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The 9 Secrets of Pre-IPO Investing

- *How to Find and Evaluate Emerging, Early-Stage Investment Opportunities*
- *How to Position Yourself to Earn Outsized Returns*
- *How to Mitigate Your Risk Through Diversification and Investment Monitoring*

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Introduction

Overview

Andy Bechtolsheim, Google's first individual investor, wrote a \$100,000 check to Google in 1998 when it was a private company. As of March 2008, this \$100,000 is worth approximately \$1.5 BILLION dollars.

In March 2008, Bebo was sold to AOL for \$850 million. Institutional investors that came in only 18 months earlier earned 9 times their investment back. Original investors again had the potential to earn over ONE HUNDRED TIMES their initial investment.



There are countless examples of investors identifying and investing in companies well before their Initial Public Offerings (IPO's) and earning truly extraordinary returns for their early investors. This guide provides an overview of Pre-IPO, or private company investing, and discusses the nine secrets to successfully investing in this market space.

What is Pre-IPO Investing?

Pre-IPO, also called private company investing, is the process of investing in privately-held companies. The earlier the stage of the company, the more likely that the investor would be an individual versus an institution such as a venture capital or private equity fund.

When the investments are made by individuals, the individuals must be classified as "Accredited Investors," which are defined as:

- a natural person who has individual net worth, or joint net worth with the person's spouse, that exceeds \$1 million at the time of the purchase;

and/or:

- a natural person with income exceeding \$200,000 in each of the two most recent years or joint income with a spouse exceeding \$300,000 for those years and a reasonable expectation of the same income level in the current year.

Private Company Returns Outperform All Other Investment Classes

According to 20-plus years of data collected by Thomson Financial, early, or seed stage, private company investing has over the long-term, **outperformed all other investment classes** -- with average annual returns of over 20.6%.

In 2006, individual investors infused \$25.6 billion into private companies, almost as much as the \$26 billion invested by venture capital funds. Venture capitalists only invested in 4,000 U.S. businesses while angel investors invested in more than 51,000 companies. According to the best available statistics, in 2006, there were approximately 234,000 active individual, private company investors and approximately 49,500 private companies which received funding from individual investors.

What Private Company Investment Success Looks Like

We have all heard of the numerous IPO successes of privately funded ventures like Google (\$100K initial investment) and Intuit (\$225K initial investment). And we've all heard of the even more numerous acquisition successes such as YouTube (acquired by Google for \$1.65 billion only 18 months after its launch), PayPal (acquired by eBay for \$1.5 billion) and MySpace (acquired by News Corporation for \$580 million) to name but a few.

But the key to private company investing is that for every one of these big name firms that is covered by the mainstream and business press, there are hundreds of smaller firms which make their early investors millions.

Some of these firms include:

- About.com: acquired for \$410 million by the New York Times
- Advertising.com: acquired for \$435 million by AOL Time Warner
- Affinity Labs: acquired for \$61 million by Monster Worldwide

- AllBusiness.com: acquired for \$55 million by Dun & Bradstreet
- Aruba Networks: IPO at a \$1 billion valuation
- Club Penguin: acquired for \$350 million cash (and possible \$350 million earnout) by Disney
- FraudSciences: acquired for \$169 million by PayPal
- Glu Mobile: IPO at a \$371 million valuation
- Last.fm: acquired for \$280 million by CBS
- Mellanox Technologies: IPO at a \$579 million valuation
- Orbital Data Corp.: acquired for \$50 million by Citrix Systems
- Overture: acquired for \$1.63 billion by Yahoo!
- Photobucket: acquired for \$300 million by Fox Interactive Media
- Speedera Networks: acquired for \$130 million by Akamai
- Skype: acquired for \$2.6 billion by eBay
- The Generations Network: acquired for \$300 million by Spectrum Equity Investors

Because the average valuation for the first investment in a private company is approximately \$2.5 million, **early investors/founders in these firms may have earned 20 to 1,000+ TIMES their investment.**

Pre-IPO Investing Secret #1

Find the Best Deals by Being in the Right Places

In February 2008, Martha Stewart Living Omnimedia, Inc. announced that it had acquired all of the assets related to the business of Chef Emeril Lagasse, other than the restaurant and foundation-related assets, in a deal that could be worth as much as \$70 million. When asked about Martha's history with Emeril she revealed that she met him over 20 years prior, before he had even opened his first restaurant, and thus already had an established relationship with him.



Upcoming
Events

Martha Stewart's organization was better suited than competitors to acquire Emeril's company due to its established relationship. Likewise private company investors who are well networked are much more likely to find great new investment opportunities.

The following factors help individuals or institutions find the "cream of the crop" deals:

- Relationships: knowing the right people, those who in turn know the "cream of the crop" entrepreneurs
- Reputation: track record for doing high-quality deals
- Online Reach: maintaining a prominent website that entrepreneurs and others frequent
- Offline Reach: attendance at trade shows and networking events

By establishing themselves as authorities in the private investing space and being in the places where great entrepreneurs congregate (online, at events, etc.), shrewd individuals and investors become privy to special situation investment opportunities that the general public doesn't hear about until much later.

Pre-IPO Investing Secret #2

Determine if the Business Plan Is Solid

Apple has sold nearly 142 million iPods since the product family launched in late 2001. Why has the iPod business plan been so successful? Simple. There was a significant market size (the MP3 player market was already \$50 million in 2001 and rapidly growing (hit \$2 billion in 2006)), customers wanted Apple's features (i.e., simple interface, large storage capacity, attractive look) and Apple held a sustainable competitive advantage over traditional electronics manufactures (i.e., computer/operating system background and expertise).



Before considering an investment in any firm, it is critical to ensure that the business plan and model are sound. Regardless of how “whiz-bang” the firm’s products or services appear to be, when reviewing the business plan, astute investors require that the following three conditions are met:

1. There is a large and growing market for the firm’s products and services
2. The firm has a sustainable competitive advantage
3. The firm has developed realistic financial assumptions

1. Large and Growing Market

The business plan must prove to investors that the company is positioned in a large and growing market and that there is a clear and compelling need for the product or service.

In accomplishing this, investors must first review the “relevant” market size in which the company competes. For example, though the U.S. healthcare market is a trillion dollar market, there is no company that could reap \$1 trillion in healthcare sales. Rather, the “relevant” market is the specific niche of the healthcare market in which the firm competes (perhaps drilling down to medical devices and then medical devices that pertain to a specific medical ailment).

Investors should beware of companies who claim they compete in broad, massive markets, because it often means that they don't fully understand their market nor their realistic potential.

In addition to assessing the relevant market, investors need confidence that this market is growing and that there is a real customer need for products and services in the market. This should be assessed by reviewing third party research by credible sources (e.g., not the company's "opinion") regarding the market size and trends. Likewise, data regarding the number of customers in the market, the demographics of these customers, and what products and services these customers are purchasing now to fulfill their needs are all critical to confirming that a market truly exists for the company's offerings.

2. Sustainable Competitive Advantage

Many businesses that seek outside financing have unique concepts, but are not positioned for sustainable competitive advantage, which is critical to potential acquirers and/or public markets.

To begin, a business that states that it has no or few competitors should be questioned, since this may imply that a real market may not even exist. Rather competitors must be assessed as any firm who is providing products and services that fulfill the same need(s) that the company fills or plans to fill.

Likewise, investors must be assured that not only is there an unmet customer need that the company can fill, but that the company has or will build sustainable competitive advantage that allows it to outperform competition in both the short-term AND the long-term.

3. Realistic Financial Assumptions

It is critical that a firm's financial assumptions and projections be realistic. Plans that show penetration, operating margin and revenues per employee figures that are poorly reasoned, internally inconsistent or simply unrealistic greatly damage the firm's chance of success.

Importantly, imperfect financials often result in the firm running out of cash, which is perhaps the primary reason why new ventures fail.

Pre-IPO Investing Secret #3

Assess Whether the Management Team Will Execute

Xiang Yu was a third century (B.C.) General in the Chinese army. He led his troops into enemy territory by crossing the Yangtze River. Then, in order to inspire his troops, Xiang Yu took some unorthodox measures. He burned all of his troop's ships and destroyed all of their cooking materials. This left the troops with only two options: Move forward and conquer the enemy, or perish. The maneuver did not make Xiang Yu very popular with his soldiers; nevertheless, the troops advanced and ultimately emerged victorious.



If you were the Emperor of China in the 3rd century, who would you rather have leading your army, Xiang Yu, or an enthusiastic but unproven soldier? Surely you would choose Xiang Yu.

The key is that companies are made up of people, and if the management team is great, often the company is great. Likewise, with a poor management team, the chances of success are dim.

As such, investors need to really assess the quality of the management team when determining whether or not to invest in a private company. Questions regarding the management team should include:

- What are the backgrounds of the management team?
- Are they respected leaders in their field?
- Do they have a track record of success?
- Have management team members successfully worked together in the past?

A strong management team is almost always a sign of a strong business opportunity. If the opportunity wasn't solid, then these talented individuals would be smart enough to focus their energies elsewhere.

Pre-IPO Investing Secret #4

Understand the Exit Potential

In February 2008, Critical Homecare Solutions Holdings Inc. withdrew its IPO registration citing poor public stock market conditions. In the same month, each of the following companies also withdrew their IPO registration citing poor market conditions: Concentric Medical Inc., Forum Oilfield Technologies Inc., BCD Semiconductor Manufacturing Ltd., Plains GP Holdings LP, Light Sciences Oncology Inc., Tully's Coffee Corp., Archemix Corp. and Biolex Therapeutics Inc.



Investors in private companies reap rewards when the companies in which they invest have an “exit” or “liquidity event” which primarily consists of being acquired by another firm or going public. At this point (or soon thereafter if a holding period exists), investors reap financial windfalls from the event.

When investing in private companies, it is crucial to understand the exit potential of the firms under consideration. Of specific importance include the following:

- 1) How long might it take to reach a liquidity event? Clearly if the company being funded is in the earliest stages of creating a prototype, it might take years for the company to perfect the product and/or penetrate the market. In such a case, investors must be prepared to not cash out for a longer time period.
- 2) How might the company exit? Issues to consider here are what types of companies might be interested in buying the company in the future, and if these companies have a history of buying other companies, or prefer to create competitive products instead.

Finally, if the expected exit is an IPO, investors must be prepared to potentially hold on to the investment longer as the timing of an IPO might depend on state of the public stock markets when the IPO is under consideration. Such is the case with the companies listed above. Fortunately for these companies and their investors, the companies are successful and will probably exit for very significant multiples of their initial investments.

Pre-IPO Investing Secret #5

Negotiate a Fair Valuation

“I recently met a company that I really liked; an innovative online financial services product. It hit a lot of my criteria for investment; it had a working product, it paralleled existing offline behavior, and it had achieved some early success in gaining distribution. And it had done all this on just \$1.5 million of angel money.

However, although I really liked the company, I didn't seriously pursue an investment. The reason is that the \$1.5 million was raised at a \$30 million valuation. The company was still very early stage, with very limited usage and an unproven revenue model. Any sort of investment that we would have made would have been at a much lower valuation than \$30 million.” (Source: Lightspeed Ventures blog)



Private companies often take advantage of novice investors by raising capital at valuations far above fair market given their early stage and risk factors. As you can see from the story above, this often hurts both the early investor AND the company, because it puts the company in a challenging position to raise more capital if and when needed (see Pre-IPO Investing Secret #7; Assess the Probability of Raising More Capital).

The key point to consider here is the valuation which the company could warrant if and when it hits the milestones laid out in its business plan. This future valuation must be significantly greater than the current valuation for it to be a viable investment opportunity.

Pre-IPO Investing Secret #6

Conduct Due Diligence

In 1998, Pixelon.com was founded with the goal of better distributing high-quality video over the Internet using new technologies. Unfortunately for investors who gave Pixelon \$16 million, the technology it presented was fake. Further, the company's founder, Michael Fenne, was actually David Kim Stanley, a convicted felon involved in stock scams who was running from the law. To make matters worse, Pixelon spent over a million dollars on a Las Vegas launch party peppered with stars like Tony Bennett, Kiss and The Who.



While the Pixelon example is far from the norm, it provides a critical lesson to private company investors: do your homework. In investing, this homework is known as "due diligence" which is more officially defined as the detailed analysis and appraisal of a business which takes place after an investment has been agreed to in principle. This process ensures that there is nothing which contradicts the investor's understanding of the current state and potential of the business.

In conducting due diligence, the following is a short list of items the investor must review:

1. Background of the company
2. Background of management
3. The Company's business plan
4. Audited and unaudited financials since company inception
5. Management discussion of company performance
6. Capitalization Table
7. Leases
8. Employment agreements
9. Purchase or sale agreements
10. Previous letters of intent
11. Status and quality of patents and/or other international property filings
12. Quality of technology (as assessed by experts in the field)

By conducting comprehensive due diligence, investors significantly reduce their risk and thus maximize their chances of success.

Pre-IPO Investing Secret #7

Assess the Probability of Raising More Capital

Akamai Technologies was launched at MIT in 1998 and held an IPO just 18 months later. But even during this short period, Akamai required FIVE rounds of financing in order to raise the capital it need to perfect its product and prove it was ready for the public market. Akamai is now valued at nearly \$5 billion.

It is rare that a private company will raise just one round of capital and then exit (e.g., go public, sell the company, etc.). Rather, most companies raise several rounds of capital in order to grow and raise their valuation before exiting.



Furthermore, a key reason why many private growth companies fail is due to a lack of adequate funding. As such, when investing in early state private companies, savvy investors assess the probability that these companies will raise capital in the future. One key to this assessment is the sector in which the company operates. For instance, in the software sector, there are numerous venture capital firms, strategic investors and private equity firms willing to finance later stage deals. Conversely, in the retail food sector, there are fewer later stage financing options.

Pre-IPO Investing Secret #8

Diversify Your Private Company Portfolio

Hummer Winblad Venture Partners has made some awful investments including giving millions to massive failures like Gazoontite.com (website for asthma and allergy sufferers) and Pets.com (pet e-commerce website). Yet, institutions continue to give Hummer Winblad more money to invest in private companies. Why? Because Hummer Winblad knows how to diversify its portfolio. While it has invested in numerous losers, it has also picked massive winners such as The Knot (NASDAQ: KNOT), Netopia, Inc. (Nasdaq: NTPA) and AdForce (IPO, then acquired by CMGI).



How many times have you heard someone say, "Don't put all your eggs in one basket"? When it comes to any kind of investing, this is very good advice.

Successful investors know that diversifying their investments can help reduce the impact that a single, poorly performing investment can make on their overall portfolio, or mix of investments.

This is particularly true with private company investing. Private equity investing is inherently variable -- with a relatively small percentage of companies building themselves to successful exits and investment harvesting. Most individual investors in private equity significantly under-diversify their portfolios -- investing in one or only a handful of companies and thereby greatly increasing their risk profile.

In private company investing, investors are taking big swings. There are big risks with early stage unproven companies, but also massive rewards when they succeed. Investing in just one private company is simply way too risky. Rather, having a portfolio of these firms is often a solid strategy. Since successful private company investments may provide a return of 10 to even over 1,000 times the initial investment, investors often win big if only a small percentage of their investments succeed.

Pre-IPO Investing Secret #9

Monitor Your Investments

Michael Egan is a wealthy man. But he should be wealthier. Egan founded and then sold Alamo Rent-a-Car for a reported \$625 million. He then made a great pre-IPO investment, purchasing a 61% equity stake in theglobe.com, which subsequently went public and then, at one point, rose in value to over 10 times its IPO price.

However, his successes made him overconfident; and he quickly starting investing in several early stage companies. Moreover, he didn't focus on these companies and failed to invest time meeting with the management teams and monitoring them. Virtually all of these unmonitored investments failed.



Private companies do not undergo the same scrutiny that public companies do. There are no quarterly reports. There are no watchdogs.

In addition, the real progress of small, closely-held companies is extremely difficult to monitor and measure. Communications between private company management and their investors too often is mostly of a promotional form -- with investors rarely getting a balanced review of the growth and profitability challenges of the companies.

Therefore, investors in these companies must keep in contact with the CEOs to understand their progress and ensure that their focus does not veer off course. They must set specific milestones and follow-up if the companies do not achieve them.

How Growththink Can Help

Growththink helps organizations prosper through our suite of integrated professional service practices. We help our clients develop professional business plans, secure capital, value their businesses, and launch new product and/or service initiatives.

Since 1999, we have worked with more than 1,000 satisfied clients including startups, small businesses, venture capital and private equity firms and middle market and Fortune 2000 companies. Our work and expertise has been recognized by leading media sources including The Wall Street Journal, BusinessWeek and Entrepreneur Magazine. You can learn more about us at www.growththink.com.



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Growththink has reviewed and participated in the creation of an extraordinary number of startup and emerging company business plans and offering memorandums. We have seen companies be spectacularly successful for themselves and their investors; we have seen others somewhat muddle along in the pursuit of their growth plans; and, unfortunately, we have seen others fail for themselves and their investors.

We have worked hard to identify the key factors that separate both the successful growth company from the unsuccessful, and correspondingly the successful investors in these companies. We have also been able to expertly position ourselves to accomplish each of the 9 key secrets contained in this report, mainly:

1. Finding the best deals
2. Confirming that the business plan is solid
3. Assessing the quality of the management team
4. Understanding the exit potential
5. Negotiating a fair valuation
6. Conducting due diligence
7. Assessing the probability of raising more capital
8. Diversifying the portfolio
9. Monitoring investments

If you are currently looking for opportunities to invest in pre-IPO companies, please don't hesitate to contact us at 800-506-5728, and/or write us at portfolio@growththink.com.



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Ideas.Capital.Action.™

6033 W. Century Blvd.
Los Angeles, CA 90045
800-506-5728
www.growththink.com