QUICK SUMMARY WHITEPAPER

How to Avoid the Pitfalls of Private Investments

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Pitfall #1
GREED

I believe every man has a level of larceny in his heart that can surface at any time. The type of partners you want will be able to control this particular emotion. They will understand that what is best for the group will ultimately gain the results they seek for themselves. When all partners put what is best for the group ahead of what is best for them, everyone wins.

It is critical to be in business with people who have similar goals to yours, not people who are simply greedy.

I recently attended a venture forum in Houston. In the room were 12 venture capitalists and about 100 capital-seekers. The program allowed three of the seekers to make a 15-minute presentation about the merits and potential of their venture.

The second presenter was a nice looking black man in his mid-20s. He was wearing an Uncle Sam costume, complete with hat and whiskers. This college graduate had a degree in accounting and a CPA designation. His entire presentation was a 10-minute discourse on how he deserved to be rich and how the venture capital providers should assist him in creating a chain of tax preparation providers (like H&R Block®) to serve the poor, black communities around the U.S.

There was no discussion of need or competition. The market wasn't explained. No business plans came forth. Budget needs weren't mentioned.

The only statements that were made were about how the young graduate deserved to be rich, and the capital providers should give him money so he could live in a style he would like.

As he concluded his presentation, everyone in the room was laughing so hard they had tears in their eyes.

He didn't get the money.

Finding good private equity investments where everyone involved wins is not an easy task. It seems that there is always one owner or manager who has a greedy streak that can ruin the program and take all the fun out of life for everyone else.

The old adage, "*Pigs get fat, hogs get slaughtered*" is one of the age-old truths surrounding good private equity investing. Greed in direct investments will lead to failure.

Be wary of words and phrases like control, calling the shots, 51%, if things don't work out. The investor who uses these words might want such a high ownership in the project that the deal originators will not profit if the project reaches every success goal.

In this case, the original entrepreneurs could consider selling the idea to the capital provider, retaining a small ownership position in the finished project, allowing the private equity investor to be in control and risk his own money in his own project.

Odds are if the investor is that greedy, the entrepreneur will probably be able to purchase the technology back at a deep discount shortly after the deal is struck.

An example of what I am talking about: a major multi-national company was purchasing small businesses that had exceptional profit margins, folding them into the big company to increase profit margins by adding economies of scale, management and capital structure. This multi-national had acquired a certain small gasket-maker who was highly profitable.

The gasket-maker was just at the limit of what they could do as a small, owner-managed company.

The multi-national wanted control over the manufacturing processes, but the company owner held all the patents.

The clever owner decided to sell his company for US$100,000,000. He gave his employees a generous retirement and retained a handsome profit for himself. The multi-national began running the company and, before long, turned it into the largest money looser on their books.

Three years later, the original owner repurchased the company for $5,000,000. Most of his original employees returned to work with him, and he was off and running again.

Obviously, the multi-national could have invested wisely with this owner and still be in a very profitable business niche today, making 100% annually on their investment, but they were greedy. They wanted to call all the shots in a market segment where they knew little. I'll say it again: ***greed leads to failure.***

A successful private equity investor understands that everyone in the program must win and does not mind if someone else makes money off of his investment, so long as he also makes the profits he is expecting. This private equity investor will own enough of the project that, if the investment succeeds, even in a marginal way, he will make a minimum threshold return on his investment.

This threshold is different for every investor because we all view risk differently. The amount sought by the investor will be commensurate with the amount of risk he faces in the marketplace and in other investment vehicles.

I am appalled by the number of unscrupulous businessmen who take staggering salaries from the profits of companies when the people who work for them make minimum wage. An ethical private equity investor will not support nor allow this circumstance to continue.

Pitfall #2

AMBITION

Of course, ambition is a requirement for any private equity investment to succeed, but too much ambition on the part of management can be harmful and lead to failure.

The people you are investing in must possess a healthy level of ambition. Otherwise, they may take your investment but stop moving to a higher and better position. Or perhaps they simply move on to other projects, leaving you in the unenviable position of locating competent people to operate your investment.

I have an acquaintance who is an accountant for a small college, working in the financial aid office. Every semester, one or two students apply for financial aid, stay in school just long enough to get their distributions of government grants and loans, empty their account, drop out and move on, never to repay the loans or grant monies they received.

Believe me, if I ever interview a person who has intentionally done something like this, I certainly won't be hiring or investing with them.

It's hard to pre-determine when ambition is at the appropriate level. Success in prior efforts can instill ambition in a person. Conversation about supporting a family and putting children through college are good signs in a manager/investee, as is talk about what you, the investor, will get out of the relationship.

An acquaintance had a graduating son who would soon need an income. The child had not worked during his college career, so he had no track-record of any type of work ethic. He made poor grades and just managed to graduate.

The son convinced dad, with typical youthful vigor and enthusiasm that the two should go into business together. Dad agreed, albeit somewhat reluctantly. He borrowed the money to purchase a franchise for his twenty-something child to own and manage on a daily basis. The books looked good, in the beginning, but the shop never reached those numbers.

Dad was hopeful that his chances for success had improved when the son jumped in, full steam ahead. But the son stuck with it all of about 90 days.

Boredom soon set in and the son decided to move on to something else, leaving his father — his investor, as an absentee owner (he lived a distance from the property) with no responsible party able to assist him in running the business.

The son bailed out, unapologetically leaving dad to clean up the mess. His ambition had outpaced his ability to succeed. This type of ambition must be avoided at all cost.

Dad made a poor business decision which cost him thousands.

I have another acquaintance who, at first blush, appears to be the most ambitious person you will ever meet; however, he thinks about himself first, and he cannot close a deal.

He is constantly turning up projects that will make him wealthy, while only giving me my investment back with a savings account return. His ambition is misplaced. I will never enter into a deal with him. My investment would be at risk of total loss.

In the 1990s, when I worked for the US Environmental Protection Agency, we ran a program called "Meet the Money" where private investors were invited to hear entrepreneurs that had innovative environmentally friendly technologies and ideas. These entrepreneurs had 30 minutes to openly present their programs, the finances and make their request.

If the investors were interested, they would schedule a meeting to inquire further into the opportunity.

Time after time, these entrepreneurs would present passbook savings returns to these private equity investors, hoping that they would become excited about the opportunity.

This was a classic example of entrepreneurial ambition being out of sync with the real world.

Regrettably, it's all too common to find entrepreneurs who think about themselves first and the needs of the equity investor second. Don't let this happen to you.

Pitfall #3

IGNORANCE

In 1976, John Smith opened a clothing store in a small town in Tennessee.

In 2003, after hearing such hype about the Internet, Mr. Smith had a local kid develop a website for his store. They posted it on the web and sat back, waiting for orders. Nothing was done to promote the site and, three years later, the record showed no sales and few site visitors.

Now it was 2006 and his son, John Jr., had studied internet marketing in college. John Jr. told his father, "*I'm going to sell shirts on the internet.*"

His father replied, "*I've tried that; the internet simply does not work*".

John Jr. invested a few hundred dollars to launch and market his site. Within a year, he had doubled the sales from his father's store. All on the internet.

As it turned out, the Internet did work as a sales tool for the one who knew how to use it. In this case, ignorance on the part of the dad led to failure.

Just because it does not work for you, doesn't mean it won't work for someone with a different skill set.

The Kelly Snyder Oil Field of Scurry County, Texas, is a classic case of how thinking "if it doesn't work for me it won't work for you" can cost billions of dollars.

In 1948, a sleepy geologist working for Humble Oil was drilling through 200 feet of rock he did not recognize. The shows of oil were intermittent and inconsistent, and there was no oil production nearby from that depth.

He was focused on the company's objective, a deeper horizon, and didn't realize the value of what he saw. On his advice, Humble plugged the well.

Two years later, Standard Oil obtained the rights and re-entered the well. They made it into a producer and went on to extend the Kelly-Snyder field several miles. The Standard geologists saw shows of oil, porosity and production within 15 miles of the location and in their mind that meant success. The geologists at Humble had a totally different opinion, which caused them to pass up the opportunity of a lifetime.

Today, this billion-barrel field contains over 1600 producing oil wells, and produced over 210,000 barrels of oil per day at its peak.
This field, initially dismissed by the best of professional oil finders, remains one of North America's premier oil discoveries of the 20th century.

A 100-room motel was built in the 1940s on the main thoroughfare between Dallas and Los Angeles. It was a great success in its heyday.

Over the years, the motel changed hands several times and became less successful. As market forces changed and as the various owners didn't keep up with innovations and maintenance, the property fell to the bottom of the market.

Then, in 2000, a new owner purchased the facility with a vision for success and the appropriate amount of capital. He paid attention to the business and was a master at the details that make for successful hospitality. The building was spruced up; the lawns were manicured; the pool was repaired and painted. The restaurant, reception area, bedrooms, and baths were remodeled.

Today the old motel yields well over 30% on equity yearly. The owner has further parlayed this initial success into a venture that includes at least five additional properties, all doing well in their own right.

You are probably familiar with the story of FedEx®, whose founder, Fred Smith, tried and failed several times to launch the innovative idea of overnight package delivery into the marketplace.

He was frequently undercapitalized.

He was told how it needed to be done by people who did not share his vision for success. He was not allowed to execute his plan, the way he knew it needed to be executed…all which led to failure after failure.

But Mr. Smith kept trying. He continued working the idea until someone with the proper vision and capital stepped up to the plate.

Today, FedEx posts revenues over $36 billion annually, delivering over 6.5 million packages a day.

Another example of how ignorance leads to failure is my youthful run at a commercial real estate development. As a young and eager investor, I lived two hours from a population center of 4,000,000. In my hometown, at the intersection of two major highways, 100,000 cars passed by daily. I thought my location was absolutely ideal for a regional outlet mall and entertainment center (read Waterpark).

I personally invested several thousand dollars in the initial stages of the development plan, including renderings, feasibility studies and construction budgets. I took my package and scheduled meetings with several national outlet mall managers about locating in my area.

In one of my meetings with the largest outlet mall management company in America, the company's CEO looked me in the eye, and said "Paul, I appreciate your research and presentation, but you just don't have the market to support even a small facility."

He proceeded to outline the demographics that made an outlet mall work and, to my surprise, he was right, and what he said made perfect sense.

Ignorance of the facts is a major pitfall in the Private Equity Investing world.

I did not have even half the necessary market with the right income structure to make my planned development work. My plan was a waste of time and money, and this man knew it.

That day I learned not to argue with a man who has superior information and experience. Once I recovered from my disappointment, this was a major breakthrough in my education about investing in private equity.

He very kindly educated me and I remain grateful for this education to this day.

Pitfall #4

ELEVATED EXPECTATIONS

Reality is never going to match up to expectations when plans aren't established in a realistic framework using numbers from an actual company or the experience of someone who has executed the plan before.

In the private equity world, the daily rule of thumb is the One-Quarter Rule (also known as the 40% Lie).

If a novice comes to you with a plan and a budget, multiply their expense numbers and time frames by four to get a more accurate view of how long the project will take and how much it will actually cost.

The 40% Lie is a pitfall that every investor has fallen into if she has been investing for any period of time.

In short, take whatever an income producing asset is quoted as making, subtract 40%, and you will probably be pretty close to the truth. This is not to say that people who are selling projects or businesses are liars, they are just the eternal optimist.

It is human nature to be optimistic.

The presenter knows that the property has produced $xx for one month or one year in the past, and they fully believe this elevated income stream is the true and consistent value of the business on the selling block.

Humans are naturally OPTIMISTIC.
Be Careful of the 40% Lie.

If you invest totally on what the seller is presenting, without doing your due diligence, you will end up broke and unhappy.

Beware the Slam Dunk

My friend, Sally, met her Waterloo at a daycare.

In the 1960s and early 1970s, in many West Texas towns, Texas Instruments® built assembly plants and put rural Texans to work building calculators and watches. TI viewed these underutilized labor forces as a source of cheap labor and for several decades the program was very successful.

Sally's story begins there.

The majority of the workers in these assembly plants were single mothers with young children. They welcomed the well-paying TI jobs which provided the resources to raise their families.

Sally worked at one of the plants and made a personal study of the environment. She realized that 500 single working mothers, most with small children, were working eight-hour shifts on a campus they couldn't leave. They needed affordable daycare at or near their workplace so they could visit their children during the day.

My friend approached the plant about setting aside a room for an on-site daycare center at a reasonable lease rate. Management liked the idea, hoping it would help them attract more qualified workers.

Sally would provide all the renovations, all the licensing, all the personnel, all the necessary equipment and transportation to and from school. She would own the business and lease space from the plant.

She had great plans and envisioned that someday, each TI plant would have one of her daycare facilities as part of the plant.

After $100,000 in expenses, paid from her retirement plan, Sally opened her doors to the plant workers.

Human nature is hard to judge,
tough to plan for, and
difficult to manage.

Everything went smoothly for a few months as the center cared for 150 kids a day. Then some of the lower-paid mothers began paying a week or two late; then others were two to three weeks late, then a month late.

Soon, Sally was dipping into her 401K to meet payroll. Over half of the customers stopped paying for the services as agreed. This all happened within a nine-month period.

Sally needed a minimum of 75 paying customers to make the program break even. Anything below that, she was losing money every day.

What she didn't anticipate was that the plant workers began to look upon the daycare as an "entitlement" program. They began to resent having to pay for the service. They began to believe that because they were working hard for TI, the company should provide the daycare.

Sally's investment — seemingly a slam-dunk — went terribly awry due to human nature. There was nothing she could do other than salvage what he could from the assets and close down.

This was a terrible education and she is still recovering from this mis-step 20 years later.

Pitfall #5

OVER-CONFIDENCE

In the 1990s, I knew a man who spent tens of thousands of dollars to build and equip a new store in a regional mall. This dessert and coffee shop needed to make gross monthly sales of $15,000 to break even.

Your WILL to make a project work won't overcome the facts.

To him, given the market he was serving, $500 per day in gross sales on coffee, ice cream, and pastries seemed like a small hurdle.

Five years earlier, a friend of mine had owned and managed a similar store in the same mall, serving the same types of products. His store was smaller and needed sales of $7,500 per month to succeed. The store was well managed, but could only average sales of $6,000 per month.

My friend relayed his experience to the owner of the new store, but his comments fell on deaf ears. The new owner was so entranced with his dream of success that he couldn't clearly look at the numbers and facts being presented. He was confident that his management was better, he knew more about coffee, his prices were higher.

My friend openly shared what he had learned about the buying habits of the patrons, the price points they would stand, the products they would buy, and the frequency of purchases. These facts indicated that the new store would not even come close to making the needed income.

The new owner went ahead with the business. The store performed exactly as experience had predicted, almost to the dollar. The store lasted less than 18 months, and the new owner and his partners lost their entire investment plus some.

Take heed when someone, armed with
experience, facts and figures,
shows that your idea lacks a critical success factor.

Pitfall #6

AVOID MARGINAL DEALS

One of the most crushing feelings anyone can have in life is to learn that all their hard work, all their sleepless nights and dedication, their years of investment, effort and sacrifice are not worth the end result.

I once knew a young man who left Texas, drama degree in hand, to work on Broadway. After all, that is every stage person's dream, be a big star on Broadway. Working on a hit Broadway show is the pinnacle, the ultimate, the brass ring.

After 7 years of mind-numbing work, struggling to pay his rent, he finally landed a position as an executive producer on one of the highest-rated, most profitable productions on Broadway. After opening night, he looked at his life, his shared one room apartment, and his salary that was not enough to allow him to ride the subway.

Then and there he concluded his lifestyle at the top of the Broadway scene was not at all what he expected. He decided it wasn't worth the sacrifices he had made to get there.

The next day, he packed his bags and moved out of New York and on with his life.

I have an associate, who I greatly respect for his wisdom in the public markets and in particular, the creation and administration of qualified retirement plans for wealthy clients. At this, he is one of the best I have ever met.

We were discussing private investing one day and he says to me "*you know, I bought a franchise.*" I looked at him and said, "*Why in the world would you do that?*"

He said, "*I thought it was a good idea, after all, the franchise support is there to help us.*"
I cringed.

My friend, whom I greatly respect, had fallen into one of today's biggest business traps, thinking that a franchise company will be there to assist him when his investment goes awry.

What was most frustrating of all was that, if this store had performed as the very top of the marketplace, created the most sales in the State for a store of its kind, it would only return 12% on his equity, not nearly enough to support the risk that was undertaken by this $200,000 investment.

All-in-all, this was a very poor decision on the part of my friend.

Why would you toil in a marginal deal that,
from the very beginning, will not pay
you or your people for the time and effort?

Lesson: Do not invest in marginal deals.

Don't invest your time and money unless success will meet your expectations.

In our world of private equity investing, the absolute minimum expectation is a 20% annual return on invested capital, without leverage, for the safest investment we can make.

Pitfall #7

COUNTING ON THE GOVERNMENT

NOTE: This section is not discussing Government Contracting as a business. If, as a company or investor, you can contract with the government for products and/or services to supplement your already-existing business, then this should certainly be done; but building a business solely on government handouts or loopholes is a poor and risky business model at best.

Having worked for years on both sides of the street regarding investments that rely on the government, my experience tells me that projects that are solely based upon government programs or subsidies are, more often than not, a poor investment. If a potential investee approached me with a gap in a government program as his main support for investing in a venture, I don't hesitate. I don't even listen. I quickly say "no thanks!"

The same rule applies to so-called "tax shelters." If the IRS leaves a loophole you can take advantage of when no one else can, watch out. My experience with "tax shelters" is that the investor spends more time and money in court trying to protect his position while the attorneys make all the money.

I don't have any "tax shelter" investments in my private equity management practice. I take the cream-of–the-crop investment opportunities, set them up in the most tax-advantaged way possible, execute, and then pay the taxes that are legally due. And we still outperform all published market indexes on a regular basis.

When I was with the Environmental Protection Agency in Dallas, I found it remarkable the number of people who would thumb their noses at the government, usually out of arrogance. This isn't smart, because when the government wants to act, they can put your face in the mud and not let you breathe without permission.

I know of several cases where "bad actors" were audited and inspected more than once a year. They spent millions of dollars defending themselves against the most mundane charges. What a waste of time and life, especially when their activities were hurting the health and welfare of potentially thousands of individuals.

This is not to say that taking government research and exploiting it is not a good idea. It is a wonderful moneymaking idea. But if you get into an investment program that depends on continued funding by the government or tax advantages from the government to be successful, you are in the most perilous of circumstances.

Some government programs are better than others.

HUD (Housing and Urban Development) programs that lend money or pay rent for poor and elderly populations are some of the more stable programs.

It is certainly wise to apply for every grant and subsidy available, but I never participate in a program that, to be successful, is solely dependent on a government loophole, tax incentive grant or loan. I also suspect every investment program that must rely on government tax benefits or tax incentives to be profitable.

If your sole profits come from a government agency,
then you are at great risk of losing your entire investment.

The government has no heart or emotion when it comes to you and your profits. The people who administer programs and vote in Congress have absolutely no loyalty to you, regardless of how much money you have donated to them or how hard you have worked in the past.

A prime example is the Supercollider project in Texas.

In 1988, Congress voted several billion dollars of government money to build a Supercollider in Ellis County, just minutes south of Dallas.

This project was a boom for the State, which was still recovering from the oil bust of 1984.

Literally thousands of skilled and unskilled personnel were hired to dig a giant tunnel in the ground.

From the very start, this was a classic boondoggle.

Billions were spent and made, but when the merry-go-round stopped, thousands of people lost everything they had worked so hard to amass and save.

When I consulted and worked for the EPA, I personally knew hundreds of former Supercollider employees. They had experienced one of the worst layoffs (termed a “reduction in force”) in government history. These people had to find new jobs and start life over again at half- and even one-quarter pay, living in rent houses, surviving paycheck to paycheck because the windfall that was to last forever was over.

As an investor, this is not the kind of end result you want — not for you and not for the people who work with you or their families. Unless you make your living servicing the government, my recommendation is that you, as the intelligent investor, should never get involved with such an endeavor because you are setting yourself (and all your people) up for disaster and financial failure at the whim of someone with no heart.

Pitfall #8

MISMANAGEMENT

I cannot venture a guess at the number of business failures that can be attributed to mismanagement or micro-management. The numbers are staggering.

I have an acquaintance whose family owned one of largest and most successful new car dealership in the United States. They sold and serviced more new cars over five decades than all the other local dealerships combined. One of every two cars on the roads of their community came from this dealership.

These men were masters at public relations and management and their operation made staggering profits.

Their secrets: exceptional customer service, fair dealing, hard work, and hiring the right team members to serve their customers. In turn, their dealership became one of the top in the country.

After a long and successful career, it came time for the owners to retire. The eldest son was poised to take over. The son gathered a few financial partners and purchased the dealership, keeping the name and all the goodwill that went with it.

Things rocked along for a year, profits were not as much as expected, but the partners thought they were in good hands because the son had “years of experience” in the management of this car dealership.

Year two rolled around and profits were down considerably. Sales were low and expenses were high. The equity partners were infusing capital they never expected to contribute.

This was a very bad sign for a business that was supposed to be profitable and cash-flowing (a cash cow as the son described). The partners began to worry about the ability of the manager to produce profitable results.

Upon investigation, it turns out that the son was a poor manager who sat in his office all day with the door closed. He did no public relations and did not meet a single customer.

He counted on others to buy and sell used cars for the used car lot. He did not visit with wholesalers or his retail staff. He did not monitor his service department. His new service people were young and rude. His sales people were greedy and rude. His used car people were dishonest and getting wealthy under the table.

The bottom line is that he did none of the things that made his predecessors successful, and his financial results didn’t hide the facts.

Within three years of the son’s ascension, his financial partners were frantically seeking a way to recover just some of their investment. The dealership lost its franchise and 50 years of hard work and reputation were gone, never to be recovered. What was worse than the lost reputation was the equity investors’ capital was lost, never to be recovered. And what was even more disappointing were the customers that had been very satisfied with the care and service for decades, now having to find a new dealer that they trusted.

Just because someone has ‘been around’
a successful business, they don’t necessarily have the
know-how to make money in that business.

Mis-management can quickly kill a business.

Next to poor capitalization, management is by far the most important aspect of a successful investment.

A few decades ago, one of my consulting clients was perhaps the world's worst micro-manager. This man had no clue about what it takes to be successful. He was impatient, rude, inconsiderate, and generally a very unlikable person.

What was humorous was that he was attempting to open and operate one of the most people-intensive businesses on earth, a minor emergency clinic. A business that must be operated by someone who enjoys helping people. Someone who cares about how people feel and how they are treated.

Smart people do stupid things every day,
but being ignorant of what is required
is totally inexcusable and the fastest way to lose money.

This client, a physician, was the typical know-it-all who really knows nothing of the practical world. He had worked in a hospital environment his entire career, where everything that he needed was supplied, just for the asking, by people who were paid to take his abuse.

In his quest for higher profits and an early retirement, he had made a major capital investment from his retirement plan into building a minor emergency clinic. Instead of purchasing an ongoing business, he chose to build the business, facilities and all, from scratch.

This investment was one of the most poorly-planned and unwise decisions I could imagine. What was this guy thinking?

If you know anything about this type of operation, money is made through repeat customers. And customers return based on how they are treated. Treat patients well, they will come back and make you money. Treat them poorly and they (and their friends) will stay away, finding other physicians to pay.

As I mentioned, this physician was the worst micro-manager imaginable. He set the most unworkable deadlines I have ever seen in my 30 years as an investor/advisor. He attempted to manage all the operations and renovations himself. He worried about every penny he was spending.

He was resolute about opening the operation within two weeks of leasing his space (which needed major renovations).

Worst of all, he was computer-illiterate (which astounded me).

All-in-all, this was a very poorly planned operation led by someone who felt he needed no assistance.

What he failed to realize was that he lacked the skills to execute and be successful by himself.

A fatal flaw at best.

The investment was doomed from the very first penny, but no one could tell him, he simply wouldn't listen. The clinic finally opened after six months and at three times the original budget.

During those first months, every time I saw this doctor, he looked like he was about to have a stroke. His hair was disheveled, his face was red, his eyebrows were crinkled; he was a wreck, screaming at everyone around him like a maniac.

There were days when the clinic didn't have a single patient. Less than a year later, the clinic was closed.

The physician lost his entire investment and eventually took a job in an emergency room at an area hospital. The last time we spoke, 20 years after this fiasco, he was still trying to recover from the financial loss.

MORAL

You Can't Do It By Yourself.

Play To Your Strengths,

Surround Yourself With High

Quality People and Let Them

MAKE MONEY!