial press owes at least part of his success to private market investing.

Do they know something you don't? Not after you read this book.

Over the past several years, I had the good fortune to be involved in some extraordinary venture capital projects. One, Hauser Chemical Research, Inc., paid some of our original investors who didn't yield to the temptation of taking early profits... a 6150% return! That's an amazing 61.5 times their money!

One of my all-time favorites is Dycon Corp. The investment was completed in 1993, and commercial operations should have started years ago. I predicted it would be one of the top 5% venture capital deals of all time. Dycon owns a mining technology, which could revolutionize the industry. But as of today, they're stagnant. The entrepreneur is a wonderful man, a wonderful Inventor but not a wonderful businessman. I mention Dycon, because it's an example of a potentially spectacular investment that went bad due to violating some of the rules you'll learn in this book. It's not dead yet, but It's not hopeful either.

But another winner was Microterra. Like Hauser, they went public. And their stock soared from 10¢ per share in 1991 to a high of over \$3 for a long time before gradually backing off. Investors made over 3000% profit (over 30 times their money). Microterra was in the environmental business and was subsequently taken over by another company.

And, we have Vivante Internationale. Investors paid 25¢ per share in 1989. It hit a high of \$3 1/2 per share less than two years later. This showed a juicy 1250% return on public stock. Vivante developed and licensed skin care and wound injury products.

Another one that hasn't taken off is Automated International. Great company, good leadership, excellent products and technology, but they haven't blossomed yet. Some big competitors are making things a little rough on them, but they're still holding their own, waiting to "crack the code".

These are just some examples of my deals, good and bad, that investors took advantage of at their raw beginnings.

And now I'm consulting with some companies with even more potential than the winners... and hopefully less risk than the losers. They're pretty much limited to the life extension niche of the biotech industry and related industries. Why? Because the anti-aging sector of the health care industry alone is projected to be a one TRILLION dollar industry by 2010. When you invest, follow the baby boomers money.

Venture Capital Perspectives

Some popular investments you heard of are Snapple and Apple Computer. Did you know almost every investor who bought Snapple stock after it went public lost money? But a small investment group who invested in *pre-public* stock made over \$1 billion! One rich man invested \$20,000 into Apple Computer at its start up stage. He wasn't rich then, but his \$20,000 turned into a hefty \$200 million. Many hi techs boast similar success stories, in spite of recent market downturns. Ditto for some of the recent hot biotechs. In my opinion, biotechs are the place to be in the near future. Also keep an eye on nanotechnology.

So as you can see, the possibilities are endless. It's just a matter of uncovering the opportunities with the most potential, separating the real ones from the fantasies and then determining which of the remainder are run by good solid people. This takes a lot of hard work (not necessarily by you), but just one successful deal can change your life forever.

This business isn't so different from some you're familiar with. Everybody knows about the difference between wholesale and retail when he shops. Hardly anyone understands the same difference could apply to investments. When you invest in an early stage private business, you invest at the wholesale level. That's where the bargains are... where you get them at rock bottom prices, long before the public ever finds out about them. Also, you're not relying on market cycles to make you money. You're in position to ride the first one... from the ground floor. You just have to shop for the best bargains... or have someone you trust shop for you. Since venture capital is usually a long-term proposition, good or bad economic times aren't as important. You invest in value.

But most so-called investment experts avoid discussing private investing. This is because it's a tough business. It takes more than just a quick look at financials. It's also a personal long-term business. It rewards those who get involved. Finally, there's no central clearing house or exchange to track companies. So it's no wonder the mainstream financial publications rarely cover private investing. According to a recent study, 9 investors out of 10 never even considered venture capital investing. They just don't understand how lucrative and safe private investing can be. It can be safe; because you can get to personally know and work with the company you're investing in. You can't usually do that with publicly traded stocks... nor with corporate bonds.

The closer you get to a company, the more your potential and the less your risk. The company's profit potential is like a shining star. The closer you get to its core, the hotter and brighter the light. The further away, the weaker and colder. The closer you get to the core of a company (buying in at the ground floor), the greater your upside potential.

You're an insider. You provide capital when it's most needed. When growing companies need capital, they *really* need it. And insiders usually get the best deals because they're in a position to *demand* the best deals too. Everyone after them generally doesn't do as well, because they're paying the insiders as well as the founders. In most cases, it doesn't pay to buy stock after it has gone public. The big profits are already

taken. By the time the official story's told in the press, the inside money's already been made.

Here's another way of looking at it. When you invest in a public company, its stock already trades at a multiple of its earnings. In emerging growth companies... often 30 times or more. This means a company earning only \$500,000 per year would be sold to the public at an astonishing \$15 million.

Now who in his right mind would pay \$15 million for a company earning only \$500,000? No one. Especially when you have a more sensible option. Why would you take 30 long years just to get your money back? But when brokers sell investors stock in public companies, that's just what they pay. Often more. And they do it day in and day out.

But while all this happens, private investors take stock in similar companies (and probably in those same companies before the IPO) at 10 cents or less on the dollar. Yes, the typical stock market investor pays \$15 million for the same company the venture capital investor would pay less than \$1,500,000 for. Since the private investor normally buys only a percentage of the company, lets assume he pays \$500,000 for 1/3 interest (or more after negotiations).

In this example, all you have to do is sell 10% of your original investment in the initial public market to recoup your entire investment. The stock will eventually settle into a logical trading range. Then, normal growth makes the private investors rich. An additional 15% per year is worth almost one and a half times (or more) your original investment if you still hold your remaining shares. Your original \$500,000 investment is now worth \$5-8 million. And all in the space of a few years. These numbers are realistic and even conservative for many successful deals.

So there are essentially two levels of stock investment. One is public investing. It's well known and usually only modestly profitable over the long term. The other is relatively unknown and can be wildly profitable... successful private investing. Public markets make brokers rich. Private markets make Angels rich. Only after they invest in private markets, do they take their companies public. It's a deliberate strategy. And it works. Buy in the private markets and sell to the public for big profits.

I promise you, once you get used to smart "insider" investing, you'll favor it over "outsider" investing every chance you get.

Now here's the really good news. 90% of seed and start-up companies in the U.S. are funded privately. Professional venture capital companies got very conservative, funding mostly later stage companies. Also, they often ignore deals under \$2-3 million. And that's just where some of the best opportunities lie.

Now let's say you have investment capital of \$1 million. What if you invested it all in conventional instruments and had above average success - 8% compounded annually. In 20 years, you'd have \$4,660,957. But what if you left \$700,000 in conventional instruments and put the other \$300,000 into private deals at an average 25% compounded return? (Most professionals target 40-60%.) Over the same 20 years, you'd have over \$29 MILLION. Quite a difference, isn't it? Your upside could be even higher. Much higher. And your downside, assuming every single private investment you made returned absolutely nothing (This book will show you why that's hardly likely.) is only - 30%... compared to an upside of over 2900%.

Some Personal History

Since 1982, I've been evaluating private and public venture investments, making money, losing money and learning quite a bit about this fascinating business along the way. In looking back, it seems I learned very little from my winners. 90% of my lessons came from the losers. When you learn a lesson hard, you learn it well. This book can save you the expense and agony of learning the hard way.

I got started in this business by reestablishing an old college friendship. In 1979, I lost a lucrative financial services business due to a severe personal injury. It was the largest life insurance marketing general agency in the United States. Since I had some discretionary dollars to invest, I threw lots of them, indiscriminately, at whichever recommendation my friend made. He was a stockbroker and trader in the highflying and very risky penny stock industry. He was successful, moderately wealthy and a good friend. So, I relied on him to decide which investments were worthwhile. Since he was one of the world's biggest optimists, this included everything that crossed his desk. They ranged from initial public stock offerings, private placements, limited partnerships and freely traded Over The Counter stocks.

Well, painful lesson number one was there is no lazy man's way to riches - at least not in the investment world. You can only rely on someone else's recommendations to a certain point. After that, it takes a lot of brain sweating personal due diligence and discipline. Although his recommendations cost me a bundle, they did reacquaint me with one of my most trustworthy and proven friends, "self-reliance". I solidified my resolve to rely on my own strength rather than someone else's compassion. Nothing works as well as self-reliance. And nothing is as satisfying.

Prior to my unforeseen change in careers, my primary vocations were real estate investment and sales and insurance. I was a real estate and insurance broker before founding what evolved into the country's largest life insurance master general agency - a marketing arm for Executive Life Insurance Company, long before their junk bond related downfall.

Since my real estate investments were profitable and time consuming, I never had the time, need nor desire to become proficient in alternative investments. So, I was a novice when I entered the equities investment arena. My combination of ego, money and ignorance was like a mixture of fire and gasoline. My portfolio was just waiting to blow up in my face. And it did!

Finally though, I did start to learn some more lessons. One was you don't make any money in penny stocks when brokers get 10% commissions and when spreads can be 10-100%. Only the brokers and traders make the money. That's why my friend was so well off. The other thing I noticed was the underlying entrepreneurs and angel investors often made fortunes. Even though the small investors often lost money, the founders and first stage investors of even moderately successful start-up companies did very well. The entrepreneurs were also a pleasure to work with in most cases, since they were generally persons of vision, energy, ambition and integrity. At least the good ones were.

Also, I had a certain kindred bond with and empathy for entrepreneurs, because I used to be one of them. Since my physical limitations kept me from rejoining their ranks, at least in the fashion I was used to, I searched for a way to work with them. My first attempt was as a founder and principal of a "blind pool".

A blind pool was a "blank check" public offering, usually on a penny stock exchange. The public invested money in our companies - without any idea of what we were going to do with it - other than to find a private company that we would decide to fund in exchange for stock. This is where I got my introduction to screening and evaluating private companies for venture capital investments.

My initial success was mixed. Of three blind pool mergers, one was a complete loss; one was a moderately big success, and the other a phenomenal success.

The phenomenal success showed an industry shaking return to the original investors in the public offering. What did I learn from this one? Mainly that, venture capital investments have a lot of upside potential.

Where I really learned some lessons though was from the 100% loser. There, I made several mistakes. One was I accepted an incomplete business plan. Another was I accepted at face value, everything the principal represented to me. Third, I was rushed into the deal. Fourth, I heard only what I wanted to hear. Finally, I only checked references superficially. I was a babe in the woods - and got my inevitable shearing. I dealt with a very disreputable character and didn't find it out until it was too late. Detailed background checking would have saved a lot of money, time and pain. The biggest losses in venture investing come from misjudging people... and not necessarily situations.

Then, when tightened regulations effectively eliminated small public stock issues, I focused my attention on raising private venture capital for the backlog of promising early stage companies in need of start-up and growth capital. Over 1.7 million new businesses are started each year in the United States, and many previous sources of financing are no longer available to them.

Venture Capital

Over 90% of seed and start-ups in this country are funded privately. A quarter million "angels" invested in 36,000 private companies - to the tune of \$15.7 billion in 2002. This is almost equal to the money invested by professional venture capitalists.

Investing in early stage private companies offers the investor the highest potential rewards of all equity investments... and with it, risk. This book is designed to reduce your risk. It's a guide and an overview that gives you a solid foundation from which to start your education in this investment arena - or as a refresher to those already experienced in this fascinating field. For more detailed information, I recommend reading the following publications:

- "Venture Capital - The Complete Guide For Investors" by A. David Silver
- "Venture's Financing and Investing in Private Companies" by Arthur Lipper, III
- "Venture Capital Investing" by David Gladstone

This book focuses on investments in four stages of growth: *Seed Investments*, or investments, usually small, in an idea or company, which is not fully developed.

Start-ups, or companies with a fully developed business plan, a prototype, in-place management (or at least identified), no revenues and possibly some initial marketing.

First Stage, which usually have a history of about one year of operations and a fully developed product with test sales. Management investigated how their product is received in the market place, distribution channels have been established, service was established, pricing has been set, the possibility of expanded product uses and markets has been explored, and suppliers have been established. The initial funding is generally depleted, and more is needed for commercial manufacturing, expansion of services and sales.

Second Stage (or Mezzanine) is the period usually 2-3 years after start-up. Sales might be in the \$5 million range, they have growing accounts receivables and inventories and have a goal to increase sales by about four times after debt financing or after a public offering.

The earlier stage your investment, the smaller the investment, the higher the risk and the higher the reward. For example, even though investments in NYSE stocks grew 41 times as much as investments in T-bills from 1925-1987, investments in small company stocks grew 144 times as much as T-Bills. Much bigger profits are possible by investing when they are still select private companies. Maybe 10 times more.

Professional venture capitalists who invest in early stage companies generally have a goal of making 5 times their money in three years or 10 times their money in five years. Or, they seek a 40-60% annual compounded rate of return (and up to 100% for seed investments) until they liquidate the investment. (Returns prior to 2001 have been much higher. Then, the venture capital Industry suffered its first annual losses ever - for three year running now. But it's turning around again, and biotechs are leading the pack.)

Liquidation usually occurs within 3-7 years. Their projected rate of return is usually a function of perceived risk. Private venture capitalists seek rates of return similar to the professionals - but sometimes slightly lower. On average, private venture capitalists are satisfied with past venture capital investments 72% of the time. 85% do not seek voting control, and liquidity usually comes in about four years.

A start-up should pay out in about five years, a first-stage company in maybe three and a second-stage investment in about two years. We have strategies that can give earlier payouts.

On average, seed and start-up investments are the most profitable venture capital investments - even if 25-50% of them are written off. This is where savvy investors can expect 40-50% annual returns over the long term. First stage might yield 30-40% and second stage 25-30%. Goals are generally higher. A "home run" could yield tens or even hundreds of dollars for each dollar invested.

Compared to some recent stock market profits, these numbers may seem conservative. But remember, these are average returns over many years and factoring in good and bad markets. Compare these with 15% average long-term stock market returns. Over 20 years, a \$1 million investment in the stock market at 15% annual gains returns an impressive \$16 million. But compare that with a 35% annual venture capital return. Over...

\$400 million!

Even though you can hit an occasional "home run" with any given early stage investment, venture capital investing is not a get rich quick scheme. You'll have winners,

and you'll have losers. Overall though, if you use common sense, are thorough in your due diligence, stay disciplined and patient, you should enjoy the rates of return earned by the pros.

You should also enjoy some other benefits. With high tax rates and maybe even higher rates on the horizon, your best tax shelter could be long-term capital gains in early stage companies. Long term gains not only give you an excellent deferment, but recent tax laws also give you the advantage of escaping half of the capital gains tax for investments in many early stage companies held for a minimum of five years.

One more note. When you provide venture capital, you "build companies". Since 1979, entrepreneurs accounted for over 30 million new American jobs, while Fortune 500 companies shrunk by over 25%. Venture Capital is the backbone and the future of America. And that's what you're ultimately building.

So, good luck. The rest of this book is dedicated to putting the odds on your side in the venture arena. Whether you have \$25,000 or \$25 million to invest, you'll learn how to lower your risks and improve your odds of making a fortune by investing in small early-stage businesses. You'll be introduced to the need-to-know basics of finding, evaluating, valuing and profitably exiting venture capital investments. You can rest assured that by applying the rules you'll learn here, by performing your due diligence, you can cover your downside while enjoying the possibility of making almost unheard of profits.

After reading this book, private investing might seem complex. It's really not. Mainly, it boils down to common sense. You won't need to follow every rule or suggestion featured here. No one does. Not even the best venture capitalists in the world. So don't be intimidated. This book simply gives you a comprehensive guide packed into minimal space. Once you grasp the fundamentals, you'll develop your own style.

Finally, I'd like to thank the following for their valuable contributions to this book and to my life. Dr. Andrew J. Galambos, the biggest influence in my life and career; close behind is Dr. Wallace Ward... founder of Neo-Tech and someone you definitely should know; Carl Oswald, who got me started in the venture capital business; and Arthur Lipper, III, A. David Silver, Stanley E. Pratt, Robert J. Gaston, David Gladstone, Roger Dawson and the U.S. Center For Entrepreneurship, my primary intellectual antecedents for the investment related contents of this book.

I. GENERATING A DEAL FLOW

The first step in venture capital investing is finding quality proposals. If you don't already have a network established which provides you with opportunities, then you can look to certain business attorneys, business associates, friends, brokers, consultants or intermediaries. By relying on someone else to refer pre-screened deals to you, you could save a tremendous amount of time and energy otherwise devoted to evaluating everything you might see advertised or referred by the average middleman. If you don't know the referrer personally - or if you don't have confidence in his expertise, you might consider asking him if he would be willing to invest himself. Or, ask if he has done any due diligence. If he hasn't done any, does he volunteer this information?

It's not usually practical for everyone who refers deals to do their own due diligence. When I was an intermediary, I used to see over 400 pre-qualified business plans or proposals each year. Even after eliminating at least 95% that still left about 20 interesting prospects. (I used roughly the same selection processes professional venture capitalists use.) Then I whittled these down to about four or five pet projects maximum.

I did perform initial due diligence. But since I made it a policy not to require exclusives, and because I didn't take retainers from those clients - and because I paid my own related expenses, it became cost and time prohibitive to perform the detailed due diligence the investor should always perform before investing. Later, I'll give you some guidelines and shortcuts in performing your own. Now, I have the luxury of working with a professional due diligence team.

Since we now work primarily as principals, partners or fund managers for life sciences companies, I'll assist you on any particular opportunity, if you have a serious interest in any of our opportunities or funds. You can be assured these will represent what I feel are the top 1% of the pre-qualified ones we see. We can't afford to work on anything less promising, since most of our profits are directly tied to the long-term success of the enterprise through stock positions.

Even though it pays to build relationships with reliable sources of pre-screened deals, I strongly suggest you use the information in this manual to independently evaluate each particular opportunity.

Your introduction to any venture capital opportunity should be a brief business plan summary from the entrepreneur - or from an intermediary or agent. A well prepared one to three page summary should be all you need to determine whether or not you have an interest in seeing more without wasting more than a few minutes of your time. If you have a continued interest, then you should request a complete business plan.

After studying the plan carefully, working closely with your agent on that proposal is entirely up to you and depends largely on your relationship. This is the time to start working directly with the principal - and the time to start getting to know him or her very well.

However, good intermediaries can be invaluable here too. Besides screening proposals and making introductions, they can often hold your deal together during your negotiations. A good one can help with your due diligence at your request and can give you valuable insights in some of the mechanics of your deal. If you find a good one, establish a close relationship with him or her, so they know and understand all your investment parameters and goals. They can help you accomplish them.

If you decide to invest in venture funds, study the fund managers' track records before investing. Also, see who else invested in the fund. If you see well-known institutions and/or financially sophisticated individuals, you can usually be more comfortable in moving forward.

II. HOW TO READ A BUSINESS PLAN

My first recommendation is, except for the very rare and special situation or for an occasional seed investment; if the entrepreneur doesn't have a complete and well written business plan prepared for you, don't waste another minute on him or her.

What is a good business plan? First, it should be neat and thorough. A good business plan is easy to read. It's easy for you to find your way around it and is the entrepreneur's roadmap to success. It's an indication of his thorough planning. The biggest cause of failure is inadequate planning. It must all be on paper... and easily explained to you.

A complete plan is an indication the entrepreneur has thought through his business. If he can't communicate this to you through his plan, then he probably doesn't understand it himself. He must prove he has done his homework. A good plan is a measure of his discipline. The plan should tell you where he's been, where he's going, how he's going to get there... and how he'll make you a profit. A concise but thorough analysis of every aspect of his business should be carefully documented.

An outline of a complete business plan is included in the Appendix. I strongly suggest you spend some time studying it. Seldom, if ever, will any one plan contain all the recommended ingredients. However, they should all contain the general categories, some in more detail than others, depending on the nature of the business.

The most important and first things to read in the business plan should be read in this order: the summary, proformas, management background and then the product description if you still have an interest. If you have a continued interest, read the rest of the plan.

Study hard and question the Use of Proceeds (and find out how prior investments were spent). Break down Working Capital to be certain management will be adequately capitalized. Under capitalization is usually a deathblow to a young company. It may not be necessary, but be prepared to spend double the projected time and money. On the other hand, make sure there is no fluff. It's your money they're discussing.

See if some of the expenses can be deferred or financed conventionally or creatively.

Critically important to the business plan are clearly identifying the existing and future market needs and the niche in which the company can exist and expand.

Ask yourself if this plan contains a complete recipe for success. If not, is there an internal plan that does? Can the business be cookie cuttered, or duplicated, if the entrepreneur dies or becomes disabled?

Study every plan hard, and question it, bit-by-bit.

III. HOW TO ANALYZE A DEAL

After you obtain a good grasp of the offer and the business, ask yourself the following questions:

1. How much can I make?
2. How much can I lose, and what steps can I take to minimize losses?
3. How do I get my money out?
4. Who says the deal is any good? Who else is in the deal as an investor, principal or customer, etc.? (Who lends credibility?)

The Characteristics of a Perfect Deal

Although it's unlikely you'll find an opportunity, which has all the following characteristics, one that does demonstrate all of them is as close to a perfect deal as you'll ever find. However, every fundable one should have an abundance of the following. Each should be addressed in the business plan, and management should show how they would correct weaknesses.

1. There is an existence of qualified buyers. No education is needed in advertising to the market. The company has a solution to an existing and identified problem. The ideal product will need less than 5% of revenues for its advertising budget. Average is about 3%... but this is usually for mature companies. Early stage or high growth enterprises often have a large portion of their budgets allocated to advertising.
2. Competent management. There is a competent idea man, producer, seller and financial man (one who sees it's all done at a profit). This must be a balanced group. It's rare that one man can wear all the hats. Management must be highly ethical.
3. Homogeneity of buyers.
4. Large number of buyers.
5. Lack of institutional barriers to selling. There are neither regulatory bodies nor large buyers' associations to contend with.
6. "Hey, it really works!" phenomenon. This enhances word-of-mouth advertising and free public relations. It should have news value.
7. Optimum price/cost relationship. Gross margin should be at least five times the manufacturing expense. Service industries should show a margin of at least three times the cost of service.
8. The company is relatively invisible. It keeps a low profile to avoid competition. It will not advertise nor publicize until it can deliver in quantity. It positions itself away from competition.
9. The product is disposable or consumable and/or the company has ancillary products or services. Most large fortunes are made from universally demanded off-the-shelf items, which are regularly replaced.
10. An established distribution system.
11. A constant, reliable and varied input supply.
12. The need for very few employees. It must be non-labor intensive or have the ability to reliably sub-contract labor-intensive processes.
13. Little or no customer credit.
14. Lack of technical or fashion obsolescence.
15. Limited liability.

Other Factors

Furthermore, experienced venture capitalists often use five factors when evaluating a company. They are:

1. The potential for long-term profits.
2. Whether the company has the right technology at the right time.
3. The potential for high profits.
4. Complete, well rounded, experienced management teams. (It's usually too late to build a team once one is needed. Plan in advance.)
5. What added value the investor can bring to the company.

Credibility should be established early in the presentation or plan. It can be established by management, customers, and vendors or by endorsements. Any major name or credentials add a lot to the deal and to the salability of the product or service.

The most important aspects of the plan to analyze are:

1. Management. Are they seasoned in this field? Have they worked together in the past? Is it a well-balanced team - or can they fill the gaps?
2. The Marketing Plan. Is there demand-pull for the product or service as opposed to product push? Will they fill a need - and more important - a want? If you're not already familiar with the industry in which you are asked to invest, become familiar with it.
3. The Product or Service.
4. Are the financial projections realistic, and are the assumptions valid?

Above all, do not invest in a product! Invest in a company. It takes a company to build any product and successfully bring it to market. This begins and ends with a strong management team. The technical work of a business and the business that does the work are two different things. The eventual team must be integrated and balanced in all areas. It's easy to be dazzled by a product without a strong company to back it up. If you do fall in love with a product though, that isn't backed up by a capable company (existing or start-up), be prepared to assume the responsibility and the commitment of forming the company yourself.

And proven current markets with a niche or an edge with current products are consistently more profitable than new products to new markets. If you have a new product, try to marry it to an existing market, such as popular chain stores or proven distribution channels. If the company doesn't have the connections, get them. It's more critical to move to a current market status from new market status than to a current product status from a new product status. Current markets give you credibility. Buy it if you don't have it.

Also, being product or service superior is usually more important than being lower priced than the competition.

In addition, look for a proprietary position the product or service enjoys or its uniqueness in the marketplace. Whether or not patents or copyrights protect the product or idea, it's vital to get a one-year or more head start or jump on the competition. Then have plans built into the business plan to keep making improvements that will keep the gap between the company and competition.

Often, trade secrets offer more protection than a patent, which discloses the technology to the whole world.

Strategies and Questions

Since most of the deals you'll consider should have some proprietary concept, it's important to be able to effectively evaluate new, unproven technologies. The following steps will put you in a position to move forward with a technologically viable deal:

1. Have a patent attorney determine the defensibility of the patent (if any). Try to get the entrepreneur to pay for this if possible.
2. Get a feasibility study done from an engineering firm for building the product if it's not yet built.
3. Have a manufacturing company in a related field determine the cost of manufacturing the product in quantity if not already determined.
4. Have potential customers review the product to determine their interest in possibly buying the product - or using it on a test basis.
5. Negotiate to share in the ownership of the technology.
6. Build and sell the device on a test basis prior to full production.

Before spending time and money on the technology, first determine if there's a market for it. And if so, how big is it? Is it growing rapidly? And is there room for your product without too much established competition? If the entrepreneur tells you there's no competition, maybe that's a clue there's no market. Never, ever, ever try to force a technology on a market that doesn't exist. Never try to educate a market unless you have very deep pockets, have a marketing genius working with you, have a valid marketing test and have lots and lots of time before you hope to see a return on your investment. An evolutionary product will have an established market. A revolutionary one most likely won't.

The successful commercialization of a new technology typically depends more on demand-pull than on technology push. Find a need and fill it. And even more important - find a want and meet it. Ask: "What exactly will be sold - and to whom?" Other key market questions are:

1. Why will the consumer buy this product?
2. Who are the ultimate users, and what major influences on their purchasing habits are beyond the company's control?
3. Who will be the competition? Are they profitable now? Why can the company successfully compete with them?
4. Is the market large and growing? Does it have multi-million dollar potential?
5. Will this be in a recognized growth industry rather than in a new industry?
6. Is there really "nothing like this on the market today" if claimed? Make sure.

Then, you should ask other questions about marketing, operations and finance that should be addressed in the business plan such as:

1. How many dollars and months are needed to ready the product for market?
2. What is the depth of the team's knowledge and extent of their track records in the markets, technologies and types of operation in this field?
3. What are the team's management skills in the three key areas of marketing, finance and operations?

4. How many unproven technical, manufacturing and marketing approaches do you contemplate?
5. What are the strengths, weaknesses and major risks of the venture?

When answering these questions, be aware everything in the business is interrelated. For example, make sure operations can keep up with marketing. Be sure to build time and financial cushions into the projections. Don't be surprised if mistakes in time are up to 100%. This is where PERT chart analysis can be an important management tool.

Reading Proformas

One of the most important components to analyze in a proposal is the set of financial projections:

- ?? Are they believable?
- ?? Why will revenues increase to various levels (Is the marketing plan carefully explained)?
- ?? The steeper the earnings ramp, the more money is usually needed at the base. Is the amount of money requested too high? Too low?
- ?? What's wrong with this deal if only a small initial investment will produce gargantuan profits in a short time?
- ?? Are all assumptions carefully substantiated?
- ?? How about basic ratios? Are they in line with industry averages?
- ?? How sensitive are the proformas to changes in key assumptions?

When doing your analysis, concentrate on the cash flow. Make sure the investment and revenue dollars are allocated properly. Will you, or someone else, have to put in more money? If so, who, how much and when? If you'll have to put in more, what will you get in return? Will it be debt, equity, etc? Get hard answers to these questions before going into the deal. Make sure you have contingency plans.

Then, do a profit margin analysis. Can the company sell the product at a profit? How much at each sales level? Why? Be accurate and realistic. Profit margins of most U.S. companies are about six percent.

Determine margins for the particular industry in which you are considering investing. Ratios and performance levels of publicly traded companies in the same industry are readily available from company Profile sections at <http://finance.yahoo.com> or are easily extrapolated from the financials in their annual reports. If there is a big deviation from the norm, find out exactly why. Is the company planning on pricing at a steep discount? Generally, they're better off pricing aggressively. Pricing is one of the most important management decisions. Determine how and why the pricing was established.

If your cash flow forecasts and profit and loss forecasts are done accurately, and if they match the PERT chart (if any), then it's simple to determine all your margins at various sales levels.

Finally, how quickly does the company plan to grow? If it's a start-up, slow initial growth to lessen mistakes. Minimizing the impact of mistakes is more prudent than explosive growth. If a solid foundation does not already exist, build one.

Some companies you might want to stay away from are small new conglomerates (they usually don't work) and service start-ups. Let a service company prove itself first, and

make sure its success doesn't depend on one individual. And remember, businesses that sell to businesses are much more likely to succeed than businesses that sell to consumers.

Although your final analysis will be mostly subjective, I had an interesting analytical tool passed on to me, which attempts to make your investment decision objective. It's called a "Decision Tree Analysis", and it did help me decide on one investment. This could be very helpful to you, but only if you're realistic in your inputs and evaluations of each component. Although it was designed particularly for technology-based deals, the general concept can be applied to any venture investment. It works like this:

The first decision of three asks: "Is this a good business in which anyone should be involved?" Six critical factors define the basic business attractiveness of the opportunity. If the answer is "yes", the second question is: "Is this a business in which the company has the competence to compete?" Another six critical factors define the Business Fit Factors that are required for commercial success. If the answer is still "yes", then the final question is: "What is the best method for investment?" Can it be done with a joint venture, loan, equity investment, etc. (see Chapter VIII)

Regression analysis involving a study of hundreds of projects identified six critical factors in each of the first two categories that are important in defining the commercial potential of any given opportunity.

If nothing else, this section should give you some idea of the type of questions you should ask in analyzing any proposal.

Business Attractiveness Factors

Rate each of these factors on a scale of 0-10:

1. Sales Profit Potential. Does this opportunity have a minimum sales/profit potential that has your interest? If "no", abandon.
2. Political/Social Constraints. Are there political, social, antitrust, regulatory or other constraints that make it illegal or unethical? If "yes", abandon.
3. Growth Potential. Is this a growth, static or an obsolescing/declining business?
4. Competitor Analysis. What is the competitive situation in this business area?
 - a. Is the business protected by strong patents, copyrights, trade secrets, a head start, proprietary technology or any other unique position not easily circumvented? (Rate on a scale of 0 to 3.)
 - b. What is the rate of obsolescence (product or process half life) in this business area? A rapid rate of obsolescence requires a strategy for rapid market penetration. (Rate on a scale of 0 to 4.)
 - c. What is the reactive capability of competitors already entrenched in this business area? A small start-up company is unlikely to successfully challenge IBM in main-frame computers, but it could in niche markets. (Rate on a scale of 0-3 and total a-c for total score for this factor.)
5. Risk Distribution. Does this business have a number of different applications sufficiently differentiated from each other by marketing, manufacturing, distribution or other constraints, so if new technology is introduced by a competitor in one application, the others will remain viable?

6. Industry Restructure. Does this business involve breakthrough technology providing such cost/performance advantages that an opportunity exists to restructure segments of the market - or create new markets?

Now, the total value for these six Business Attractiveness Factors should be 35 or more before proceeding to the next set of "Fit Factors". If the total is less than 35, then the probability for eventual success is low.

Fit Factors

Each of these factors is also rated on a scale of 0 to 10:

1. Capital Availability. Is there sufficient readily available capital to fully exploit the growth potential of this opportunity? Under capitalization could open the door to competitors - or worse.
2. Manufacturing Competence. Do or will facilities exist that can provide competent, timely and satisfactory cost/performance production sufficient to meet the growth potential of the markets?
3. Marketing/Distribution. Is the in-place competence here sufficient to provide maximum market penetration within the expected product, process or service life cycle and the expected emergence of competition?
4. Technical Support. Is the technology base sufficient to provide competent customer service, continuing product or process improvements and diversification?
5. Components and Materials Availability. Are there redundant sources of critical components or raw materials involved so interruptions of supply are not catastrophic?
6. Management. Is the top management strongly supportive, and are legal, financial and other forms of management expertise readily available? Does a component "champion" exist who is determined to make this business a success?

The sum of the Business Attractiveness and Fit Factors determines the probability of commercial success. A total score above 80 points results in a statistical probability of 80-90%. But below 70 points, the success ratio drops off to less than 10%. For example, a business opportunity with a Business Attractiveness rating of 40 points and a Fit Factor rating of 50 points ($40 + 50 = 90$) is a very good candidate.

However, if the same opportunity had a 40-point Business Attractiveness rating but only a 30-point Fit Factor rating ($40 + 30 = 70$), it's not likely to be very successful. But, a 30-point rating in the Fit Factor category means weak or missing capabilities might be acquired through an acquisition, a joint venture arrangement or bringing in additional management, which would raise the total to above 80 points.

No analytical method can guarantee 100% success. But careful attention to the most critical factors can increase the probability of success rather significantly.

Miscellaneous Suggestions

An additional factor to consider in your analysis is the timing of the company's entrance into the marketplace. Get on the right side of trends. Don't be fooled by a technology that seems to be way ahead of its time, therefore, a natural and instant winner in the market. Innovations are more often too early than too late. Keep in mind

that all through nature, you'll find the same law: "First the need... then the means." Make sure there's sufficient market pull before you bet your bankroll on success. The element most needed for a successful business is a customer. What real or perceived problem are you going to solve in his or her life? Then, buy marketing capabilities early in the venture. Just don't jump the gun by preparing your market before your product is ready.

Although there are many common reasons why deals are turned down, be alerted to these common business-killing entrepreneur weaknesses. If they can't be overcome, seriously consider walking away immediately. Some of these are:

- * Lack of continuity - There must be a plan of uninterrupted operation if key employees leave or die.
- * Unwillingness of entrepreneur to part with equity
- * Inability of entrepreneur to take criticism
- * Underestimating capital needs
- * Lack of a total plan
- * Unrealistic, low expense forecasts
- * Overestimated revenue projections
- * Little or no experience in area of operation - Can compensate by hiring experienced managers or consultants
- * Unrestrained ego
- * Too much show - Extravagant offices, cars, etc.
- * Seeking more money than is needed
- * Using investors against each other
- * Lack of appreciation for the learning process - Rapid learning ability is essential
- * Sweet-talking investors
- * Lack of managerial wholeness
- * Wrong timing
- * Lack of pragmatism - Unreasonableness in negotiating process
- * Inability to communicate - Clear and logical written and oral skills are a must
- * Lack of trust - Withholding information, criticizing former relationships (paranoia)
- * Lack of appreciation for the team approach
- * Intolerance - Touchiness when questioned about background
- * Lack of testing
- * Lack of caution - Must only be moderate risk takers

After you absorbed all the information available, asked all your questions and after all your analysis, one of your most reliable, and your ultimate tool for your final decision is your own intuition, especially if you have a good history of deal making. You should have your own set of rules to go by. Some of them could be:

Never invest in a company...

1. unless it is adequately financed.
2. unless its management had prior experience in running a business.
3. which is labor intensive and unionized.
4. which is dependent on government contracts, protection or largesse.
5. which is dependent upon financing from a single financial institution.
6. in which an inventor is the chief executive officer.

7. that is in a business in which unsavory individuals are present.
8. in which the entrepreneur is experiencing marital discord, is a philanderer, drug abuser, heavy drinker, compulsive gambler or is extremely obese.
9. in which you cannot be proud.

To be a successful investor, maintain an open and unbiased perspective. Don't make the mistake of assuming there is only one right answer. Look for the second... and the third. Then sort everything else out. This keeps you (and the entrepreneur) from overlooking a better right answer.

A New Tool

Finally, I'd like to share a slick venture capital and investment tool with you, the Maturity Curve test. It's so good; I added it to the 10-point scale I use to evaluate venture deals.

The following information comes from an interview with Marty Chenard from Advanced Business Strategies, Inc. Over the past 13 years, Mr. Chenard's direct marketing campaigns and joint ventures generated nearly \$2 billion in sales for his clients.

Mr. Chenard is very bullish on Harry S. Dent, the author of *The Great Boom Ahead* and *The Great Jobs Ahead*. Mr. Dent is the world's leading authority on maturity curve analysis and a genius at predicting new markets and emerging growth opportunities. Some years ago, he discovered economic expansions and spending waves are directly related to population growths and the aging of those population groups. "Demand" he says, "is driven by the amount of the population growth in size and their consumption needs during different stages of their lives." Through the use of his methodology and Maturity Curves, he makes some outstanding calls.

Until now, this was a closely held venture capital secret. Savvy venture capitalists make millions with this tool. We're going to explore how to use their criteria and selection processes to choose opportunities on your personal scale.

This strategy's foundation boils down to timing. Having the right product, price and selling to the right market, trail timing in importance.

The secret is...Venture capitalists choose opportunities by their Maturity Curve.

There's no better way to select low-risk, high-profit, low cost-per-sale opportunities than selecting only those opportunities in the proper cycle of a maturity curve.

The right timing can make a difference of 800% more in profits

Here's how it works: Every product, every business, everything driven by a life force goes through a maturity curve. A Maturity Curve has its life split into thirds. For example, if the total life cycle of a product is three years, then each third lasts one year.

This is important, because 80% to 85% of all the profits are made in the middle third of a life cycle. By itself, the first third of the Life Cycle represents only about 10% of the total sales. During this Product Introduction stage, demand is low. It's hard to find customers, costly to sell them, and profits are really low. Annual sales increases happen very slowly. Product availability exceeds demand, so pricing is sometimes less than real

value to stimulate demand... or at the high end to try to protect profits. This also drives up the cost per sale. Either way, profits suffer during this "Pioneering Stage".

One of the biggest reasons entrepreneurs fail is because they choose opportunities during this first third of the Maturity Curve cycle. One advantage is however... if they make it to the Growth Stage, they have a head start on competition. But most start-up companies don't have the financial staying power to get that far.

So the lesson is: *Entrepreneurs and small businesses have to be in the Middle Third of the Life Cycle to make maximum profits in minimum time.*

Another profitable strategy is to launch another product that is just starting its Growth Stage... or prepare to sell your business about halfway through the Middle Third of the Life Cycle. That's when profits usually peak and start to decline. Then sell your business toward the end of this portion of the Life Cycle.

Usually, after 3 to 5 years, a winning product in a winning market will enter its High Growth Stage. That's when companies are usually cash poor and can't finance the growth they need to meet demand. Here's your lowest risk venture capital opportunity. Your upside potential won't be as high as with earlier stage companies, but profits can still be high.

Mr. Dent also discovered that if you took the U.S. birth rate and moved the curve forward to match the average annual family spending by age group, you'd have a predictable chart of future spending and economic growth.

Some of his conclusions are:

1. He expects the current spending wave to propel the Dow to 18,000+.
2. He expects high growth spending won't peak until 2008 or 2009 when the Baby Boomers spending drops off, and they begin saving for retirement.

If he's right, the next 4 years or so will give us (investors and entrepreneurs) more opportunities than we've ever seen. Properly selected venture capital deals will make thousands of new fortunes.

Here are his specific industry highest growth opportunities:

- Health (This is a comforting corroboration to my general interest in the life sciences and specific interest in aging.)
- Travel and Leisure
- Finance
- The Internet

These calls were made in 1997, before the stock market and the dot com booms. It's 2004, and I'm going to add "nanotechnology" to that list.

IV. EVALUATING MANAGEMENT

Without a doubt, management is the single most important element of any business, new or old. The market must also be strong. If you find a great manager in a weak market, drag him over to a strong market, and watch him soar. If management isn't strong, then the enterprise is doomed for mediocrity - at best! Smart investors invest in companies (management), not products, services, inventions nor innovations. A good management team will make a mediocre concept work, but weak management could kill the best of ideas. If the company doesn't already have strong management, provide it, help them get it, make sure they get it, or forget the deal!

The only occasional exception to this rule is when you have the opportunity to sell a product without regards to competitive prices. Strong, in-demand proprietary products could make up for weak management, but only temporarily. Lots of great opportunities are lost when investors disregard blockbuster products without existing management to match. Eventually though, people selection still prevails, because competition emerges. Just make sure the entrepreneur is willing to give up good incentives and some management control to the right managers when you find them.

An entrepreneur who understands and lives by the numbers is the one you want to back. The most successful are "cash flow fanatics".

Another basic objective in evaluating management is how entrepreneurial it is... from top to bottom. Two key ingredients are integrity and commitment. These are even more important than competence. With integrity and commitment, management could gain competence. But competent management without integrity and commitment will seldom, if ever acquire those attributes. People's values are better predictors of future behavior than their actions. So, if you're not comfortable with management's capabilities and/or honesty, and you can't get someone you're comfortable with - stay away from the deal, no matter how tempting!

A true entrepreneur exhibits an incredible sense of "driving to completion". This mentality is a rare trait. That person dives into all areas he must in order to solve all the intricacies necessary to complete his project, no matter how many tangents this takes him on. Almost everyone has a weakness to driving to completion.

A good gauge of future long-term stock value is the degree to which the entrepreneur is committed to the free enterprise system. Make no mistake about it. His philosophy is important. And the extent to which he lives it in his business enterprises is equally as important. If he's a strong believer in individualism and self-determination, and if he relies on his independent judgment coupled with factual reality rather than the irrational basis of what others think, feel or wish, then you could have the foundation of a winner on your hands.

When evaluating the entrepreneur's talents and characteristics, be certain he's at risk in the enterprise. A philosophically well-grounded entrepreneur will agree. He (they) should definitely risk his money. No commitment is as strong as a strong financial commitment. The bigger the percentage of what he owns which he commits to the company - the better off you are. If he hocks his house or puts up a personal guarantee, he's committed. The amount isn't as important as the commitment. And, he should certainly risk his time and his job.

The four key management areas are: Marketing, Production (Manufacturing or Operations), Engineering (Research & Development) and Finance. Is management already strong and balanced in all these areas, or will gaps have to be filled? If there are gaps, is there a definite plan to fill them? Does the entrepreneur have the necessary judgment to hire skilled managers? Are potential managers already identified? Have they committed? Hire the best people available as soon as they are affordable.

Often, the key financial officer isn't needed until the company develops further. Whoever he is, he should have some experience with small growing businesses. And, marketing isn't needed until the product or service is fully developed. But the initial plan should address both these areas.

For the existing management team, or committed team for a future date, has the team worked together in the past? Do they have a strong excited leader? Ideally, look for someone obsessed, someone on a mission... a champion, determined to succeed... someone who has to make it work. Enthusiasm can more than make up for deficiencies in experience. I think the number one secret in making money is being involved in doing something that excites you the most. If your entrepreneur (and/or managers) fit this mold, the odds are strongly on your side, especially if he has a good track record of completing jobs correctly, particularly in this field. Research the management (present and future) as carefully as you would a product or market.

Remember, good managers take advantage of each other by interacting as much as possible. It's a huge advantage if they have successfully done this elsewhere. Ask what the team has accomplished so far. What have they done in the past, either as individuals or especially together? These are all important, basic key questions. If you find there's any reason to believe any member will be unproductive, establish stock buyback agreements and performance standards going in. Also remember - the managers with the best track records are most likely already established in profitable businesses. The older proven entrepreneurs bring a wealth of experience with them - when you can find them. But young entrepreneurs usually have more energy and enthusiasm... and are often a better bet.

Marketing

Marketing, in my opinion, is the single most important management function. You don't necessarily need the best technology, price or location - just the best marketing. Some of the best products and services fail miserably in the marketplace. In fact, I think once you're capitalized, business success is 80% marketing and 20% the strength of your product or service. It's also the most difficult task to master day in and day out in changing markets.

Think about this: Marketing has the greatest leverage of virtually all business tools. Good marketing can increase the pulling power of all advertising and direct sales efforts. Given a fixed size, ad costs won't change. But great copy, a sizzling headline or superior packaging can easily generate ten times the response of average advertising. Since those costs are fixed, most of this goes straight to the bottom line with no downside risk whatsoever. And each additional dollar of profit can instantly make your company worth an extra \$10-\$20 or more.

A published Forbes 400 revealed this strictly unexpected change in where great wealth was being created in the 90s. It used to be real estate. Now it's marketing. To illustrate this, they cited the three wealthiest Americans. Bill Gates, John Kluge and the Walton

family. They all made their fortunes by out-marketing their competition. And the list goes on and on. The key to achieving great business success and financial independence today boils down to that one key element... marketing. Your company simply must be better at selling than your competition.

If your team is not strong here (or even if it is), you can't go wrong by contacting either Jay Abraham and/or Gary Halbert. Jay and Gary are probably the two most effective and innovative marketing mentors in the country. No matter what your product or service is, they'll be able to boost your sales dramatically. Jay Abraham presently has several options for his participation in or guidance for every single aspect of your marketing program. Gary Halbert may or may not be available, but he does have a library full of information you simply cannot afford to be without if you plan on selling anything to anyone at any time. I paid \$3000 for a lifetime subscription to his newsletter. Now you can get the back issues free at <http://www.thegaryhalbertletter.com/>.

Or you might try Joe Polish, a new kid on the block, and one of the best marketing consultants in the world.

Jay Abraham's address is: Abraham Publishing, 609 Deep Valley Drive, Suite 310, Rolling Hills Estates, California 90274, Telephone 310-265-1840, <http://www.abraham.com>. You can reach Gary Halbert at Cherrywood Publishing, 3101 S.W. 34th Ave., Ocala, FL 34474-7447, Telephone 352-861-1664. Joe can be reached at: Piranha Marketing, Inc., 7318 S. McClintock Drive, Suite 1, Tempe, AZ 85282. Telephone 800-275-2643. Or go to <http://www.joepolish.com/>. They have contrasting styles, and either, or all, can help make your sales go supersonic.

Entrepreneurial Characteristics

Arthur Rock, the godfather of American venture capital, once said entrepreneurial dreamers possessed "the potential to change the world". The good ones can see the future. And seeing the future through their eyes is what I call excitement.

When evaluating the entrepreneur, bet on one with a history of high achievement, and look for well known characteristics most successful ones seem to share. The most common is he had a job or jobs as a child.

The seven most important traits of entrepreneurs are they have:

1. High energy levels
2. Tremendous commitments to succeed
3. Resourcefulness
4. Street smarts
5. Honesty (including intellectual honesty)
6. Intelligence (The ability to produce desirable results)
7. Skill or education in their chosen field and their market

If they have these traits, and the ability to stay in control of all the details of their operation, then they can afford to be mediocre in other areas.

Use the above traits in your overall evaluation. But for more detailed analysis, know a successful entrepreneur will also exhibit an abundance of the following characteristics (There is a definite overlap between the characteristics of a successful investor and a successful entrepreneur):

1. Although money is very important to him, he is more goal or achievement oriented than money oriented.
2. He is future focused. He has a long-term outlook.
3. He enjoys good health.
4. He has a need to be in control of his destiny and environment.
5. He does not see himself as a risk taker.
6. He has a strong need for recognition and approval.
7. He is an early riser.
8. He takes a realistic approach to facts.
9. He loves what he does.
11. He is married.
12. He has a strong heart and guts. He is tough.
13. He has supreme self-confidence.
14. He is disciplined. He works long hours and makes personal sacrifices.
15. He is extroverted.
16. He has physical and mental stamina.
17. He is tenacious, persistent.
18. He is highly focused on his goals with a sense of urgency to get things done.
19. He has a healthy ego.
20. He is enthusiastic.
21. He exhibits leadership qualities.
22. He is creative. He has the ability to add a "twist" to an existing product or service.
23. He is willing to accept responsibility.
24. He is inquisitive.
25. He was an Eagle Scout as a youth.
26. He does not smoke a pipe.
26. He has the ability to anticipate and solve problems.
27. He has the ability to focus on the individual (customer, partner, etc.).
28. He is win/win oriented.
29. He is calm under pressure.
30. He is aggressive.
31. He has persuasive communications skills.
32. He has a reputation as a trustworthy person.
33. He has a tremendous sense of cost discipline. He conserves money like he would use water going across a desert.
34. He respects numbers. All great entrepreneurs invariably dig into accounting.
35. He has broad general business knowledge. He's not a specialist.
36. He doesn't necessarily know what's going on in the world. He's totally consumed by his business.

It's difficult to assess all or most of these characteristics in anyone without an intimate relationship or without observing him under trying circumstances. However, personal interviews and social interactions coupled with discussions with two to three references (or the references' referrals) should give you a good feel for his character. When you do interview your entrepreneur, the cardinal rule is to be an effective listener. Listen between the lines.

Dealing With the Entrepreneur

If, during your interviews, management cannot respond to the following sort of questions, then they probably won't be able to handle real related problems. Ask all that are applicable and others you can think of:

1. What if the company falls short of projections for two consecutive months (or quarters or years)?
2. What if certain executives are found to be incompetent?
3. What if future funding commitments fail to materialize?
4. What if a key employee dies or becomes incapacitated?
5. What if a competitor makes a bid for the company? At what price and conditions will you want to sell out?
6. What if a natural or civil disaster interrupts or destroys the operation?
7. What if a union attempts to organize the workers?
8. What if the source of critical supplies dries up?

It's important not to overpay the entrepreneur, nor to underpay him during the early period of the enterprise. It's also important he doesn't seek compensation, which is out of the norm. Consider it a real red flag if he demands a comfortable salary at the inception of the business. You want entrepreneurs whose goals are long-term capital gains - not high short-term perks and salaries.

Conversely, if he accepts no salary, the financials will be skewed. (Although his willingness to do this is a great indication of his commitment and should be seriously considered.) For example, if he becomes incapacitated and has to be replaced, an allowance will have to be made for his replacement's compensation. This could include saving some equity to attract his replacement (and other key management personnel).

A good rule of thumb is to pay him just enough to survive comfortably, but no more than he made previously. And a good idea for all employees' compensation is to let the market pay them as early as possible. If you set up a solid well thought out performance based pay schedule, the company will usually grow faster and bigger while possibly reducing your investment. And, it tends to weed out the deadwood early in the enterprise. That also keeps morale high. Each employee should represent a profit center - and not be an expense. They should all have entrepreneurial attitudes. Profit sharing plans for employees could fuel this, but discourage big bonuses for management. Their incentive should be capital gains.

Also, when evaluating management, decide whether you want to be an active or passive investor. If you plan on being part of the management team, your initial compensation should be in line with the entrepreneur's.

If your entrepreneur is the creative type - and not strong management material, then keep him doing what he does best, and have someone else manage. It's the good manager that will eventually make a success out of the company. He's usually older, more conservative, tougher (managerial toughness keeps you at the top) and more experienced than the entrepreneur.

One note of caution: As the company matures, entrepreneurs either become good managers themselves, hire good ones on an incentive basis or have the company acquired. If you don't see this happening, then take your profits and run. (Ultimately, the best managers are entrepreneurs who grow into management roles.)

Sometimes, the entrepreneurs will be a husband and wife team. Unfortunately, marriages deteriorate faster than business partnerships. A divorce between married partners could tear a company apart, so it's always a good idea to have a stock repurchase plan. If one leaves the company, the stock is sold to the one who stays. Non-married business partners should also agree to this.

Finally, if possible, keep director seats for members with lots of business experience (and to those who currently hold lots of board seats). Board seats should be reserved for outside businessmen who have something to offer the company. They should not be used as rewards or perks to management. And directors' compensation should not be based on management performance. Rather, make it a fixed fee per meeting.

It's usually a good idea to limit the initial board to about five members in early stage companies. And if the investors put up all the money, they should have control of three of these, at least until they get paid back. Be certain to get director indemnification and director and officer liability insurance if it's available and affordable, especially if it is or will be a publicly owned company.

V. HOW TO IDENTIFY AND MANAGE RISKS

Venture capital can truly be an adventure. And big adventures usually carry risks.

As the Swiss financial writer, Max Gunther said. "...if your main goal in life is to escape worry, you are going to stay poor. You are also going to be bored silly. Life ought to be an adventure, not a vegetation." But you can manage risks and still profit.

A composite of private venture capitalists (angels) shows they anticipate, on average, sustaining over a 50% loss of their investment on any one single deal, 30% of the time. This chapter is devoted to reduce your risks to the absolute minimum, with the understanding in private investing, risks are commensurate with rewards. Since you can target, on average, annual compounded rates of return of 40-50+% on your portfolio, it's logical that managing your risks (avoiding them is tough) separates winners from losers in this arena. Obey all warning signals, no matter how small.

The first rule is not to invest more than you can afford to lose in any one company. Although there are proven ways to cut your losses, keep your eyes open to the fact the entire investment could disappear on any given one. But if you follow the rules, you should rarely, if ever, experience a complete wipeout on any one investment, and very few 50% losses.

There are three basic strategies of risk management. They are:

1. Risk avoidance. The only certain means of eliminating risk with this strategy is by passing up the deals that are too risky.
2. Risk reduction. Put in an extra measure of safety where possible. Keep in mind each dollar you save goes straight to the bottom line, or it's a direct reduction in your investment. Buy used equipment, lease, get terms, subcontract, etc.
3. Risk anticipation and transference. Insure against risks with offsetting measures, sinking funds, self-insurance, management or board control, etc. Get outside insurance such as property, casualty, life, health, liability and employee benefits.

As soon as you develop a serious interest in investing in a particular company, start determining the potential risks and problems. Then, to the best of your ability, determine the odds of their happening and how to avoid them. After you do this, develop a contingency plan to overcome them in the event they are not avoided. In other words, anticipate all the disaster scenarios, and position yourself accordingly.

Strategies

How do you do this? First of all, keep in mind throughout your process of evaluating deals; successful investing is a combination of common sense, experience and getting accurate answers to hard questions.

Second, work with your entrepreneur and consultant, if you have one, to compile a list of potential pitfalls and good points, and assign a percentage to the probability of each. Then, brainstorm with management to decrease the odds of the pitfalls and increase the odds of the good points. If most of these points haven't been covered in the business plan or in other management pre-planning, then it's time to question management's abilities.

Third, after negotiating final terms with the entrepreneur, cool off for a few days, and analyze the above paragraph before endorsing your final documents. And under no circumstances should you turn over any money until legal documents are signed.

In identifying the risks, remember the key risk areas are management and its marketing in early stage companies. Management is by far, the most vital risk. Of the three major questions to ask...

1. Can the product be produced?
2. Can the product be sold?
3. Can the product be sold at a profit?

...Time and time again, of all management's functions, number three, its ability to sell at a profit, proves to be the biggest risk.

For developmental stage companies, you'll want to ask a fourth simple question: "Can the product be developed?" The hardest part of any job is completing it. The last 10% of completing a product or service can take as long as the first 90%.

If you're satisfied with management, or when you or the entrepreneur attracts critical managers, get key man term life insurance on the key employees to protect your investment. Keep the insurance in force until your investment is recaptured, or get decreasing term insurance to match any gradual payback. Either you or the company should be named as beneficiary. Most venture capitalists recommend making the company the beneficiary, but I disagree. If you are the sole beneficiary, you still have the option to reinvest the proceeds in the company. However, if the company is the beneficiary, and the employee proves to be irreplaceable, then you lost control of your investment, unless you have voting control. Even then, if you're not the CEO, you might not have as much control as you think.

If you do have a need for life insurance, two life insurance companies offer no-load or low-load policies. They are both highly rated companies, and their rates are as low as I ever saw. One is USAA Life, telephone number 800-531-8000, and the other is Veritas (Ameritas Life), 800-552-3553. Often, for estate planning purposes, your might be better off contacting a first class estate planner for your insurance needs. The rates might be higher, but a good planner could more than make it up with potential or real tax savings. Call me if you need a referral in your area.

A real expert, Jim Vigue, provides investment management services and financial planning services for some of the most famous people in the country. If you have a pending deal, or even a sizeable personal estate and want professional advice, I strongly suggest you call him at 407-261-0218.

Pitfalls

Investments usually go bad because of one or more of four reasons.

First, the valuation was not determined properly.

Second, management is incompetent. It's vital to monitor their performance and retain the ability to rectify shortcomings. Get accurate monthly progress and financial reporting to head off potential pitfalls. Then, you can anticipate strategies to take if things don't go as expected, good or bad. Always maintain a good working relationship with the

entrepreneur. (See Chapter IV for more on management.) By nature, they're an optimistic lot. But if you do see warning signs, you'll probably have to be the first to react, even if it jeopardizes your relationship.

Third, there's the timing of your exit from the investment. It's important to have an agreement of when the deal will be sold. You want to press for at least partial, if not total liquidity as soon as the deal is successful. And, you should recapture your initial investment at the earliest time possible in order to reduce your risk. In determining all of the above, figure a 25% fudge factor in the PERT costs and times.

Finally, the concept is not valid. This is the least common of the four. In addition, be very careful before investing in one single product or idea, especially if it's a "big ticket" item. Also, remember all products have a life cycle. As markets mature, the rate of growth declines, and margins often fall. Obsolescence is your silent competitor. Keep monitoring your market for your product's life span. Conditions can change rapidly. If your product or service won't adapt to change, no matter how good it is now, it won't survive.

If you don't control the board, at least demand a seat, if your investment is significant. If you keep these positions until you're repaid, you'll stand a much better chance of getting repaid. If you want to avoid personal liability, such as unpaid payroll taxes, take a position as a "Friend of the Board" instead of being a regular board member. You get as much information this way without the liability. You can lock up the entrepreneur's votes by putting his shares into a voting trust. Then, under certain pre-determined adverse conditions, you can vote his shares to elect a new management team if necessary.

Since a percentage of the companies you back have a chance of folding, consider protecting your investment by the judicious use of loans and debentures rather than straight equity investments. Or, you might even take ownership of the company's equipment, and lease it back to the company. Then, if the company does fail, you don't have to lose your whole investment. Above all though, do thorough due diligence before investing.

Another strategy to protect yourself is to have your attorney represent the company after funding as corporate counsel or as co-general counsel. This is not an unreasonable request, especially if you're putting up all or most of the money. And, you can get the right to co-sign all non-routine checks over a certain amount and monitor or approve all major expenditures and borrowings. You can be pretty certain there will be a need for more capital as the company grows. A good control would be to have your attorney serve as corporate secretary.

If your entrepreneur is in charge of the books, insist on regular financial reports and audits by an independent CPA. This should quickly turn up any dishonest or sloppy accounting practices and is an excellent checks and balances tool.

Also, be aware success is often enhanced in inverse proportion to the distance between the entrepreneur and the investor or his representative. In today's modern world of jet travel, email, video conferencing, fax and other forms of communication, the geographic distance is not necessarily as important as the intellectual distance between you and the entrepreneur. Make sure you share general business goals and philosophies.

As a parting thought, it's usually best to diversify your venture deals in order to spread your risk, just as in any other risk oriented investment program.

VI. DUE DILIGENCE

Usually, when we're cheated, we're not fooled. It's usually because we hear and see only what we want to hear and see. Because we grew up with Santa Claus and Superman, we're conditioned to believe fairy tales.

Be objective in your due diligence.

Before going to the time and expense of carrying on serious due diligence, get the general terms of your deal in place in a loose letter of intent. Have the entrepreneur take his deal off the market for the two to four weeks you might need to perform your due diligence by entering into a "subject to" agreement. And while you secure your terms, get a clause that states the company or entrepreneur pays the investigative and negotiating fees if the deal doesn't close due to misrepresentations. Or, if you have to pay all the fees, get more for your investment. If you offer the entrepreneur a deal based on your due diligence (within a specific time frame), he should pay the due diligence expenses if he turns the deal down. If your due diligence turns up something that impacts your agreement, you might opt to renegotiate the terms rather than dropping the deal.

Then, "do your homework". Refuse to be rushed into a close. Be thorough. Don't invest unless and until you answered all your important questions completely. Sometimes, superficial due diligence can turn up invalid negatives. These could actually be hidden opportunities rather than reasons to drop the deal. So be sure to dig below the surface.

You can take some shortcuts. One of the first is getting a list of people who turned the deal down. One almost certainly exists. Don't be afraid to ask the entrepreneur or intermediary for the list. Just because someone else passed on the opportunity doesn't mean it's not right for you. But you should find out why they declined. Contact the other investor(s) and creditors. Then, have their objections and problems answered to your satisfaction. If you take this step first in your due diligence process, you can save a lot of time and expense, if the objections are also valid for you.

Due diligence usually covers three major areas. These are checks on the entrepreneur's past, the technology behind the product and the realities of the marketplace.

In all your questions with the entrepreneur, be open and explicit from the beginning, and demand he be the same with you. If you can't open and maintain clear accurate and honest communication during the due diligence process, you're asking for problems during your business relationship. So, confront the entrepreneur with all the negatives you find. Often, the answer will prove or reinforce the existence of the niche the business will fill.

One of your first due diligence steps is to find out who else is in the deal. Who are the existing risk takers, lenders, suppliers and customers? Significant or credible associates lend tremendous endorsement to the proposal.

Another important step is obtaining background and credit checks on the business, entrepreneur and key managers. Is there a Dunn & Bradstreet rating yet? If so, get a copy. Credit reports can be obtained from the following companies. You'll usually need to provide a full name, Social Security number, date of birth, a present and previous address and written authorization from the entrepreneur:

Equifax
P.O. Box 4081
Atlanta, GA 30302
Tele. 404-885-8000

TRW
P.O. Box 596
Pittsburgh, PA 15230
Tele. 800-682-7654

Trans Union
760 West Sproul Road
Springfield, PA 19064
Tele. 800-916-8800

An individual can get a copy of his own report for a nominal fee or at no cost. Ask him to furnish it.

It's also a very good idea to check into the entrepreneur's health condition. A quick and easy way to do this is to ask him to furnish you with a report from the Medical Information Bureau (MIB). If he's ever applied for life, health or disability insurance... and if he's got a health problem that could affect his longevity, then MIB might have that information.

MIB will send any individual or his doctor a copy of his file upon request. Have him write to: Medical Information Bureau, P.O. Box 105, Essex Station, MA 02112 for details. If he can't or won't get an MIB report, you might have him get a complete physical exam. He'll need this anyway, if you get a large key man insurance policy on his life.

Always get professional background checks on your entrepreneurs. In fact, this should be one of the first things you do. If you're going to turn over large amounts of money to anyone you don't know well and miss this step, you're just asking to be taken. It's amazing how many people ignore this. Three national investigative agencies, Pinkerton, Bishops and Proudfoot can provide very fast and inexpensive background checks if you provide them with some basic starting information. Pinkerton's, Inc. is located at 15910 Ventura Blvd., Suite 900, Encino, CA 91436, Telephone (818) 380-8800, and most likely has a regional office in your area. Bishops and Proudfoot specialize in white-collar crimes and can furnish you with histories of litigation, associations with bankrupt companies, personal bankruptcies, directorships held in other companies and more.

For more personalized, speedy expert service, contact Buddy Bombet for very prompt economical service. His telephone number is 225-275-0796. He's reliable and extremely honest. Whomever you use, tell them exactly what you want - and why. Do not rush this step! "Deal with whom you know, and know with whom you deal." Use plain old good business sense, and you won't get burned.

You might get valuable information yourself, including basic starting information, from driver's licenses, vehicle registration records, real estate records, divorce records, corporate records and UCC-1 tax searches.

It's an excellent idea to verify the entrepreneur's credentials listed on his transcript or resume. Verified Credentials of Minneapolis, MN can provide credential checks, as well as credit and criminal checks.

Credit checks, health reports, background checks and credential checks are simple and easy to get - and it's not unreasonable to request the entrepreneur provide them, or at least as much of them as possible, at his expense. It should all cost him less than \$500. If he can't afford it (many expended all or most all of their money on their companies), then provide some way to get reimbursed if you pay, and something negative comes up which deters you from proceeding.

If you move along with negotiations before doing background checks, you could save money and time by having an insurance company do some of it for you. How? If any of

the entrepreneurs or key managers will handle money, sensitive documents or valuables, have them bonded. The bonding insurance company will do background checks before bonding your personnel. And premiums are usually low.

Also, if the company is at all seasoned, you can check for any liens against the company or against its securities. And check for judgments against any other companies the entrepreneur is or has been associated with.

Once you've done your background checks, it's time to check the entrepreneur's references and to do your due diligence on the technology and on the market.

References

First, he should be able to give you reference letters from his lenders, attorney, accountant, vendors, independent representatives, principal stockholders and clients. Reference and background checking are the areas of greatest weakness for amateur investors, yet they are quite simple and quick to do.

One hint is the farther back you go in time when checking references, the better and more accurate they will be. Contact at least five to ten individuals. Will he give you bad references? Unlikely. So from some of the references, find out whom else the entrepreneur might have done business with in the past. In other words, get references from the references.

When calling references, simply politely tell them the entrepreneur (or his reference) gave you his or her name and the exact reason for your call. Mention to them you not only want to decide whether or not to invest, but also to determine the entrepreneur's strengths and weaknesses. Say this is so you can help create an environment most productive for all those involved in the business, including the entrepreneur. Of course, assure them the information they give you will remain confidential. And keep your promise. Following are some questions you might ask:

1. When and how did you meet the entrepreneur?
2. What was and is the nature and quality of the relationship?
3. Are you still in contact, and how often?
4. What bad things can you tell me about his performance under pressure?
5. Does he seem to seek stressful or comfortable situations?
6. How does he handle failure or situations that do not develop as he planned or would have liked?
7. In instances of failure or problems, does he tend to blame himself, others, or circumstances beyond his control?
8. When he fails to succeed, how long does it take him to bounce back with an alternative plan to accomplish the same goal or with another new idea?
9. What can you tell me about his family relationships?
10. Can you think of anyone who might question his integrity?
11. Do you know anyone who might dislike him or have disagreements with him?
12. Other than the names of such individuals, can you tell me anything about the problem or disagreement?
13. What are the best things or strongest points you can tell me about him from the perspective of a future partner or investor?
14. Were you able to observe how he works with other people? Does he work better with peers or those he is supervising? How does he relate to superiors?
15. Does he complete projects, or does he become distracted?

16. Who do you know who is closest to him or is in a very good position to provide insights about him?
17. Did you expect this call, and did you have others of a similar nature? If so, from whom? Did you tell them the same as you are telling me?
18. What do you think he'll be doing 10 years from now? What do you think he really wants to be doing 10 years from now?
19. If you had the opportunity to invest in a business to be managed and possibly controlled by him, would you invest?
20. If you did not have the money to invest, would you borrow it if there were no interest payments and if you only had to repay, in case of a loss, 50% of the amount borrowed? If not, why not?

The ultimate questions are #19 and #20, whether or not they would be comfortable in turning their money over to the entrepreneur.

These questions, all or some, might be all you need to ask. Or they will lead to others. Determine whether or not the subjects do their job as outlined, if they are loyal and if they have the capacity to manage in a growth environment. In any case, be comfortable with your information on the entrepreneur and management (especially key marketing personnel) before you invest.

Finally, in checking out the entrepreneur, you should visit him at his home and workplace. What kind of environment has he established for himself? Does he have an organized and happy home life and workplace? If not, why not? Will this carry over to the business you're helping build?

You'll find mistakes, weaknesses and shortcomings with everyone you check out. Should they kill the deal? Not necessarily. Not unless definite negative patterns form. Also, if he tries to cover something up, lies or withholds information, you should walk. And of course, his association with unsavory characters is a major reason not to do the deal.

Investigating the Deal

Now that you checked out the entrepreneur and key managers thoroughly, you'll concentrate on the deal itself. First, find out who says it's any good. Again, get references from the entrepreneur, but this time on the business itself. Ask for the names of some customers and suppliers, and talk to them. The business plan should have endorsements from several of these, either explicit or implied. Follow up on them. A trickier area will be talking to competitors. But if you think you can get honest objective information from them, they could be your best source of data.

Get a hands-on demonstration of the product or service, at least by photographs, samples or videos. Will the product or service do what it says it can? Can a device be built economically to do it? How strong is the market? How big is it? Is it growing? Can the company compete? Can the product or service be sold at a profit?

To investigate the technology, you might employ consulting engineers. Maybe you can convince the entrepreneur to do this at his expense and supply you with an independent engineering report. Some consultants for major technologies such as Battelle and A.D. Little might take part of their fees in equity.

For a due diligence shortcut on any industry, get copies of the industry's leading newsletters or periodicals. Then ask the editor, publisher or a leading writer to recommend someone who might have the information you're looking for. Maybe they'll even be the experts you want. And, "The Encyclopedia of Associations" can give you accurate information on market size, where to get brochures, dates of conferences and much more valuable information. Check your local business library. The "Directory of Directories" tells you what directories are available in specific fields. Publisher is Gale Research Co., 835 Penobscott Bldg., Detroit, MI 48226. "Macrae's Blue Book" lists manufacturers by name and product. Contact Macrae Blue Book Co., 817 Broadway, New York, NY 10003. You might also get valuable data from the U.S. Department of Commerce - and even from the Yellow Pages.

Basically, due diligence is getting the answers to every relevant question you can think of.

Then, you'll have a routine checklist to go through. Get, check, verify and evaluate whichever of the following is pertinent:

- * Articles of Incorporation and Bylaws
- * License(s) to do business if needed
- * Audited financials if necessary with a statement that since the date of the last financial statement, nothing significant occurred which would substantially change the financial picture without notifying the investor in writing
- * Tax returns and audits
- * A list of pending/threatened legal actions or a statement that there are none
- * Proof of clear title to properties, including patents, processes and leases
- * Schedule of assets and contracts
- * Purchase orders issued and received
- * Company's contractual commitments
- * Schedule of adequate insurance coverages
- * Labor difficulties and the potential for unionization
- * Conflicts of interests of key personnel
- * Disclosure statement reaffirming all statements made to the investor are true and complete, and all relevant information known to the entrepreneur has been made to the investor

Finally, you'll want to make sure a real and growing market exists for the product or service. This topic was covered in Chapter Three and should be a major portion of your due diligence efforts.

Even though we have these many tools and guidelines to go by, evaluation is subjective. After performing due diligence, most private investors use their gut feel and experience in making the final judgment as to whether or not to invest.

VII. LIQUIDITY - EXITING YOUR INVESTMENT

You make every investment with one purpose - to make a profit. You don't profit though, until you cash in. Paper profits seem to have a way of disappearing. So until you have hard cold cash in the bank or freely traded stock in a rock-solid public company, your profits on private investments are illusory.

This chapter gives you a brief idea of how to exit, or cash in, your investment. Don't make the mistake of assuming this will take care of itself when the time is right. Nothing can be further from the truth, especially when you're holding a minority interest in a private company. Your minority position will always be difficult to sell. So always, always provide a liquidity or exit provision in your funding agreement before you invest. Or, at the bare minimum, at least make plans to recapture your investment with interest. As in all investments, go to the ends of the earth to protect your principal. Look out for number one. The best advice I can give you is to hope for the best - but prepare for the worst.

Since your position could well be a minority one, always have a provision to control the board if pre-determined performance standards are not met. This is the biggest lever you can give yourself in a private company.

In establishing your exit provisions, if the structure prevents or restricts a sensible exit strategy, then consider getting more equity for the liquidity you give up. You're much better off however, to trade some equity for liquidity, but ask for both. Remember, stock in a public company could have a market value of over 100% more than a comparable private company. And, if it's an actively traded stock, you have an existing market for all or part of your shares. Think liquidity at all times. Whatever your strategy, let the entrepreneur know your stock is for sale at any time (if it is). It's only a question of price.

So when do you plan to exit? This will be a function of the company's stage of development and of its cash flow characteristics, if the company itself will fund your exit. One thing to keep in mind though is to never let the entrepreneur become liquid first.

Establish a mechanism, if you can, to give you an option for an early exit. That way, you can exit earlier than planned if you lose confidence in management, if a trend of declining profit margins (three months running should alert you) establishes itself... or if the investment simply stops being fun.

Strategies

There are a number of ways you can liquidate. The most desirable and profitable would be via an initial public stock offering. Here, get a provision having the company pay all offering expenses.

Second best would be through a merger with or acquisition by a larger company. Preferably, this would be a public company, which would give you public stock and maybe some cash for your interest. Your company should have sales volumes (or potential sales volumes) of over \$20 million or at least \$1-2 million of after-tax profits to be an attractive IPO or acquisition candidate. An often-overlooked advantage of owning stock in a public company is your potential to borrow against that stock, thus delaying or avoiding capital gains taxes.

If these options are not realistic, then you should arrange a buy-back mechanism or other liquidation options with the company. In fact, these should be arranged anyway as a fallback strategy. If you do get bought out privately, you might consider additional compensation if the company does an IPO or is acquired shortly thereafter. This might keep the entrepreneur from buying you out cheaply with the anticipation of turning right around and making a profit on the stock he bought from you. Keep him honest. People have a tendency to forget how important your services or contributions were, once they're performed.

You could demand a put to the company after a realistic period of time with the price based on a pre-determined price to earnings ratio, at book value or as some function of cash flow. On the other hand, you can also give the company a call option on your stock at a high price for maybe ten years out (more or less). You'll want to have the call pretty far out to keep management from doing an IPO right after they get you out at a low price.

Or, you can establish a buy/sell agreement with the entrepreneur with you both holding options of initiating it. If one party refuses the other party's offer to buy or sell, then he must meet it himself. For example, if you offer to buy him out for a specific amount of money or with specific terms - and he refuses your offer, then he must make the same offer to you to buy you out. This is a good safety valve in 50/50 deals, and it tends to keep the players on both sides honest.

In case of a potential private sale of the company, you could structure an agreement giving you the right to participate in any offer made by outsiders who want to take out the entrepreneurs. If you get an offer for your shares, the entrepreneur might get the right to participate with you. This clause prevents both groups from bailing out without the other, unless the other approves.

You could have the company establish a sinking fund for liquidity in case the exit plans fall through. If the company misses payments, they are in default.

Finally, you might consider using a domestic trust as your organization's structure. This is a bit esoteric, and it's not for every situation, but it could give you the best advantages of C Corporations, S Corporations and partnerships.

Essentially, instead of having stockholders of a corporation, you have beneficiaries of a business trust. Income is distributed to all beneficiaries... pre-tax, and you operate and file much like a corporation with limited liability. Depending on some pending legal opinions, you might be able to exceed the 35-shareholder limit of S Corporations, and beneficiaries aren't limited to individuals. There could be some other advantages too. If you'd like more information, I'll be happy to put you in touch with an attorney who can structure these inexpensively and explain them to you in more detail.

A possibly better, and more popular concept is the Limited Liability Company (LLC). In fact, LLCs promise more than domestic trusts.

A good corporate attorney could fine-tune these strategies for you, but I strongly advise keeping him out of the picture until you and the entrepreneur agree on general terms. Attorneys really do tend to kill deals if they get involved in early negotiations and consultations. This also goes for, and maybe especially for, the entrepreneur's attorney. Why? He might lose his client to your attorney.

VIII. THE STRUCTURE OF A DEAL

Your deal structure could ultimately be more important than the pricing. The possibilities are infinite, but if you keep it simple and beneficial to both parties, everyone should be happy through the exit. Just know your own motives and objectives. Use the entrepreneur's offer only as a guide, unless it fits your parameters. If you have to deviate too much from your comfort level, then you could be getting into a stressful situation for years to come.

Probably the most important thing to consider for the structure is your preservation of capital. Always take heavily secured senior positions when possible, especially in early stage investments - or get lots of equity for yourself with an earn-back provision to the entrepreneur. Consider holding title to the company's assets with a provision to exchange for equity later on. As the investor, you will most likely have a chance for more equity for lower-risk, later-stage financing.

Although most private investors don't seek voting control, a good loose general rule is, if you put up all the money - get control! At least until you get your original investment back. You can always give the entrepreneur an earn-back, earn-up or earn-out provision. If he performs satisfactorily, he has the ability to earn back some of the equity he gave for your money. This can happen by reaching or exceeding projections or by repaying you on or before schedule. Or, it can be based on reaching or exceeding a pre-determined company valuation. If the company has an initial public offering, you can base it on that valuation. If there's no IPO, then discount the valuation from a comparable public price by 25-50%. Or, you can use some other set standards you are both comfortable with.

If it takes longer to exit than anticipated or promised, whether it's via an IPO, merger or another mechanism, you might have management's equity reduced according to the extra time it takes. Give them plenty of incentive to give you the opportunity for early profits.

A good way to set fair respective equity positions would be to reward the entrepreneur for meeting or exceeding projections by bonusing him stock, and/or, he could be penalized for falling short. Be careful with this strategy though. It could backfire by impinging on efficient management. One example is management could sacrifice long-term viability for short-term profits by cutting R&D expenses. So if you do incorporate this strategy, and if you base it on revenues, net profits, ratios or anything else, give allowances for R&D or other expenses that will contribute to the overall well being of the company.

Consider establishing a mechanism to take control of the enterprise if the entrepreneur consistently misses projections by wide margins. You might not be willing or able to manage the company, but you'll at least be in a position to liquidate the company more quickly, if it becomes necessary.

Another strategy you might consider when circumstances permit is to make your investment in predetermined stages. When milestones or benchmarks are met, you automatically make your next stage of investment. If a particular milestone is not met by a certain time, then you have the option to not invest any more and cut your losses. Or you can invest and get additional equity because of the management's under-performance to that point. A ready supply of too much money in an early stage company tends to stifle creativity.

Your contribution can be made by direct investment or by loans and/or loan guarantees. You can take your interest in the company in many forms. It can be revenue participation certificates (RPCs), preferred or common stock, warrants, options, debentures or other creative forms.

Revenue Participation Certificates (RPCs)

Personally, I favor getting some sort of revenue participation (or royalties) on gross revenues, if the cash flow and company structure allow it. This is especially true when you have a minority stock position. Royalties based on gross are easier to calculate than those based on net. They also protect you from creative bookkeeping that funnels perks to management or tax strategies that reduce net profits.

RPCs can be perpetual, for a fixed period of time, increase or decrease with time or revenue levels and possibly convertible into equity at a predetermined time or event. They give you lots of flexibility, and they put the burden of meeting projections on the entrepreneur, since he only makes money on his equity, reflected in the profits he generates. If he has other functions outside of management, such as being the innovator, then he could also get an RPC based on his innovative contribution. Otherwise, profits could be inflated. Conversely, if you, the investor, have other functions such as managerial or entrepreneurial, then you should also get equity.

One drawback of RPCs is they impinge on cash flow. Since cash flow is almost always critical in early stage companies, an allowance must be made to keep RPCs from giving the company a fighting chance to blossom. You might solve this by starting revenue participation in the second or third year, or whenever certain standards are achieved. Even the most successful companies have cash flow problems for a long time, due to explosive growth. Growing companies need nourishment in the form of more and more cash to manage that growth. If you can't acquire enough debt financing to manage this as the company matures, then you could have a provision that converts your RPCs to equity.

Your provisions should also allow you to convert to equity when the company is acquired or when it goes public. To protect you against overly optimistic projections, you could have a set minimum payment. Conversely, the entrepreneur could set a maximum dollar level paid in order to protect the company from an unfair liability.

Maybe you could start your revenue participation only after a certain revenue level is met. Also, to make it easier on the company, it could start immediately, but increase gradually with revenue levels. For example, you could get 1% of the first \$5-10 million of sales and an additional 1% of each \$5 million over \$5-10 million up to a capped rate of maybe 5%... all depending on profit margins.

RPCs are excellent tools for repaying guarantors, lenders or investors. Once the original loan or investment is repaid, then the revenue participation payments could be reduced or converted to equity. This is fair to both parties. If you use this strategy, your buyout could be based on a formula, with the buyout increasing each year it's postponed, if your goal is to convert to stock.

Finally, RPCs have the advantage of representing off balance sheet financing. And they don't dilute the entrepreneur's equity... at least not until you exercise any conversion privileges. Here's a summary of advantages to you, the investor:

1. You get paid first - before creditors and owners.
2. No double taxation.
3. Your return on investment might be higher than with stock.
4. Early liquidity.
5. Minority stockholder power.
6. Return is fixed to a percentage of sales and can't be changed without mutual consent.

And some advantages to the company:

1. Payments aren't fixed, as with a loan. They're tied to the revenue stream.
2. Doesn't dilute company ownership.
3. The investment goes directly to increasing net worth.
4. All payments to investors are tax-deductible.
5. Investment can be tied to particular products or situations.
6. Does not require collateral or liens on any assets.
7. Improves company's credit (off balance sheet financing).

Secured Positions

Whether you use RPCs or not, go for the strongest instrument possible. This is always a secured loan. Your downside is protected mostly when you have a senior debt position. Remember, hope for the best, but always, always prepare for the worst. If your downside is covered, the upside usually takes care of itself.

Get covenants to protect against default which give you the ability to control the board and which give you a demand for immediate repayment. Even though the debt might be hard to collect, these serve as enough of a threat to management that they should do everything in their power to keep the covenants from being exercisable. Include a clause that accelerates principal payments if installments are missed. If installments aren't paid when due, the entire balance becomes due. Your purpose is to give management flexibility if things go well - but to give you a mechanism to exert pressure if they don't. You want to be able to get in control of the board immediately if serious problems develop.

When your loan is repaid, it often makes sense to promise to give back some of your equity. This way, you might have a controlling interest in the company when your money is at risk, but control is given back to the entrepreneur after he fulfilled his promise to pay you back. This strategy also gives him the added incentive to perform early. Once he proved himself, and once you are no longer at risk, he could very well have earned the right to control his deal. In fact, if he pays you back ahead of schedule, you might give him an extra stock bonus. Make his bonuses creative and enticing. When possible, base incentives on net, and pay them to the entire management team.

If you prefer, you could put the entrepreneur's shares in a voting trust in order to take emotion out of decisions. Then, free it up, all or in part, under pre-set conditions. You could retain a proxy or get a proxy, also under pre-determined conditions. Your proxy might give you the right to sell or liquidate the business under pre-set guidelines. Or, maybe take all the stock, and agree to sell back 50%, 60%, etc. five to ten years later, or sooner, for say 150% of your cost for all the stock. This way, you control the company, except for hands-on management, while giving the entrepreneur the ability to grow the company and to get back in control with his stock option after he meets projections.

If you use preferred stock as your favorite form of investment, consider taking convertible preferred stock with voting rights. This way, you have your senior stock position without giving up a say in management decisions.

If you use convertible debt instruments, you can be repaid by installments if cash flows permit, or by a balloon payment, principal and interest, at some future point. Or, you might receive interest only and the principal at one lump sum. Amortizations tend to be confusing and unnecessary. The advantage of a debenture is you have the security and yield of a debt instrument without restricting the company's ability to borrow from banks. It also has more options than straight equity while also having deductible interest payments

One effective way to cover your downside is by purchasing the necessary equipment and property. Then lease it to the company rather than loaning the money. As additional security, buy all the company's assets for a nominal fee, and sell it back to the company after the loan is repaid. If you use this strategy, you could arrange to exchange the assets at a future date in exchange for stock.

With any secured position, remember if it's heavily secured, you can expect less equity than if it isn't. However, it's usually well worth giving up something to reduce your risk. But try to marry your downside protection with upside potential, even later on, when the company matures. Just because it reaches later stages, doesn't mean it's risk-free. If you use loans with stock options or warrants now, consider asking for less equity for a lower price later on - rather than more of a company for a higher price. And if your options state a fixed number of shares rather than a percentage of ownership, include an anti-dilution clause.

Additional Safeguards

Whenever possible, make certain the entrepreneur has something to lose if the deal goes sour. Start by having him legally endorse all his representations, projections and personal guarantees. If he can't take a financial risk, make him take a credit risk by co-signing on all loans. If possible, you might even have his family members and friends put up a guarantee. This might not lower your risk of loss, but it could enable you to recapture some or all of your investment down the road, on the entrepreneur's next deal, if he's still on the hook for repayment.

Get an indemnification from the entrepreneur for legal action resulting from any of his prior actions. To be extra careful, if there's a question as to how clean the existing corporation is, you could form a new corporation which acquires all the assets of that entity - and not the liabilities. Also, you have the added benefit of structuring the new corporation any way you want.

One thing to consider when setting your safeguards is the entrepreneur must continue to have incentives, while you continue to have a healthy return on your investment. The enterprise will probably have at least one more dilution after your investment for expansion capital, so make certain you are both aware of this possibility. You might even be the source of the next round of financing. So, if you want to participate, get a right of first refusal at the outset for follow-on investments, either in this company or even on a future undertaking by the entrepreneur. At least, get an anti-dilution clause in every deal, which gives you the option to invest in more stock under pre-set guidelines. These come in many common forms - and are covered in the books, which I recommend to you in the Preface.

The entrepreneur will eventually be a statistic. Death, divorce, unforeseen changes in management or other potential disasters could severely impact your investment. To guard against these types of pitfalls, get a buy/sell agreement and/or voting trust. If the entrepreneur dies or becomes disabled, he'll have to be replaced. It's only fair his replacement's compensation comes out of his share if it's not insured against. If his responsibility is to operate the company, you shouldn't be the one penalized if that responsibility is interrupted by an unforeseen circumstance. Plan for it.

When drafting your agreement, insert a provision giving you a mechanism to acquire voting rights, cash, stock or other consideration if the entrepreneur breaches his agreement or attempts to change management control. Also, get employment agreements and non-compete agreements from all the key employees, and make sure they are free from restrictions from previous agreements. Have them sign non-disclosure agreements too. Sometimes, according to laws, these have more teeth than non-compete agreements. Have each employee or consultant who is privy to confidential information or trade secrets sign a confidentiality agreement. If any key employees, including the entrepreneur, decide to leave before any contract period expires, arrange a buy/sell agreement that sells their stock back to the company. This could include a vesting plan for all management, founders and entrepreneurs. Or, if they transfer some or all of their stock, get a right of first refusal to receive it.

On a more positive side, good managers should be encouraged to stay through the use of golden handcuffs. Direct ownership with stock options is usually best and is one of the strongest motivators. When writing employee contracts, include provisions for amendments under certain conditions, such as the sale of the company. This could keep the company and employee from being encumbered.

None of these potential disasters is meant to discourage you from this exciting business. Rather, they're mentioned to give you the opportunity to lower your risks to the greatest degree possible and to lock in the profits your hard-earned investment dollars generate.

Lawyers

Lawyers can be your best friend or - your worst enemy. And when I say your worst enemy, I mean your attorney... not necessarily his! Lawyers only make fees as long as your case is open, not when it's closed. So keep tight reigns on them.

All these seemingly complex items might be routine for your attorney. He can be a big help in drawing up your financing documents - but only after you and the entrepreneur have agreed on all general terms. If your lawyer's not well versed in corporate law, find one who is. In fact, some attorneys specialize in venture capital. If you'd like to speak to one, call me. I'll try to introduce you to one in your area. They generally work with the large venture capital companies and are expensive, but they might accept you as a client. Usually, however, a competent corporate attorney with a background in accounting and tax law should suit your purposes.

Whatever you do, don't bring him into the deal until your terms are set with the entrepreneur. Consider using a neutral attorney for these tasks, rather than each of you having an opposing attorney. Either way, don't involve him or them from the beginning in negotiations, etc., unless you want to risk killing the deal before it ever had a chance. Some are OK, and I even know one who actually saved a deal for me, but most can be

deal killers. Give him specific outlines to draw up your documents in legal form, such as your purchase agreement, which contains a disclosure document, terms and conditions of the investment, collateral, representations, a description of the ongoing relationship between you and the company, letter of intent and maybe to help you with some investigative work. But give him specific direction and tasks, and your relationship should be good. Most problems that lawyers work on are not legal ones at all. They are simply problems clients leave them to solve.

Don't let your attorney dictate business philosophy to you nor negotiate for you. Lawyers are merely specialists - nothing more - nothing less. Don't expect any more from them.

When choosing your attorney, beware of those who are in court all the time. You want one who is not afraid of going to court - but one who will do everything possible to keep you out. Lawyers are trained in negatives and spend their time and your money on deals or situations that went bad. You, however, are building on a positive. CPAs and friends are in the same category. Since they have nothing to gain if your deal works, they usually dwell on its negatives. No proprietary interest! But if you find the decision maker for the other side is a third party, make it clear the decision maker is the only one you'll talk to.

Also, whatever you do, try to avoid having lawyers settle disputes between you and the entrepreneur. If you don't, they could easily eat up most of the money - yours and the company's. Instead, consider putting an arbitration clause in your agreement. Arbitration is usually quicker, less expensive and more amicable than litigation. A clause I favor in most of my documents reads something like this:

In the event of a dispute, each party agrees to draft and submit a proposed settlement, within thirty days of formal written complaint by one party to the other, to an independent arbitrator in the State of (your state) referred by The American Arbitration Association. The arbitrator will be instructed to choose one proposal in its entirety, and both parties agree to be bound by its terms. Each party will equally divide the cost of the arbitration.

This kind of agreement tends to encourage each party to submit a fair proposal. In fact, the terms of both proposals often end up being fairly close to one another, so even the loser is usually satisfied with the outcome. And, by choosing one in its entirety, the arbitrator can settle almost any dispute to both side's satisfaction - inexpensively and virtually overnight.

Finally, unless you're the only investor... or a major investor, you won't have the power to impose many of the restrictions and safeguards listed in this chapter and elsewhere. Often, you'll only purchase equity in a limited partnership or be one of several investors in a private offering. Most of this information still applies. However, if there are only a few investors, you might assume a leadership role in due-diligence, structure and negotiation. In this case, try to spell out compatible goals and philosophies with your co-investors.

IX. VALUATION AND NEGOTIATING

Private investors (adventure capitalists) usually seek a minimum annual return of 20-30%. Most want 30-40%, and some always want 60% or more. A general rule for start-up companies is a return of ten times your invested capital in five years. This comes to about 60% compounded per year.

So how do you value your deal? First, determine what stage your target company is in. Investments in seed projects should return ten to twenty times in five years. Start-ups should give you at least a ten times yield. For developmental stage companies, look for two to six times your money, and one and a half to three times your money for profitable companies. These are minimum targeted five-year returns. You'll aim for more.

These returns also assume no early liquidity. If the deal is structured to give you high liquidity in the early years, then you might settle for lower returns.

Although professional venture capitalists sometimes use various complex pricing methods, my advice is to keep it simple. Figure your exit valuation or royalties, and then determine the annual rate of return. If it's realistic and satisfactory, then move ahead. If not, renegotiate, or forget the proposal, and go to the next offer.

The simplest way to determine the percentage of the company you need is to take the third to fifth year's projected after-tax earnings and multiply by a price to earnings ratio of, for example, 10 to 12. Multiply your investment by ten or whichever multiple of your investment you're looking for. Then divide this resulting number by the first sum to get your necessary level of ownership.

For example, if the fifth year's projected earnings are \$2,000,000, your investment is \$500,000, and you want a ten times return on your money, then you multiply \$500,000 x 10 (your targeted multiple). This \$5,000,000 is your anticipated return. You divide this by \$2,000,000 x 10 (P/E), or \$20,000,000. The result is 25%, your needed percentage of ownership after five years to reach your targeted return, if the projections are met and if it's structured to command those P/Es.

If a small investment creates huge valuations in the near future, say within five years, it will most likely need more money to grow. So, you should allow for any future dilutions into your calculations for expansion capital. If the entrepreneur denies any more money will be needed, get a valid reason why. But position yourself for future dilutions. If you anticipate a later 50% dilution, then you need a 50% equity share going in by using the above example.

Your valuation could be doubled or better if the company is realistically planning on going public within your planned exit period. If the private company is 10% or more the size of a comparable public company, the private valuation is 60-76% of the public company if it's equivalent in other areas. So when you're public, the value could easily jump by 70% - or more!

Always hope for public P/Es at your exit, but plan for private company P/Es.

When determining your valuations by using public companies as a guide, keep in mind comparisons are only valid for later stage companies with historical financials. Projected figures are only as good as their ultimate accuracies.

However, if you're inclined to in-depth financial analysis, use your comparisons with one large, one medium and one small listed company. Then compare key operating statistics and ratios. Include revenues, operating costs, margins, overhead and administrative expenses, net profit margins, net worth, return on equity, long term debt, current ratios and finally P/Es.

Remember, P/Es for early stage high growth companies are almost always far in excess of mature companies.

Most of these comparisons should also be made with projected figures to see how realistic and balanced the projections really are. Did the entrepreneur just arbitrarily assign expenses and margins, or did he do his homework to determine realistic ratios, etc.?

Finally, leave lots of leeway when making your valuations. In the real world, valuation isn't particularly scientific. It's partly intuitive. It's usually 50% or more subjective and negotiable. Assume the entrepreneur's projections won't be met, but reward him if they are. And don't forget to go for control if you put up all the money.

Negotiating

When negotiating, you'll do best by assuming full responsibility. If you decide to use outside help, especially your attorney, you're just asking for disaster. If you ask him to determine valuations or to make investment decisions, you're putting him in the position where he has everything to lose from a wrong decision and nothing to gain from a right one. Therefore, his advice will almost always be negative.

Besides, it's hard to be a good lawyer and a good businessman too. They are two different professions. It's your vested interest in your deal, so you're the one who makes the ultimate investment decision. The fact that you're financially qualified means you probably have independent thought anyway... and more business experience and more talent to make these kinds of determinations than an advisor or consultant with a non-proprietary interest. You also probably possess another rare quality - namely, the ability to recognize true value or potential.

So, negotiating should be up to you. Just try to be fair with your future partner, because you'll be together after your investment. If you're not both happy from the beginning, you're asking for difficulties later. And, be prepared to, and know when to walk. There will always be another opportunity.

Even though you might have your own style, here are a few words on what I think should be incorporated into your negotiations.

First, make sure each party feels like a winner. This can best be accomplished by making each other aware of and sensitive to each other's objectives. Don't jump to conclusions about the other party's needs and wants. You're not necessarily seeing the negotiation from the same point of view, but there's not necessarily a conflict between you. Learn to understand and appreciate the other's position and values. Each party

should feel as though he was treated fairly and would enjoy dealing with the other at any time in the future.

Negotiation really boils down, in my opinion, to information and communication. And it starts with the way you position yourself during your first contact. Find out early in the game exactly what it is the other party wants. Then, find out as much as you can about him. What are his motivations? What makes him tick? A lot of the information that you need can come from the business plan and from your first meeting. The most essential aspect of any negotiation is your ability to listen. Start by simply asking him exactly what it is he wants. Ask careful, probing educated questions. Then, listen like a hawk! Assess if he really means what he says, while having absolute respect for what he says. Only after you get enough information should you even think about trying to reach an agreement.

An easy way to blow a deal is to reject an initial position out of hand. Avoid making the first offer. You might get more than you want if he suggests the terms first. Don't react to early claims until you establish rapport. If you take your time to do it right, both parties should come away satisfied. If you try to rush to a close, you'll most likely have an incomplete agreement and end up cheating yourself out of a smooth transaction.

Now this doesn't mean you should lay all your cards on the table from the outset. Be fair, but be tough. He'll be trying to get the best deal for himself, as should you for yourself. Assume he's bluffing until you're convinced he isn't. It's a game, hopefully with two winners.

Without good clear communication, your negotiations are destined to fail. Don't assume anything. Point out how your offer benefits him. Convince him. If you don't understand what he's saying, say so. Most major objections are hidden. Ask him outright what bothers him about your proposal if you sense reluctance. Encourage him to be open and honest with you.

Right up front in your negotiating session, identify the core issue(s) and common objective(s), and agree what they are before going any further. Clarify all the issues while taking control of the agenda. Don't proceed until the other side agrees on the agenda. Then, get him to agree you have a deal if you can resolve all the identified issues. Begin your negotiations by mutually identifying optional ways of settling each issue, and narrow the options as they are raised. Casually close on each. This is a very short efficient process. Then, you take control of the first draft of the agreement.

Always assume the role of a reluctant investor. Most people assume the other's position is stronger than it really is. So, play on this. You have the money - and the power. By being a reluctant investor, you can nudge up the entrepreneur's negotiating range before the real negotiating begins. A certain way to lose this advantage is to show anxiousness. The other party will sense it, and of course, that weakens your position.

However, many investors overplay their power and this can come off as arrogant and cold-hearted. Although this tactic is almost always intimidating to the other side, and although he sometimes caves in to it, you can bet he'll try to get his revenge someday. I find it best to be tough, but at the same time to be agreeable and friendly. You're really much better off dealing with a friend than an enemy in a situation where you're going to be working together for years. So be diplomatic. Show empathy for his position, and make sure he understands yours.

Some entrepreneurs resent the fact that investors treat their money as more important than the entrepreneur's sweat equity, time and innovations. If you get him to understand your money is a direct result of your own sweat, time and innovation, while respecting his position, you'll be off to a strong start. Above all, never lose your cool. If the other side gets emotional, be understanding, but remain firm and rational. Don't cave in to irrationality.

Then, once you're friends, you're in the position to ask for more than you really want or expect (while leaving a little leeway), without turning him off. Now, you've edged up his negotiating range a bit more, and you might even get what you asked for without losing his cooperation in future dealings. At least, you've created a climate of friendly compromise - in your favor. This way, when you leave the table, the entrepreneur will also feel like a winner once he gets a little back. Asking for more than you want leaves room for fair play and good feelings. So, with this in mind, never jump at the first offer, no matter how good it looks. Even if it's a great offer, if you grab it too quickly, the other side will begin to second-guess himself. And, you'll begin to wonder if you couldn't have gotten a better deal too. So, to make you both feel better, always be reluctant.

You can also establish a bargaining advantage by letting the entrepreneur know if you'll need final approval of the offer from someone else. This could be your wife (or husband), partner, board of directors, banker or anyone else who needs to be convinced. This way, you can always come back to him with a slightly better deal for you, and you can avoid being pinned down for an immediate decision. And he'll know his offer has to do more than convince just you.

Closing Your Deal

Start resolving easy issues first. Start with agreements. During your negotiation process, side issues will most likely occur. If they do, and if you're asked to make concessions, always make sure you get something in return for each one you make. This will usually stop the entrepreneur from nit picking you to death with minor issues. Or, you will at least accumulate favors he owes you for the big issue. Don't forget to mention it when the time comes.

Sometimes these side issues aren't minor at all. If you become deadlocked on them, or even on a major issue such as price, don't let them bog down your negotiations. Simply ask to set them aside for discussion later. Then, once you start to agree on minor points, the set aside issue is easier to resolve.

All during your negotiations remember you can always walk away and look for another opportunity somewhere else. Once you let him know he has something you want badly, you lost a major negotiating advantage. Once you decide to walk, all the pressure to get you back is suddenly put on the entrepreneur. Use this as a last tactic though, because he might let you go. By maintaining a sense of indifference throughout, you can probably avoid the necessity of this tactic.

Don't forget, in the eyes of most negotiators, their own position seems to be the weakest and their opposition's the strongest. This is because each party knows what he stands to lose, not what anyone else has at stake. You can reinforce this by gently pointing out all the negatives of his deal to him.

Capitalizing on this perceived weakness is especially easy when one party has some knowledge the other doesn't. Your entrepreneur will almost always have more knowledge,

technical and otherwise, about his company or industry. Even though the investor has the real power because of his ability to provide the money at any time, the entrepreneur's knowledge or ability sometimes intimidates him. Don't make that mistake. Just keep defusing his apparent advantage by asking him to explain everything to you simply.

Then there's timing. Your entrepreneur will almost always be under the gun to get his financing immediately. This will either be real or imaginary, but you can bet he puts lots of pressure on himself to close the deal quickly. This is one of the biggest advantages you'll have. Take enough time to be thorough in your investigation. No matter how good the deal is, it's rare when the entrepreneur has the luxury of picking and choosing among offers. The way you can use this to your advantage is to ask for a certain concession at the eleventh hour. If it's not unreasonable, you'll almost surely get it if you promise a timely close in return.

So, if you keep a friendly reluctant attitude, use time to your advantage and subtly let him know you have other real options for your money, the entrepreneur should assume a realistic picture of the situation and be prepared to make a fair and equitable deal with you. If you stick to these common sense rules of negotiation, you'll have the ability to cut almost any kind of doable transaction. Just keep in mind, this is all one big game, hopefully with you both coming out on top. If it's not fair to both parties in the long term, it will have a good possibility to all fall apart somehow before you ever have a chance to take your profits. You're not making a one-time deal with someone you'll never see again. You're just starting an ongoing relationship.

At the end, after reaching an agreement, it helps to reinforce his feeling of a good deal by letting the other side know you conceded more than you ever planned. Subtly reinforce the fact he got a fair shake, so he carries only good feelings into your partnership.

You'll rarely need to use even a small fraction of these strategies. But they're valuable tools. If you master them, you can turn losing situations into winning ones.

By using this book as a rough guide, there's no reason you can't cleanly close your average deal within 30 to 90 days from the time you start your serious discussions with the entrepreneur and be on your way to a long and mutually profitable relationship.

X. IN CLOSING

I decided to wait until the end, to admit to you this book was written by an incredibly ignorant man. But ignorance isn't always bad. Sometimes, it's only a measure of unanswered questions. Ignorance actually increases with knowledge - and is reflected in the ability to ask questions. It surely beats stupidity, or not knowing and not even caring nor striving to know.

So this short book's purpose is not to give you all the answers by any means. I wish I knew them all. It's purpose is to get you asking the right questions... which should improve your odds of making profitable investment decisions.

Now the rest of this chapter isn't even about investing at all, at least not specifically. However, in my humble opinion, it's by far the most important. This chapter has a little to do with philosophy. If you can truly master this ten-page chapter, and when I finally manage to learn all the lessons that follow, successful investing should be routine. (It will also be trivial compared with whatever else we'll be doing with our lives.)

This chapter contains a summary of just about everything important I ever learned about life.

And like most people, I learned my lessons the hard way. In 1976, I met one of the most important people who ever lived. Hardly anyone ever heard of Dr. Andrew J. Galambos. All he did though was to totally integrate the volitional (social) sciences. In doing so, he innovated durable solutions for, in one fell swoop, every social problem imaginable. He did for the social sciences what Newton did for the physical sciences. If his theory is ever known and accepted, major social problems will simply cease to exist.

Hopefully, that will happen. But revolutionary ideas take a long time to take hold, especially in the absence of a marketing genius. Also, there's always been resistance to change because of major vested interests in the status quo. However, through Dr. Galambos' Free Enterprise Institute, I was lucky enough to personally profit from his teachings. Dr. Galambos is the biggest influence on my life.

But, I was far too smart to learn the lessons directly from his lectures. First, I had to get beat up in the real world, lose millions of dollars by getting stung by a business partner - and then repeat the same mistake (but with less money at stake) from an only semi-slick con man. The ironic part of it is nearly every mistake I made could have been avoided, if only I would have really learned Galambos' lessons in the classroom. I didn't appreciate most until I reflected on them, painfully, after the facts. I lacked the wisdom then to truly understand what I was being taught.

One reason I was so vulnerable after those lectures was I suffered a very serious physical injury in 1978. As a result, I lost a lot of my independence. The biggest loss was mental though, rather than physical.

Initially, I found myself looking to others for guidance and support rather than depending on myself as I had before. I found myself creating distortions, illusions, and mind created realities in order to make my environment fit into the mold I thought it should. I lived under the delusion that others would "show me the way". This made me very susceptible. But it wasn't long before I was reminded of the fact you can't change reality by wishing things were different.

I got through it all with a lot less money than I could have had, but with no emotional scars or callousness. One day, about fifteen years ago, I decided to put my philosophy on paper. After my second fleecing, I wanted to see where I went wrong, and I wanted to make sure I didn't repeat my costly mistakes. That's when "Kekich's Credo" was born (see next page).

The fact you received this book means you're most likely a successful person, and you probably have a lot you can teach me. I hope you do sometime. I also hope I can offer you something of value in the last eight pages of this chapter. These are the bulk of my life's lessons, encapsulated in 100 points. Even though I learned most of them the hard way, and even though they are emblazoned on my soul, I still read them carefully, just to keep myself on track. It's still easy to stray by taking the path of least resistance.

The more I read them, the more meaning they have for me - even after fifteen years. There was a time in my life when I thought I had all the answers. That's a classic example of stupidity. Now, I'm just beginning to learn to ask the right questions. Each little speck of knowledge seems to present more questions than answers. Age and experience can certainly humble.

It's easy to write down these or any thoughts. It's even relatively simple to think of a new idea now and then. But developing or implementing ideas are the hard part. So, publishing my Credo puts additional pressure on me to live it. This helps me in the long run by forcing me to put my beliefs to practice. Therefore, I get something out of giving you my Credo.

Hopefully, you'll profit from some of these ideas too. Maybe you might even be tempted to put some of yours on paper for your own use. The important thing though, is to crystallize your thinking and your own personal philosophy. So if you do profit from my Credo (or from my book), I'd love to hear from you. In fact, I'd like your comments... one-way or the other.

Good investing... and long life!

KEKICH'S CREDO

1. People will do almost anything to stay in their comfort zones. If you want to accomplish anything, get out of your comfort zone. Strive to increase order and discipline in your life. Discipline usually means doing the opposite of what you feel like doing. The easy roads to discipline are 1) setting deadlines, 2) discovering and doing what you do best and what's important and enjoyable to you and 3) focusing on habits by replacing your bad habits and thought patterns, one-by-one, over time, with good habits and thought patterns.
2. Cherish time, your most valuable resource. You can never make up the time you lose. It's the most important value for any productive happy individual and is the only limitation to all accomplishment. To waste time is to waste your life. The most important choices you'll ever make are how you use your time.
3. Think carefully before making any offers, commitments or promises, no matter how seemingly trivial. These are all contracts and must be honored. These also include self-resolutions.
4. Real regrets only come from not doing your best. All else is out of your control. You're measured by results only. Trade excuses and "trying" for results, and expect half-hearted results from half-hearted efforts. Do more than is expected of you. Life's easy when you live it the hard way... and hard if you try to live it the easy way.
5. Always show gratitude when earned, monetarily when possible.
6. Produce for wealth creation and accumulation. Invest profits for wealth preservation and growth. Produce more than you consume and save a minimum of 20% of all earnings. Pay yourself first.
7. You're successful when you like who and what you are. Success includes achievement... while choosing and directing your own activities. It means enjoying intimate relationships and loving what you do in life.
8. Learn from the giants.
9. A little caution avoids great regrets. Hope for the best and prepare for the worst. Keep fully insured physically and materially and keep hedged emotionally. Insurance is not for sale when you need it.
10. Learn the other side's needs, offer as little information as possible, never underestimate your opposition, and never show weakness when negotiating.
11. Never enter into nor invest in a business without a solid, well-researched and well thought-out written plan. Execute the plan with passion and precision. Plan and manage your life the same way.
12. Success comes quickly to those whom develop great powers of intense sustained concentration. The first rule is to get involved by asking focused questions.
13. Protect your downside. The upside will take care of itself. Cut your losses short - and let your profits run. This takes tremendous discipline.
14. The primary purpose of business is to create and keep customers. Marketing and innovation produce results. All other business functions are costs. Prospecting and increasing the average value and frequency of sales are the bedrock of marketing and business.

15. If it's not proprietary, it won't work. Pay only on performance. Proprietary interest is one of the most powerful forces ever known. Whatever you reinforce or reward, you get more of.
16. Competence starts with guaranteeing your work.
17. Life operates in reverse action to entropy. Therefore the universe is hostile to life. Progress is a continued effort to swim against the stream.
18. Find out what works, and then do more of it. Focus first on doing the right things, and then on doing things right by mastering details. A few basic moves produce most results and income.
19. Use leverage with ideas (the ability to generalize is the key to intellectual leverage), work, money, time and people. To maximize profits, replicate yourself. Earning potentials become geometric rather than linear.
20. Rationalizations are generally convenient evasions of reality and are used as excuses for dishonest behavior, mistakes and/or laziness.
21. Always have lofty explicit goals and visualize them intensely. Assume the attitude that if you don't reach your goals, you will literally die! This type of gun-to-your-head forced focus... survival pressure mindset, no matter how briefly used, stimulates your mind, forces you to use your time effectively... and illuminates new ways of getting things done.
22. The value of any service you have to offer diminishes rapidly once it's provided. Protect your compensation before performing.
23. Incalculable effort and hardship over countless generations evolved into the life, values and happiness we take for granted today. Every day should be a celebration of existence. You are a masterpiece of life and should feel and appreciate this all the way down to your bones. Aspire to create, achieve and build onto the great value momentum-taking place all around you.
24. Enthusiasm covers many deficiencies - and will make others want to associate with you.
25. Working for someone else gives you little chance to make a fortune. By owning your own business, you only have to be good to become wealthy.
26. Religiously nourish your body with proper nutrition, exercise, recreation, sleep and relaxation techniques.
27. The choice to exert integrated effort or to default to camouflaged laziness is the key choice that determines your character, competence and future. That critical choice must be made continually - throughout life. The most meaningful thing to live for is reaching your full potential.
28. Keep an active mind, and continue to grow intellectually. You either grow or regress. Nothing stands still.
29. Most accomplishment (and problem avoidance) is built on clear persuasive communication. That includes knowing each other's definitions, careful listening, thinking before talking, focused questioning and observing your feedback. Become a communications expert.
30. Power comes from stripping away appearances and seeing things as they really are. Socialism appeals to psychological and intellectual weaklings. Identify and replace all external authorities

with internal strength and competence. Take full control of, and responsibility for, your conscious mind and every aspect of your life. Being incompetent or depend

31. If there is not a conscious struggle to be honest in difficult situations, you are probably being dishonest. Characters aren't really tested until things aren't going well or until the stakes are high.
32. Do not compromise if you are right. Hold your ground, show no fear, ask for what you want, and the opposition will usually agree.
33. If the situation is not right in the long term, walk away from it. Maintain a long-term outlook in all endeavors. Live like you don't have much time left... but plan as if you'll live for centuries.
34. Invest only after strict and complete due diligence. Don't allow yourself to be rushed. Make important decisions carefully, consider your gut feelings... then pull the trigger.
35. Stress kills. No matter how painful in the short-term, remove all chronically stressful situations, environments and people from your life.
36. Keep your overhead to a minimum. Rely more on brains, wit and talent... and less on money.
37. Business is the highest evolution of consciousness and morality. The essences of business are: honesty, effort, responsibility, integration, creativity, objectivity, long-range planning, intensity, effectiveness, discipline, thought and control. Business is life on all levels at all times.
38. That which is most satisfying is that which is earned. Anything received free of charge is seldom valued. You can't get something for (from) nothing. The price is too high.
39. By adhering to a strong honest philosophy, you will remain guiltless, blameless, independent and maintain control over your life. Without a sound philosophy, your life will eventually crumble.
40. It takes almost the same amount of time and energy to manage tiny projects or businesses as it does to manage massive ones... and the massive ones carry with them - proportional rewards.
41. There is no such thing as "just a little theft" or "just a little dishonesty".
42. Lead by example.
43. Take full responsibility for your actions or lack of action. He who errs must pay. This is an easy concept to grasp from the recipient's end.
44. An hour of effective, precise, hard, disciplined - and integrated thinking can be worth a month of hard work. Thinking is the very essence of, and the most difficult thing to do in business and in life. Empire builders spend hour-after-hour on mental work... while others party. If you're not consciously aware of putting forth the effort to exert self-guided integrated thinking... if you don't act beyond your feelings and take the path of least resistance, then you give in to laziness, make bad decisions and no longer control your life.
45. Out-think, out-innovate and out-hustle the competition, and vividly visualize yourself as winning before entering into every deal or competitive situation. Maintain a blood-smelling, fighter pilot life-or-death attitude when any deal gets near to a close.
46. First impressions are lasting impressions. Put your best foot forward. People treat you like you teach them to treat you. A success key is positioning yourself at the top of their agenda.

47. The right thing is usually not the easy thing to do. You may sacrifice popularity for rightness, but you'll lose self-esteem for wrongness. Don't be afraid to say "no".
48. If someone lies to you once, he'll lie to you a thousand times. Lying is for thieves and cowards.
49. Have strict and total respect for other people's property.
50. Producing results is more important than proving you're right. To get things done, try to understand others' frames of references, points of view, needs and wants. Then determine what is honest, fair, effective and rational... and act accordingly.
51. Long term success is built on credibility and on establishing enduring loving relationships with quality people based on mutually earned trust. Cut all ties with dishonest, negative or lazy people, and associate with people who share your values. You become who you associate with.
52. Don't be preoccupied with things over which you have no control, and don't take things personally.
53. Spend more time working "on" your business than "in" your business.
54. Don't enter into a business relationship with anyone unknown to you without being furnished with references dating back at least 10 years. If he doesn't have good enduring relationships, stay away. Check all representations on which you will rely made by everyone.
55. Enjoy life. Treat it as an adventure. Care passionately about the outcome, but keep it in perspective. Things are seldom as bleak as they seem when they are going wrong - or as good as they seem when they are going well. Lighten up. You'll live longer.
56. Identify exactly what it is you want. This takes a lot of thought. Then don't let anything stand in your way of getting it.
57. You can get any job done through the sheer force of will when combined with uncompromising integrity and competence. Strong leadership is the key.
58. You are responsible for exactly who, what and where you are in life. That will be just as true this time next year. Situations aren't important. How you react to them is. You have to play it where it lies.
59. The foundation of achievement is intense desire. The world's highest achievers have the highest levels of dissatisfaction. Those with the lowest levels are the failures. The best way to build desire is to make resolute choices for the future.
60. Integrate every aspect of your life (body, mind, spirit, relationships, business) and each within itself. Integrating means understanding and digesting a process... and seeing relationships among seemingly unrelated phenomena. It's a sign of innovative genius.
61. Never be deceptive when trying to achieve a personal gain. Shortchanging others results in loss of self-esteem.
62. If your purpose of life is security, you will be a failure. Security is the lowest form of happiness.
63. Never enter into a contract unless all parties benefit. But no partnership is ever 50/50. There will always be inequities.
64. Review the basics of your profession at least once per year.

65. Bitterness, jealousy and anger empower your enemies and enslave you. Negative thinking results in the destruction of property. It is anti-property, therefore anti-capitalistic and anti-life. It also erodes your health. Forgive, learn your lessons, and get on with your life.
66. Most people spend 90% of their time on what they're not best at and what they don't like doing - and only 10% of their time on their best and most enjoyable ability. Geniuses delegate the 90%... and spend all their time on their "unique ability".
67. High self-esteem can only come from moral productivity and achievement.
68. There are an infinite number of new opportunities. Actively seek them out, and position yourself to recognize and take advantage of them.
69. There is no such thing as a good idea unless it is developed and utilized.
70. For maximum profits, identify and market universal needs, wants and trends. Creating desire, satisfying needs and wants and replacing problems with creative innovations are the essence of profit generation.
71. To maximize opportunities, seek and master the complicated. The major solutions you find will be surprisingly simple, and the competition is minimal.
72. Always have options. Options are a primary source of power. Power also comes from stripping away appearances and seeing things as they really are.
73. Nothing wins more often than superior preparation. Genius is usually preparation.
74. Patience is profitable. Achievement comes from the sum of consistent small efforts, repeated daily.
75. Persistence is a sure path to success with quality activities. Never, ever, ever give up.
76. "I will do this" is the only attitude that works. "I'll try" or "I think" doesn't work.
77. Always work on increasing the size of the pie, rather than just your portion.
78. Rewards are rare without risks, but take only carefully calculated risks. Make sure the odds are on your side.
79. The "how" you get it (with integrity) is more important than the "what".
80. Be explicit and semantically precise in all communications, agreements and dealings. Summarize and write down important discussions... and make sure all sides agree. Putting agreements in writing avoids misunderstandings. Memories are fallible, and death is inevitable (so far).
81. The best way to get started is to get started. Life rewards action... not reaction. Wait for nothing. Attack life. Don't plan to death or ask for permission... but act now... and apologize later.
82. Question everything. Don't believe it's true or right just because it's conventional. Strip all limits from your imagination on every deal and look for an unconventional creative opportunity in every mistake, crisis or problem. Be flexible, and be willing to turn on a dime when advantageous.

83. Have fun. The single key to a successful happy life is finding a vocation you enjoy - one that excites you the most.
84. Nobody gets old by surprise.
85. When it's a matter of producing or starving, people don't starve.
86. You get what you expect, not what you want. Fill your life with positive expectations. Demand the best. Attitude and desire contribute to 90% of your achievement. Anyone can learn the physical mechanics.
87. The surest way to accomplish your business goals is making service to others your primary goal. The key to success is adding value to others' lives.
88. The source of lasting happiness can never come from outside yourself through consuming values - but only from within yourself by creating values. Producing more than you consume is the only justification for existence.
89. Unattended problems will not go away, but will usually get worse. Anticipate and avoid problems - or meet them head on at the outset. Overcome fear by attacking it.
90. Find an excuse to laugh every chance you get, especially when you least feel like it.
91. When someone makes a big issue about his honesty or achievements, he is probably dishonest or a failure.
92. Put the magic power of compound interest to work with every available dollar.
93. The best investment you will ever make is your steady increase of knowledge. Invest in yourself. Thirty minutes of study per day eventually makes you an expert in any subject - but only if you apply that knowledge. Study alone is no substitute for experience. Education is always painfully slow.
94. For each important action you take, ask yourself if you would be embarrassed if it were published. It takes a lifetime of effort to build a good reputation but only a moment of stupidity to destroy it.
95. You are exactly what you believe and think about all day long. Constantly monitor your thoughts.
96. Skepticism is a key to rational thinking. Be especially skeptical of your own cherished beliefs. You might be wrong... and things change.
97. Anxiety is usually caused by lack of control, organization, preparation and action.
98. The first rule of sharpening your mind is to be an alert and sensitive observer. Assume nothing. If it can't be observed, it's not true. Never act on blind faith. Whenever something sounds too good to be true, it almost always is. Refuse to be swayed by emotion when it conflicts with reason. Observation is the genesis of all knowledge and progress... and is the first and last step of every thinking man's tool - The Scientific Method. All science and most progress are built on the Scientific Method (most non-scientists use it by accident). The steps are 1) OBSERVATION. Gathering and rationally organizing facts. This is where most people fail. 2) INDUCTIVE REASONING. Forming a hypothesis - or a generalization of facts held to be true. 3) EXTRAPOLATION. Making a projection or prediction based on the hypothesis in areas you didn't yet observe. 4) OBSERVATION. A test for the hypothesis to see if it works.

99. Experience is not what happens to you. It's what you do with what happens to you. It takes a wise man to learn from his own mistakes... and a genius to learn and profit from the mistakes and experiences of others.

100. The purpose of life is to delay, avoid and eventually reverse death.

Special Gratitude to:

Dr. Andrew J. Galambos

Dr. Wallace Ward	Napoleon Hill
Frederick Mann	Bobby Jones
Dr. Craig C. McGraw	Joe Paterno
Daniel Sullivan	Dr. Yul Brown
George S. Clason	Patrick Malloy
Gary C. Halbert	Vince Lombardi
Sir Isaac Newton	Thomas J. Peters
Michael Gerber	Harry Stottle
Winston Churchill	

Anonymous (all those wonderful insightful heroes who influenced me one way or another, either consciously or unconsciously, but whose names I can't attach to any particular Credo.

XI. A FREE OFFER

I hope you found *How The Rich Get Richer With Quiet Private Investments* valuable and enjoyable reading. A lot of research went into it. That should help you increase your profits for many years... wherever you invest, or with whomever. Virtually none of this information will become outdated - at least not during our investment careers.

I'm sure your time is important. So I did my best to eliminate all the filler. What you got was maximum usable information in as little time and space as possible.

I select many of my projects to get you a reasonable chance of at least 10 times your investment return. I also reduce as much of the risk as possible inherent to these early-stage investments. Since these combinations are rare, I make very few recommendations.

I also publish a newsletter. THE KEKICH VENTURE CAPITAL SUCCESS LETTER. If you're an accredited investor and would like a **complimentary subscription**, please fill out the Survey Form on the next page, and send it to me at the address on the form.

That's a Free newsletter you'll get intermittently. Topics change from letter-to-letter. But of course, venture capital is the central theme. The letter's irregular, because I'll feature a new opportunity each issue - along with my editorial material.

By the way, existing subscribers paid up to **\$195** for the letter. However I decided to stop selling it, shorten it and start giving it away for four reasons.

First, it was supposed to be monthly, but that's impractical, because I simply can't find that many worthwhile opportunities. Second, marketing a newsletter takes too much time. Third, my primary purpose for the letter is introducing opportunities along with some philosophies and techniques to evaluate them yourself - not to sell subscriptions. And finally, by keeping the letter shorter, I can spend more time evaluating deals.

Therefore, if you want a free subscription, I'll start sending you brief summaries of all my projects in the newsletter (one at a time). If you have an interest in them... that's great! If not, you at least should get value from the letter's brief editorial content. Minimum investment is usually \$25-50,000.

Profitable investing,

David A. Kekich

CONFIDENTIAL FREE NEWSLETTER SURVEY FORM

YES. I'm an accredited investor. Please send me a FREE subscription to your private investment newsletter, *The Kekich Venture Capital Success Letter*. I understand the information below will remain strictly confidential.

Please type or print clearly:

Name _____ Company _____

Street _____ City _____ State _____ Zip _____ Country _____

Telephone (Day) (_____) _____ Evening (_____) _____ Fax (_____) _____

E-mail address _____

What type of business are/were you in? _____ Retired? Yes No

If you find a promising private investment, please check the highest level of investment that you would be able to provide through an equity investment, loan or loan guarantee for any one company:

\$25,000 \$50,000 \$100,000 \$250,000 \$500,000
 \$1,000,000 \$2,000,000 \$5,000,000 \$10,000,000 Other \$ _____

I certify I'm an Accredited Investor. An individual "Accredited Investor" is one with either a net worth of \$1 million or more or a net income of \$200,000 or more for each of the past two years, or \$300,000 if married and files jointly.

Please check all industries in which you might have an investment interest:

<input type="checkbox"/> Any	<input type="checkbox"/> Food/Beverage	<input type="checkbox"/> Retail
<input type="checkbox"/> Biotechnology	<input type="checkbox"/> Gaming	<input type="checkbox"/> Service
<input type="checkbox"/> Consumer Products/Services	<input type="checkbox"/> Internet	<input type="checkbox"/> Software
<input type="checkbox"/> Energy	<input type="checkbox"/> Medical/Healthcare	<input type="checkbox"/> Technology
<input type="checkbox"/> Entertainment	<input type="checkbox"/> Natural Resources	<input type="checkbox"/> Telecommunications
<input type="checkbox"/> Environmental	<input type="checkbox"/> Nutraceuticals	<input type="checkbox"/> Wholesale
<input type="checkbox"/> Financial Services	<input type="checkbox"/> Pharmaceuticals	<input type="checkbox"/> Other (Specify) _____

Please check any investment stage(s) that you would consider: Seed Start-Up Expansion

Please check any geographical location(s) you would limit your investments to:

Any USA Specific Region - USA or Foreign (Please Specify) _____

I would consider being an: Active Investor Passive Investor Either

Other criteria, investment guidelines or comments: _____

Return to: Red Tree Intl., 1533 Via Leon, Palos Verdes Estates, CA 90274. Tele. 310-265-8644/Fax 310-544-9684

APPENDIX

BUSINESS PLAN OUTLINE

Intellectual property of Red Tree International
(With credit to: Stanley E. Pratt, A. David Silver, McKinley Institute
Arthur Lipper, III and Bruce Blechman)

Title page including:

1. Company name, address and telephone number
2. Contact person
3. Logo

Next, a clear Table of Contents with each section's and sub-section's page numbered.

I. Summary, 1-3 pages

- A. Activities, management and past performance
- B. Distinctive features of product or service and proprietary position
- C. Overall strategy and how the company will reach objectives
- D. Attractiveness of market and niche and customer benefits
- E. Who else is associated? Names of prominent customers, suppliers, investors
- F. Summary of five-year financial projections and history
- G. Amount of money sought and form (equity, debt, etc.) and purpose and collateral
- H. Exit vehicle and time for investor and potential return
- I. Whom to contact and how

II. Description of business and industry

- A. Brief description product, to whom it will be sold, nature and current condition of industry and where company fits
- B. The company
 1. Description of business (including history)
 - a. When founded
 - b. List of important events from beginning
 - c. Summary of founder's management team
 2. Description of product
 3. Description of customers
 4. Description of geographic area for operations
 5. Past problems and reasons they won't repeat
 6. Reasons for entering into this business
- C. Description of industry
 1. Economic trends
 2. Technological trends
 3. Regulatory trends
 - a. How they will meet requirements
 - b. Anticipated changes and why
 4. If plan is to go public in the future, list of industry's average P/E ratio for large, medium or small firms, dependent on company size - also list of average financial ratios

III. Features and advantages of product or service

- A. Description in detail without getting too technical
 1. Distinguishing features and advantages over competition
 2. Highlighted differences
 3. What needs do they satisfy
 4. Present stage of development
 - B. *Proprietary position. This is critical!
 1. Explanation of range of protection and strategy to create barriers to others in the market beyond patent or copyright protection
 2. *Uniqueness - how do they differ (very important)
 3. Patents, trade secrets, etc.
 4. Head start
 5. Plans for the future
 6. What technology is superior or equal to theirs
 7. Non-disclosure/compete agreements with owners and key employees
 - C. Potential
 1. Encore performance
- *IV. Market research and analysis (This must be thorough and detailed) Company should be market oriented... not product oriented
- A. Customers
 1. Who
 2. Where
 3. Why they buy
 4. Significance of price, quality, service, personal contacts and political pressures (by order of importance)
 5. Actual or potential customers and why
 6. Actual or potential customers who dropped and why
 - a. How are they overcoming negative reaction
 - B. Market size and trends
 1. From discussions with potential distributors, dealers, sales reps and customers
 2. Published data also
 3. Size of total market in units and dollars
 4. Potential annual growth of market
 5. Market projections, three years minimum
 6. How are industry trends, new technological developments and new and changing customer needs affecting market growth
 7. Review previous market trends and explanation of difference between past and future growth, or will they assume the same
 8. Identified barriers to market entry
 - C. Competition
 1. Realistic assessment of strength and weaknesses and names of companies
 2. Comparison with competition (in table form if possible)
 - a. Price
 - b. Performance
 - c. Service
 - d. Warranties
 - e. Etc.
 3. Management strengths and weaknesses
 4. Financial strengths and weaknesses
 5. Marketing strengths and weaknesses
 6. Operations strengths and weaknesses
 7. Recent trends in sales, market share and profits

8. Why do customers buy from 3-4 key competitors
9. Why can company capture some of their business if that is necessary

V. Estimated market share and sales (present and future)

- A. How the figures were arrived at for projections
 1. Justification by bottom-up approach based on projections using specific customers
- B. Which customers made or will make purchase commitments and to what extent

SALES AND MARKET SHARE DATA

		<u>1st year</u>				<u>2nd year</u>			
		<u>Q1</u>	<u>Q2</u>	<u>Q3</u>	<u>Q4</u>	<u>Q1</u>	<u>Q2</u>	<u>Q3</u>	<u>Q4</u>
Est. Tot. Market	Units Dollars								
Est. Sales	Units Dollars								
Est. Mkt. Share	%								

(If an existing business, have chart for two prior years also)

C. Marketing plan (a plan within the plan)

1. Marketing strategy
 - a. Evidence of customer acceptance
 - b. Focus on only one or two opportunities, products or product lines
 - c. Kinds of customers for initial and later sales efforts
 - (1) How to identify
 - (2) How to contact
 - (3) What features are stressed
 - (4) *What are the customer benefits and why (documented with claims if possible)
 - (5) How the company fills the wants and needs of the market
 - d. If seasonal, discussion of out of season sales
2. Pricing
 - a. How will price enable company to:
 - (1) Secure/increase acceptance of offer
 - (2) Maintain and increase market share
 - (3) Produce profits
 - b. Justification of price increases over competition
 - c. How to profit if priced below competition
3. Identification of first customer and how they will get
 - a. Most important one
 - b. Establishment of credibility with a "name"
 - c. What kind of deal will they have to make
4. Identify marketing niche
 - a. Most lucrative
 - b. Easiest to penetrate

- c. Names of target customers with specific times and dates
 - D. Sales tactics
 - 1. How will they sell and distribute the product/service
 - 2. Margins to retailers and wholesalers and commissions and/or salaries to sales reps. Comparison with competition
 - 3. Special policies regarding discounts and exclusive distribution rights
 - 4. Elaboration on positioning strategy
 - E. Service and warranty policies
 - 1. Importance
 - 2. How they will handle service problems
 - F. Advertising, public relations and promotions
 - 1. If advertising is a significant part of expenses, indication of how and when costs will be presented
 - 2. Description in detail of free publicity plans
- VI. Design and development plans
- A. Developmental status and tasks
 - 1. Current statuses and what needs to be done to make marketable
 - 2. Description of competence or expertise company has or will acquire to complete
 - 3. Description of future R&D to keep market
 - B. Difficulties and risks
 - 1. Problems and approaches to solve
 - 2. Impact on timing
 - 3. Cost of design or development
 - C. Costs
 - 1. Show 10-20% contingency
- VII. Operations plan (Must show capability of operating business in detail)
- A. Description of kind of facilities, space requirements, capital equipment and labor force
 - B. Geographic location
 - 1. Advantages/disadvantages in terms of: wage rates, unions, labor availability, closeness to customers/suppliers, access to transportation, state and local taxes and laws, utilities and zoning
 - C. Facilities and improvements
 - 1. Equipment/space: leased or acquired, new or used, costs and timing
 - 2. Expansions, improvements, moves
 - a. Future equipment and space needs
 - b. Three year planning period
 - D. Strategy and plans
 - 1. Make or buy strategy
 - a. Justification
 - 2. Identification of potential subcontractors, suppliers, assemblers
 - 3. Production plan
 - a. Manufacturing process
 - b. Cost/volume information at various production levels
 - (1) Materials
 - (2) Labor
 - (3) Purchased components
 - (4) Factory overhead
 - (5) Inventory (at various sales levels)
 - (6) Seasonal production loads

- c. Quality control
 - d. Production control
 - e. Inventory control
 - 4. Purchasing function and plan
 - E. Labor force (exclusive of management)
 - 1. Full description (number, union or not, white or blue collar, etc.)
 - 2. Training
 - a. How they will pay for training
 - 3. How they will attract and keep good employees
 - F. Department by department budget
 - G. All managers should sign off on operations plan
- VIII. ****Management team (Most important. It is could be too late to build a team once one is needed. They should plan ahead.)**
- A. Organization (chart if possible)
 - 1. Where management has worked together
 - 2. When they will join
 - 3. How are they locating and securing commitments
 - 4. Are they part-time specialists/consultants
 - B. Key management personnel
 - 1. 3-4 sentence career highlights for each individual
 - 2. Complete resumes for key management
 - a. Education, training, experience, accomplishments (specific, and who can attest to these)
 - b. Rewards received (pay increases, promotions)
 - c. Address; tele. number; personal, professional and trade references of each
 - 3. Is management team experienced, and do they have complimentary skills
 - C. Management compensation and ownership
 - D. Board of directors
 - 1. 1-2 sentence statement
 - a. Background
 - b. How they will benefit company
 - c. What investment have they made
 - E. Management assistance and training needs
 - 1. Unique strengths and weaknesses of each manager and director
 - F. Marketer
 - 1. Need one with experience and contacts in their industry
 - a. Only efficient way to open doors in a closed system (assume all are closed)
 - G. Supporting professional and support services
 - 1. Accounting, public relations, advertising, banking, contractors, etc.
 - 2. Association with credible people to gain credibility
 - H. Offer to supply formal credit and personal background check reports on principals
- IX. Overall schedule
- A. Month by month
 - 1. Incorporation
 - 2. Completion of prototypes
 - *a. This is a key, an ability to perform
 - 3. Hiring sales reps
 - 4. Dates of displays at trade shows
 - 5. Sign up distributors and dealers

6. Order of materials for full time operation
 7. Start of operation
 8. Receipt of first orders
 9. First sales and deliveries
 10. Payment of first accounts receivable
 11. Past problems and solutions
 12. Key milestones, etc.
- B. Discussion of activities most likely to cause a schedule slippage and steps to correct and the impact on schedule's slippage
- C. Allowance for underestimation of time
- D. PERT Chart (an illustration of a time study of the flow of events in the company that creates receipts and disbursements - an essential management tool)

X. Critical risks and problems

- A. Explanation of all pertinent such as, and how they hope to overcome:
1. Price cutting
 2. Potential unfavorable industry trends
 3. Design or operational costs in excess of estimates
 4. Sales projections not achieved
 5. Development schedule not met
 6. Difficulty or delays in getting raw materials
 7. Tight money
 8. Costs to remain competitive (innovation and design)
 9. Lack of trained labor
 10. New competition
 11. Etc.

XI. The financial plan

- A. Current financials - certified if available
- B. Discussion of all assumptions (bad debts, discounts, sales, general or administrative expenses, etc.) as a percentage of costs or sales and in great detail
- C. Assignment of probabilities of reaching projections, and stated rationale for projections in all statements. If it's a guess, do they say so
- D. Projections must not deviate excessively from industry norms. They should be enticing, but most of all - realistic
- E. *Cash Flow Forecast (most important financial forecast by far)
1. By month for first year
 2. By quarter years 1-3
- F. Profit and Loss Forecast
1. Sales forecast is crucial
 2. Per month for first year
 3. 2nd and 3rd year by quarter
 4. One page annual summary for years 1-5
- G. Balance Sheet Forecasts (optional)
1. Shows assets required, and through liabilities, how they will be financed
 2. Prepared at start-up
 3. Prepared for 1st six months
 4. Prepared end of year forecasts for years 1-5
 5. Included Accounts Receivable and Accounts Payable Aging (if applicable)
 6. Included Schedule of Major Assets and Schedule of Major Liabilities
- H. Cost and Cash Flow Control

1. Brief description of how they design, install and maintain systems for controlling costs and cash flow

XII. Proposed Company Offering

- A. Summarization from cash flow projections amount needed over three years
- B. Capitalization
 1. Names of current shareholders and number of shares owned by each
 2. How many shares authorized but unissued after offering
 3. How much we will they give for investment and projected return on investment
- C. Use of (loan or investment) Proceeds
 1. Specific, and in great detail

XIII. Appendix

- A. Support data
 1. Articles
 2. Brochures and price lists
 3. Patents
 4. Purchase orders, contracts, letters of intent
 5. Testimonials
 6. Glossary of terms
 7. Background report on principals (Offered to furnish on request)
 8. Credit report on principals (Offered to furnish on request)
 9. Principals' tax returns and financial statements (Offered to furnish on request)
 10. 5-10 personal and professional references
 11. Color photographs
 12. Market survey
 13. Production flow chart
 14. Resumes
 15. Contracts
 16. Technical data
 17. Etc.
18. A final touch could a home video tape, which illustrates:
 - a. Manufacturing process
 - b. Facilities
 - c. Product
 - d. Verbal biographies of key personnel
 - e. Testimonials
 - f. Any other dramatic support data