

Managing Risk of Direct Investment in Private Companies



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Overview

Today's investing environment is unlike any in recent history. Several external factors such as the continued lack of liquidity in the credit markets, the volatility in the public equity markets and the uncertain legislative environment have combined to make this a difficult time for investors to adequately gauge risk and evaluate investment opportunities. However, even during uncertain times such as these, significant opportunities may be found through direct investments in private companies. With the restriction of the credit markets and limited venture capital available for growth stage companies, many private companies are turning to family offices seeking equity investment. While private company investments can yield significantly higher returns than public equity or fixed income investments, there are numerous risks that must be managed when considering direct investment in private companies.

The following discussion highlights three key aspects to successfully analyzing private company investment opportunities. First, because private company operations typically lack transparency, a careful and detailed due diligence process must be undertaken to adequately assess operational risk. Second, since most private companies are operated with tax efficiency as a high priority, thorough analysis, adjustment and recasting of the financial statements is often required to understand the true underlying cash flow generation capabilities. Third, due diligence of the management team and/or transaction sponsor is critical to making sound direct investments in private companies.

Assessing and Managing Business/Operational Risks

From a business and operational diligence perspective, obtaining the requisite data to properly analyze a company's industry and operations can prove difficult and time consuming. However, it is critical that family office advisors go beyond reading the private placement memorandum or business plan and conduct a proactive due diligence investigation. Some key questions that should be considered include:

- Market trends – Is the company pursuing a unique or underserved niche in the market and are macro trends favorable? As Warren Buffett says, "it doesn't matter how hard you row if you're rowing upstream." Thus, family office advisors should ask probing questions about the industry and market. For example, what differentiates the target company from other competitors? Have they carved out a defensible niche? With adequate resources and focus, how long would it take a competitor to catch up to or surpass the target company? In other words, how much of an edge does the company truly have? Are the industry and market growing? To grow, will the company have to take market share from competitors, or is the industry growing quickly enough to accommodate many competitors?
- Customer trends – Is the company targeting customers in a growth industry or market? Can the company capitalize on macro trends to push it to the next level?
- Sales channel trends – How is the company currently selling its products? Does this method provide for barriers to entry from competition? Are current sales channels forecast to expand, change, etc.?

- Intellectual property – Does the company's success rely on intellectual property? If so, does the company have the necessary protection in place, and how well are the company's proprietary processes or products protected from existing or potential competitors?
- Supply chain – Does the company have a clearly defined strategy for managing its supply chain and do adequate raw materials exist at prices forecast in the business plan?
- Technology risk – Does the company control all of the necessary technology to implement its plan?

A detailed, bottom-up analysis is usually required to reconcile the data received to the financial statements. This additional level of scrutiny also helps identify gaps in information and sometimes inaccuracies in financial reporting. Additionally, and of equal importance, a thorough review of legal issues, insurance coverages, human resources, and benefits, etc. is necessary to fully understand the target company.

Overall, this phase of the diligence process often involves lengthy discussions with management, in-depth review of documents, and consultation with outside professional advisors in order to ensure all bases are covered and business/operational risks are clearly defined and understood before an investment is made.

Assessing and Managing Financial Risks

Financial diligence includes a detailed review of all of the company's financial statements, internal management reports, accounting policies and procedures, budgets/forecasts, and any relevant financial metrics/ratios.

There are several common areas of consideration when analyzing a company's financial condition. Questions to ask during this phase of diligence include:

- Are the financial statements audited? If so, is the auditing firm well regarded?

This is often one of the most important considerations. A set of audited financial statements provides the investor a baseline level of comfort with financial controls and reporting methods, as GAAP has a well defined set of rules that make comparison and analysis between companies easier. Unfortunately, many private companies, particularly earlier stage companies do not have audited financials.

- If the financial statements are unaudited, how does the company account for revenues and expenses?

Most private companies use a modified accrual type of accounting, which is somewhat of a hybrid between cash based accounting and GAAP. Determining the underlying cash flow position is essential and should usually entail a quality of earnings review with thorough analysis of cost and revenue recognition practices.

- Does operating income need to be adjusted (normalized) to more accurately reflect both historical and future cash flow?

It is not uncommon for private companies to have owners' or shareholders' personal expenses, assets and liabilities on the company books. These items can often significantly affect company cash flows and overall financial position; therefore, potential investors should thoroughly analyze the company's financial statements to identify any possible non-recurring or extraordinary items that should be added back to earnings or would require restatement of the company's balance sheet. These include:

- Personal expenses (e.g. excessive salary or cash distributions, college tuition for the owner's children, etc.)
- Personal liabilities (e.g. credit cards, loans, etc.)
- Personal assets (e.g. owner's or shareholder's car, property, etc.)
- One-time charges not associated with normal business operations (e.g. litigation expense, one-time fees for outside consultants or professional advisors, etc.)
- Use of personal charge cards or cash for company expenses. This is not as uncommon as one would think, as many officers may seek to manage monthly cash flow by using personal charge cards for corporate expenses. These charges must also be added back to normalize earnings.

- How reliable and robust are the company's internally generated operating budgets and/or forecasts?

Operating budgets and forecasts vary widely among private companies. Some have good internal budgeting procedures that provide a potential acquirer with a clear and accurate picture of the company's future growth potential. Often times however, companies lack the sophistication and data necessary to create reliable and realistic forward looking statements. Understanding the true historical operating performance of the company, along with micro and macro economic factors can help an investor interpret and gauge the reasonableness of the company's budget or forecast.

Ultimately, the key financial component to understand is the underlying operating cash flow of the entity and the company's ability to grow that cash flow to provide the investor with the projected return. A quality of earnings review at the front end of the investment process can significantly diminish financial risks.

Assessing and Managing Management Risk

Along with financial and operational risk management, comes analysis of risks related to company management. Understanding existing management capabilities, objectives and motivations is integral to a successful transaction. Often times, there are hidden agendas or misalignment between management and investor objectives. Irrespective of how compelling the investment opportunity, it is critical to thoroughly investigate management and assess the team's ability to work together to execute the plan. Typically, since no one is in a better position to objectively evaluate a company's performance and future growth prospects than its existing management, the onus falls on the outside investor to adequately diligence the management team. The first issue that needs to be addressed is management integrity, competency and ability. Questions to address include:

- What are the personal backgrounds of all key members of the management team? Ideally, in addition to reviewing resumes and contacting references, a background check should be performed on all team members. The use of third party private investigators to vet the team can avoid costly mistakes associated with investing with the wrong people. As President Ronald Reagan said, "Trust, but verify."
- How effective is the management team at working together? A long history of working together is usually a good indicator of future success. However, if the company is undergoing a major transition, which is often the case when outside capital is sought, management team dynamics can become strained. In some cases it may be worthwhile to use team dynamic or personality profile analysis to evaluate how the team may react under pressure.
- How focused is the management team on growing the company? Are they aware of industry trends and dynamics, and do they have the capability to keep the company in a leading market position?
- Are they visionary leaders? Do they have a well articulated plan for achieving superior financial results?
- How deep is the management team? If one or two key executives were to leave the company, how proprietary is their expertise? Are they replaceable or integral to the continued success of the company?
- Finally, is the current management team capable of managing the company if it were to double or triple in size? Have they set up the right processes and controls to enable operational growth? Will they be willing and able to handle the transition in culture from a small to a larger company?

Once management integrity and competency have been assessed, the next step is to understand the objectives of management, both during and after the transaction is closed, which often involves aligning management's incentives with investor objectives. Alignment is typically created through carefully structured employment agreements that include both cash and equity incentives.

Conclusion

Direct investment in private companies can provide significant returns that have the potential to far exceed that of public equity and fixed income markets while providing attractive diversification and increased control. This increased upside return potential comes with increased risk, requiring a higher level of diligence on the part of family office investors. This diligence process can often prove to be lengthy and complex, but it increases the likelihood that the investor will realize an attractive return, while protecting capital.

The three key risks to analyze are: (1) financial, (2) operational/business, and (3) managerial. The goal in financial diligence should be to gain a thorough understanding of the company's cash flow, how it is generated, risks thereto, as well as future growth potential. Through

operational diligence, the investor should come away with an in-depth understanding of the company's processes, procedures, customers, products/services, intellectual property, market and industry. Lastly, the investor should perform comprehensive managerial diligence, assessing management's integrity, competency, objectives and motivations.

When investing in private companies, knowing the landscape and having the wherewithal to navigate through the complex and tumultuous pre-investment diligence phase will greatly increase the probability that the investor will enjoy the significant upside potential often associated with this lucrative asset class.

ABOUT THE AUTHORS:

Joe Durnford is the Senior Managing Director and CEO of JD Ford & Company, Investment Bankers and its affiliated companies. Mr. Durnford has over twenty years experience in corporate finance and has structured, negotiated and completed in excess of \$1 billion in mergers, acquisitions, divestitures and financing transactions. Mr. Durnford is also the founder and chairman of numerous private companies, and has served as audit and finance committee chairman for publicly listed corporations. Prior to founding JD Ford & Company in 1996, Mr. Durnford was a corporate finance and business consultant at the predecessor firms of Pricewaterhouse Coopers and Deloitte. Mr. Durnford earned a BSBA (Accounting) at the University of Colorado Leeds School of Business, is a Certified Public Accountant (inactive), a Certified Valuation Analyst, a Certified Merger & Acquisition Advisor, and holds Series 24, 27, 7 & 63 securities licenses.

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