A CONSUMERS GUIDE TO MAKING VENTURE INVESTMENTS IN SMALL BUSINESSES

The State of Idaho has adopted procedures that make it easier for small businesses to raise start-up and growth financing from the public. Many investors view this as an opportunity to “get in on the ground floor” of emerging businesses and to “hit it big” as these small businesses grow into large ones.

Statistically, most small businesses fail within a few years. Small business investments are among the most risky that investors can make. This pamphlet suggests criteria for determining whether you should make a small business investment.

Risks and Investment Strategy

The overriding principle that should control any decision to invest in a small business is: **NEVER MAKE A VENTURE INVESTMENT THAT YOU CANNOT AFFORD TO LOSE ENTIRELY.** Never use funds for a venture investment that might be needed for other purposes, such as college education, retirement, loan repayment or medical expenses. Instead, use funds that would otherwise be used for a consumer purchase such as an extra vacation, or a down payment on a boat or RV.

Venture investments are sometimes structured as convertible debt. This does not mean that you should count on receiving the interest payments or even return of principal. The primary reason for structuring the investment in this manner is to give the investor a preferred claim over those of common and preferred stockholders if the company goes into bankruptcy or receivership, while preserving gain potential through the equity convertibility provision should the company prove successful.

Above all, never let a securities salesperson (who is paid by commission) convince you that the investment is not risky. Any such assurance is simply inaccurate. Venture investments are almost always highly illiquid even though the securities may technically be freely transferable. Thus, you will usually be unable to sell your securities if the company takes a turn for the worse.

Also, although the business may have registered or filed forms with a government agency, the agency has not evaluated or endorsed the investment. Just because the agency has registered the offering or received forms does not mean the particular investment will be successful. (If anyone suggests otherwise to you, he or she is guilty of a criminal offense.)

Typically, professional venture capitalists do not invest large portions of their portfolio in a single company. Instead, they invest in a large number of companies and hope that a few highly successful investments will more than offset many unsuccessful ones. If you plan to invest large amounts of money in small businesses, you should consider this strategy. Even when using this strategy, **DO NOT INVEST FUNDS YOU CANNOT AFFORD TO LOSE ENTIRELY.**

Professional venture capitalists (who manage large amounts of money full-time after years of experience) often operate in syndicates and see the best deals before others do. Accordingly, their results may be substantially better than yours may be using the same strategy.

Analyzing the Investment

Assuming that you have disposable income to spend on a venture investment, what factors should you consider when making an investment decision? Although there is no set formula for making successful investment decisions, certain factors are often considered particularly important by professional venture investors. Some of these factors are discussed below.

In assessing potential investments, do not over-value a company's potential for future success. Much can (and usually does) go wrong before a company is successful. Be careful not to pay too much for securities in a company that lacks a history of operations from which an assessment of value can be made. No matter how successful the company may be, the investment is not good if the price of the securities is too high.

Management

Most professional venture investors single out management quality as the most significant factor in the success of a small business. Inexperienced investors often give too much weight to a glamorous product and too little weight to management experience, skill and integrity. Critical questions are:

- How much experience does management have as managers in the industry and in a small business?

- How successful were the managers in previous businesses?

Also consider whether management is dealing unfairly with investors by taking salaries or other benefits that are too large in view of the company's state of development or is retaining an inordinate amount of equity of the company compared with the amount investors will receive.

Industry

Perhaps the second most important factor to consider is the company's industry. A growth industry is desirable, but careful attention must be paid to ease of entry and other competitive factors. Much key information concerning an industry is not usually included in prospectus or other disclosure document. You may wish to make an in-depth investigation of the industry on your own. Industry research reports by securities analysts, and statistics in trade journals, may be useful. Be careful when analyzing articles in the business press. These articles often reflect only the views of companies in the industry and may contain exaggerated prospects. Also, when analyzing a new industry, do not confuse a "need" with a "market". Much advertising and other expensive and time consuming selling efforts may be required before customers actually purchase products that meet particular needs.

Marketing

Do not overlook the cost of marketing and the time it takes to penetrate a market. A classic analytical trap is to estimate the total size of a market (often confusing "need" with "market") and then to assume that the company will somehow obtain some percentage of that market without actually analyzing what is involved to achieve that percentage. This type of analysis is simplistic and misleading. Consider it to be a warning sign if encountered.

The proper approach is to make a step-by-step analysis of the marketing strategies, efforts, and time required to penetrate a particular market segment, and to evaluate this in light of the company's resources for these purposes. This analysis will be more apt to provide a realistic assessment of market penetration than are percentages assumed without foundation.

Realizing on Your Investment

In your analysis of an offering, anticipate the method by which investors are likely to ultimately realize on their investment. The two classic methods are resale in the public securities markets following a public offering or receiving cash or marketable securities in a merger or other acquisition of the company.

If the company is not the type that is likely to go public or be sold out within a reasonable time, it may not be a good investment irrespective of its prospects for success. Being a minority security holder in a private company is generally not a happy prospect. Management may receive a good return indefinitely through generous salaries and bonuses if the company is successful but remains private. Be wary of family businesses. Some businesses are simply not prospects for eventual public offerings. A review of the various types of companies that are public should give you insight as to whether a particular type of company is or is not a good prospect for an eventual public offering.

Other suggestions

The Disclosure Document usually used in public venture offerings is a "Small Company Offering Registration Form (Form U-7)" which has a question and answer format. The questions are designed to bring out particular factors that may be crucial to the proper assessment of the offering. Read each question and answer carefully. If an answer does not adequately address the issues raised by the question, reflect on the importance of the issue in the context of the particular company. Be cautious.

Remember, there are generally far more investment opportunities than there is venture money to go around. Even the best venture offerings are highly risky. Obey your instincts. If you are not entirely comfortable, the best approach is usually not to invest. There will be many other opportunities. Do not let a securities salesperson pressure you into making a premature decision.

It is generally a good idea to see management of the company face-to-face so you may size management up. Focus on experience and track record rather than a smooth sales presentation. If at all possible, take a sophisticated business person with you to help you in your analysis.

Beware of information that is different from that in the Disclosure Document or not contained in the Disclosure Document. If it is significant, it must be in the Disclosure Document or the offering will be illegal.

Conclusion

The regulatory procedures in the State of Idaho enable greater numbers of public investors to "get in on the ground floor" by investing in small businesses. This provides a source of capital for small businesses in the state, which in turn enhances the state's economy and provides additional jobs for its citizens. Investors have new opportunities for investment success but must balance this against the inherently risky nature of small business investments.

Statistically, most small businesses will fail and only a few will "hit it big". If you are cautious and prudent in making your venture investments, your chances of obtaining a good return will be substantially improved. A side effect of this type of activity is that new worthy businesses are formed (many of which will prosper), and investment capital is properly allocated within the economy. The more investors that secure a rewarding return, the greater the interest will be in small business investments.

The Idaho Department of Finance maintains a current list of offerings registered using the Small Company Offering Registration Form (Form U-7), including the names and telephone numbers of persons to contact for copies of current Disclosure Documents. This list may be obtained by contacting the Department in writing or by telephone.

Idaho Department of Finance Securities Bureau, 800 Park Blvd., Suite 200, Boise, Idaho 83712, P.O. Box 83720, Boise, Idaho 83720-0031 (208)332-8004

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