INVESTOR AWARENESS BULLETIN

A GUIDE TO:

MAKING VENTURE INVESTMENTS IN SMALL BUSINESSES

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INVESTMENT IN SMALL BUSINESSES

Small businesses may raise start-up and growth financing by selling stock or debt to the public. This type of financing often is considered public venture capital. In fact, many investors view such financing as an opportunity to get in on the ground floor of emerging businesses and to realize huge profits as the small businesses grow into large ones. BEWARE! Small business investments are associated with high risk. Purchasing the stock or the debt instruments of a small company is a highly speculative investment. Statistically, most new businesses fail within the first few years of operation.

REGISTRATION OF SMALL BUSINESS SECURITIES

Arizona offers Uniform Limited Offering Registration (ULOR) to small businesses. ULOR is a simplified registration procedure to reduce the costs of a public offering. Lower costs make it financially feasible for small businesses to sell their securities to the public. Corporate officials describe their business and their business proposals on a Form U-7. The U-7 follows a question and answer format to elicit information very similar to that found in a standard business plan. Once the securities are registered for sale by the Arizona Corporation Commission, the Form U-7 becomes the offering document for investors.

Small businesses may also offer their securities without registration if the businesses follow the terms of specific exemptions from registration. The businesses should still give an offering document that describes the company and the offering to potential investors.

Whether offered under an exemption from registration or as a registered public offering, securities of small businesses include investment risks you need to consider thoroughly before investing. Read the following discussion closely to determine if an offering is within your risk "comfort zone" and satisfies your investment objective.

WHAT ARE YOUR INVESTMENT RISKS?

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**. The ability of a small, vulnerable enterprise to survive in a competitive business climate is not known. Given this uncertainty, never use funds for a venture investment that might be needed for necessary expenses, such as your children's education or your own retirement. Instead, use discretionary dollars that would otherwise be spent on a consumer purchase, such as an extra vacation or a down payment on a boat or recreational vehicle.

The ability of a new or small company to provide a return on its debt offering or appreciation on its stock offering also is uncertain. Never let a securities salesperson (who is paid by commission) convince you that the investment is without risk or that the Arizona Corporation Commission endorses an investment because it has been registered for sale. Any such assurances are false, and you should report the salesperson to the Commission's Securities Division. Also, never let a securities salesperson rush you to make an investment decision. Always take the time to read and understand the offering material.

Another uncertainty in venture investments is that they are almost always highly illiquid. The securities technically may be freely transferable, but the resale market may be "thin" or nonexistent. Thus, not only is your potential for profit not guaranteed, but you may be unable to sell your securities.

KNOW YOUR INVESTMENT STRATEGY

Typically, professional venture capitalists do not invest large portions of their funds in a single company. Instead, they spread their risk by investing in a large number of companies and hoping that a few, highly successful investments will more than offset the many unsuccessful ones. If you plan to invest large amounts of money in small businesses, you should carefully consider your strategy. Even when using this strategy, do not invest funds you cannot afford to lose entirely.

HOW TO ANALYZE YOUR VENTURE INVESTMENT

Assuming that you have discretionary dollars 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. Consider these factors carefully while reviewing the offering documents. If you have any questions, require management to answer all questions to your satisfaction before you invest.

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 in the industry, in a small business, and in financial and marketing functions?
- How successful were the managers in previous businesses?
- Has management prepared contingency plans for an unexpected death or resignation of a key executive or product developer?
- What is management's reputation in the local business community?
- What is management's salary and benefits package? Is it appropriate given the company's financial condition?
- What position if any, is management retaining in the company's ownership, i.e., what percentage of stock will be held by management?

Make sure that all of your questions and concerns are addressed. In fact, you may want to meet the management team about to have the use of your money. Remember to focus on their prior business history and not on their rehearsed sales presentation.

Industry

Always consider the company's industry. A growth industry is desirable, but you must pay careful attention to the ease of entry into that industry or market and other competitive factors. The offering document to investors often lacks much detailed information on the company's primary or related industry. You may wish to conduct your own industry investigation. Study research reports by securities analysts and statistics in trade journals to learn about growth trends and the financial health of competitors. Articles in the business press also are helpful, but reflect only the subjective views of companies in the industry. Finally, 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 their particular "needs."

Marketing

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

An accurate marketing plan makes a step-by-step analysis of the sales strategies, the efforts, and the time required to penetrate a particular market niche. Evaluate this plan in terms of the company's management and financial resources to be expended on marketing and the resources available to the company's competitors. This analysis will provide a realistic assessment of the company's ability to capture market share.

Financial Condition

Examine the financial statements (including the footnotes). Look to the cash and debt positions, among others, to indicate performance potential and a solid financial base. If the corporation is new, it will have no track record. Instead, you must base your investment decision on assumptions of future sales and expenses. Are the assumptions realistic? Are the cost components and profit expectations within normal industry ranges? What corrective actions will management take if projected results are not obtained? A good business library should be able to give you the information to confirm or reject the financial conclusions made in the offering document. Also, study again the industry trade journals.

Notice whether the financial statements are reviewed or audited. A review is substantially less comprehensive than an audit. While a review may bring to the accountant's attention significant matters affecting the statements, there is no assurance that there are not significant adjustments that must be made in order to fairly present the issuer's financial position. Read the accountant's report carefully.

Finally, consideration of financial projections will help to put a value on the price of the issuer's securities. Do not overvalue the potential for profits and thus pay too much for securities in a company that lacks a history of operations. No matter how successful the company may become, the investment is not good if the price of the securities is too high.

Use of Proceeds

How will your investment be used by the issuer? Purchases of equipment, facilities, or distribution routes are examples of investment in a company's growth. Expenditures on management salaries and other "overhead" or administrative items may not contribute to the company's profit. The "Use of Proceeds" is discussed in the offering document. If you are concerned or do not understand the disclosure material, ask management for an additional explanation.

Exit Strategy

Before you purchase any stock or debt instrument of a small business, consider how you will eventually sell your investment.

The two standard methods are selling your investment in the public securities markets or receiving cash or some other form of compensation resulting from a merger or an acquisition of the company.

If the company is not likely to develop a secondary market in its securities or is not likely to be sold within a reasonable time, it may not be a good investment irrespective of its prospects for success. Your dollars and your percentage of the profits they helped to generate will be "trapped" in the company. Being a minority security holder in a small 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 illiquid. In this regard, be wary of family businesses. Review the various types of companies whose securities are publicly traded. This should give you insight as to whether the particular type of company under consideration will offer investors an exit strategy.

USE YOUR BEST JUDGMENT

The sale of small business debt and stock offerings enhances the state's economy and provides additional jobs. A larger capital base allows Arizona businesses the opportunity to grow. Likewise, opportunities to invest in small businesses give Arizona residents new opportunities for investment success. However, investors must balance the potential for success against the inherently risky nature of small business investments. They should consider discussing any investment opportunities with their attorneys, accountants, or other business advisors.

Remember, if you are cautious and prudent in making investment decisions, your chances of obtaining a good return will be improved significantly.