

## How do you invest in a private company? V2

### Purpose of this article

- 1) Outline questions to ask as you're considering whether or not to invest in a private company. The questions are focused on a long-term established company. The company would not be a candidate for early stage or venture capital investing.
- 2) This article asks questions which may not be part of a standard financial, legal, and human resources due diligence.
- 3) This article does not cover all of the required due diligence tasks, which include financial analysis, legal reviews, intellectual property reviews, etc.

There are 10 sets of questions to consider:

- 1) Question #1 focuses on the company's potential market size and understanding of its customers.
- 2) Question #2 focuses on the potential to grow the value of the company.
- 3) Questions #3-#10 focus on your relationship with the company and how you'll get value from your investment.

### **#1 What is the current and future market place demand for the company's solution?**

Who are the target customers and users? What is their value proposition? Value proposition is the customers and users perception of value. What are all the financial and non-financial benefits achieved? e.g. time savings, convenience, status, reducing negative emotions or risks, benefits achieved (financial and non-financial) achieved by the customers? What are all the costs incurred by the customer (purchase costs, costs to switch to your company, other adoption costs, ongoing costs)?

### **Market Size Metrics**

Market size = (The number people (or organizations) with an urgent problem or need that they are willing to spend money) times (the amount they are both willing and able to spend).

#### What is TAM (Total Addressable Market)?

- 1) What would be the company's revenue if 100% of the customers demanding a solution to their problem bought the company's solution. This assumes all potential geographies, distribution channels and partners. The number of customers demanding a solution will be fewer than the number of customers that have the problem or need.
- 2) The best way to calculate TAM is with a bottom up calculation, starting with a clear description of the target customer segments, their problems and needs, and then considering the subset of customers who will actually provide revenue, and the revenue per customer. Recognize not everyone in every country will be able to afford the solution.

#### What is SAM (Serviceable Addressable Market)?

- 1) This is the portion of the TAM that is within the reach of the company's current geographies, distribution channels, and partners, and the company's ability to deliver and support their solution. This still assumes 100% market share of those customers demanding a solution.

#### What is SOM (Serviceable Obtainable Market or Share of Market)?

- 1) SOM will be lower than SAM for three reasons: there will be competitors, customers who are demanding a solution may not actually buy a solution, and there will be an adoption rate ranging from early innovators to laggards.

### **Customer Metrics**

New customer value achievement leading indicator (e.g. for Slack it was 2,000 team messages sent within 60 days).

New customer success metric (e.g. % of new customers achieving new customer value achievement indicator within 60-90 days).

**NPS (Net Promoter Score)** The single most important question is asking "Would you recommend our solution to others?" (Follow on questions could be "If so, why? If not, why not?") This metric is known as NPS. What is your NPS? Above 0 is good. Above 50 is excellent. Above 70 is world class. How do you compare to your industry and competitors? What has been your NPS trend?

The Net Promoter Score concept was initially developed by Bain. The following is a link to the Bain website homepage for Net Promoter Score, which contains several short articles:

<http://www.netpromotersystem.com/about/why-net-promoter.aspx>

The following is a quick overview of using Net Promoter Scores:

<https://www.forbes.com/sites/shephyken/2016/12/03/how-effective-is-net-promoter-score-nps/#1b1391b423e4>

## **What have been the findings and trends from ongoing customer interviews and surveys?**

### **What are the scenarios for future market size?**

What will be the impact on customer problems and needs due to potential startups, actions of current competitors, and established companies entering the market place either organically or by acquisitions? Remember what happened to Blackberry. The customers no longer had problems and needs which the keyboard-based Blackberry could solve.

### **#2 What will drive the value growth of the company?**

There are four ways to grow the value of the company:

- 1) Remain focused on the problems and needs of current customers, but increase the number of customers by expanding geographies, channels, and partners.
- 2) Target new customers, with different problems and needs which the current capabilities of the company can solve by creating new solutions.
- 3) Eliminate unprofitable customers, customer segments, geographies, channels, and partners.
- 4) Improve the internal operations of the company: develop current talent, acquire new talent, eliminate inappropriate talent, improve or change the processes, improve or change the technology. Talent includes: the board of directors, CEO, C-Suite, employees, advisors, consultants, contractors, and outsourcers.

The above four value growth opportunities could be addressed organically, by acquisitions or divestitures.

How are you going to help drive the value growth of the company, in addition in addition to your capital?

- 1) Using your network to help obtain customers, employees, and other investors?
- 2) Using your knowledge, skills, and experience to serve on the board of directors or advisory board?
- 3) Coaching and mentoring the CEO or C-Suite?

### **#3 Who will buy the company or your shares in the future?**

- 1) A strategic buyer?
- 2) A financial buyer?
- 3) An owner/operator?
- 4) Employees?
- 5) IPO?

### **#4 Why will they buy it?**

- 1) Growth potential?
- 2) Operational improvement potential?
- 3) Access to company's customers, distribution channels, and partner?
- 4) Access to company's talent and intellectual property?
- 5) Leading and defensible market position?
- 6) Non-concentrated channels and partners?
- 7) Sustainable margins?
- 8) Proven management team with successors?

### **#5 What will they pay for it?**

- 1) Multiple of EBITDA or free cash flow?
- 2) Terms and conditions?

### **#6 What is the exit plan?**

- 1) You or major shareholder(s) die?
- 2) One shareholder wants to exit?
- 3) Your plan to exit in Y years? If so, how?

### **#7 How will you and other shareholders take value out of the company?**

- 1) Final sale of the company?
- 2) Interim financing enabling your partial or total exit?
- 3) Dividends?
- 4) Products or services?

### **#8 How will decisions be made?**

- 1) What decision will be reserved for shareholders and what is the decision process?
- 2) What % of equity and what % of shareholders will be required for decisions?
- 3) What veto power will individual shareholders have?
- 4) Does the CEO have any veto power?
- 5) What decisions, if any, will be made by the board of directors?
- 6) What is the delegation of authority to the CEO?

### **#9 What is your fit with the other shareholders and management team?**

- 1) Do you have a common set of values, morals, and ethics?
- 2) Can you work together?

### **#10 What will be in the shareholder's agreement?**

- 1) What the shareholder objectives are?
- 2) The answers to questions #6, #7, and #8.

### **Your next steps**

- 1) Define your investment decision-making criteria and process. This includes: the financial aspects of your overall long-term financial plan, and your long-term life plan.
  - 2) Which criteria are deal-killers?
  - 3) Define the overall due diligence process – structured data collection and data analysis.
  - 4) Execute your structured data collection, data analysis, and decision-making process.
- Recognize that emotions and gut-feelings will still play a key part in your final decision.

### **Further reading**

- 1) How can a private company sell securities in Ontario?

<http://koorandassociates.org/selling-a-company-or-raising-capital/how-can-a-private-company-sell-securities-in-ontario/>