A CONSUMERS’S GUIDE TO SMALL BUSINESS INVESTMENTS

State laws have been relaxed to 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 guide suggests items to consider for determining whether you should make a small business investment.

Risks and Investment Strategy

A basic principle of investing in a small business is: NEVER MAKE A SMALL BUSINESS INVESTMENT THAT YOU CANNOT AFFORD TO LOSE ENTIRELY. Never use funds 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 a vacation or a down payment on a boat or RV.

Above all, never let a commissioned securities salesperson or an officer or director of a company convince you that the investment is not risky. Any such assurance is almost always inaccurate. Small business investments are generally 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, just because the state has registered the offering does not mean the particular investment will be successful. The state does not evaluate or endorse the investment. (If anyone suggests otherwise to you, it is unlawful.)

If you plan to invest a large amount of money in a small business, you should consider investing smaller amounts in several small businesses. A few highly successful investments can offset the unsuccessful ones. Even when using this strategy, DO NOT INVEST FUNDS YOU CANNOT AFFORD TO LOSE ENTIRELY.
Analyzing the Investment

Although there is no magic formula for making successful investment decisions, certain factors are often considered particularly important by professional venture investors. Some questions to consider are as follows:

1. How long has the company been in business? If it is a startup or has only a brief operating history, are you being asked to pay more than the shares are worth?

2. Consider whether management is dealing unfairly with investors by taking salaries or other benefits that are too large in view of the company's stage of development or by retaining an inordinate amount of the equity of the company compared with the amount investors will receive. For example, is the public putting up 80% of the money but only receiving 10% of the company shares?

3. How much experience does management have in the industry and in a small business? How successful were the managers in previous businesses?

4. Do you know enough about the industry to be able to evaluate the company and make a wise investment?

5. Does the company have a realistic marketing plan and do they have the resources to market the product or service successfully?

There are many other questions to be answered, but you should be able to answer these before you consider investing.

Making Money on your Investment

The two classic methods for making money on an investment in a small business are resale in public securities markets following a public offering and receiving cash or marketable securities in a merger or other acquisition of the company.

If the company is the type that is not likely to go public or be sold out within a reasonable time (i.e., a family owned or closely held corporation), it may not be a good investment for you irrespective of its prospects for success because of the lack of opportunity to cash in on the investment. Management of a successful private company may receive a good return indefinitely through salaries and bonuses but it is unlikely that there will be profits sufficient to pay dividends commensurate with the risk of the investment.
Other Suggestions

The Disclosure Document usually used in public venture offerings is the "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.

Even the best venture offerings are highly risky. If you have a nagging sense of doubt, there is probably a good reason for it. Good investments are based on sound business criteria and not emotions. 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 to size them 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 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

Greater numbers of public investors are "getting in on the ground floor" by investing in small businesses. When successful, these enterprises enhance the economy and provide jobs for its citizens. They can also provide new investment opportunities, but that must be balanced against the inherently risky nature of small business investments.

In considering a small business investment, you should proceed with caution, and above all, never invest more than you can lose.

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Adopted by the North American Securities Administrators Association, effective October 9, 1994.