



Investing to Gain Information: A Small Business Growth Investing Approach

We acquire information for the purpose of making investments.

Should we also invest for the purpose of acquiring information?

I. The Market Need

We will define High-Potential Firms as those businesses for which:

- (1) pre-tax earnings are between \$50,000 and \$500,000;
- (2) there is evidence that sustainable profit growth would occur as a result of use of certain additional assets, services, or personnel ("Additional Resources");
- (3) the smallest package of Additional Resources that could possibly produce a sustainable annual return of 100% on such package's cost ("Return 100%") is such that the maximum number of such packages for which the company could possibly simultaneously Return 100% for all packages is sufficiently high ("Package," "Max Number of Packages");
- (4) it is possible to track with certainty all of the specific revenues or cost savings related to or produced by the Additional Resources;
- (5) the nature of the contribution to the business of the Additional Resources and the relevant circumstances of the business are expected to be unchanging over the next 3 years;
- (6) the owner is unwilling or unable to purchase the Max Number of Packages, possibly because the owner requires most of the cash flow generated by the business to fund his personal consumption and retirement savings; and
- (7) the business has no rights to IP that would attract venture capital.

Small private equity investors will not invest in a High-Potential Firm because arriving at an agreeable price with a seller is typically impossible. Small business market prices (often 2x to 3x EBITDA) reflect prices paid primarily by buyers who get good deals on moderate-potential firms owned by highly motivated sellers. As a result, market prices are too low for the owners of High-Potential Firms. On the other hand, asked to pay a 7x EBITDA multiple, a buyer will look elsewhere – to a deal where he can pay for actual rather than expected performance.

Because of the above, there is virtually no supply of risk capital for High-Potential Firms.

II. The Proposed Solution

A new entity is created into which cash is placed ("Option Co"). Option Co invests in the Additional Resources as per an agreed-upon schedule. Option Co allows High-Potential Firm to use the Additional Resources. The direct result of the Additional Resources in producing profit for High-Potential Firm is tracked. For example, if High-Potential Firm operated an e-commerce website and the Additional Resources comprised a 12-month Google Adwords campaign, then the revenue earned as a result of site visits produced by the campaign would be tracked. Option Co would then be paid a percentage of the revenue tracked as resulting from the campaign.

To take another level of detail, Option Co's investment in Additional Resources would occur in two phases: In Phase I, the Option Co would invest in one Package and allow High-Potential Firm to use the Package. If the Package Returned 100%, then in Phase II, Option Co would invest in a number of Packages, up to the Max Number of Packages. Phase I is an option for Option Co to participate in Phase II.

To take one more level of detail, Option Co could have simultaneous arrangements with multiple High-Potential Firms in order to spread risk and make the size of the opportunity large enough to attract a sophisticated investor



to purchase Option Co (for a nominal amount).

Option Co takes advantage of leverage generally not available for small business investors in two ways:

- (1) It enables investment to leverage lower returning resources paid for by High-Potential Firm.
- (2) It allows for the first phase of investment to act as a financial option for the second, allowing the second phase to leverage the information acquired in the first.

III. Key Terms for Deal between Option Co and High-Potential Firm

Before an investor is identified to fund Option Co, Option Co and High-Potential Firm will sign a Letter of Intent establishing that both parties acknowledge that Option Co will have the option of entering into an Agreement with High-Potential Firm upon identification of such an investor. That Agreement will have the following key terms:

- (1) One Package will be made available by Option Co to High-Potential Firm per Schedule I. The Package will be used by High-Potential Firm per Schedule I
- (2) Revenues produced or expenses reduced that are related to or produced by the Package ("Return") will be tracked by the means given herein. Option Co will retain reasonable auditing rights.
- (3) X% of Return will be paid to Option Co.
- (4) At the option of Option Co, with no fewer than sixty (60) days notice, Option Co may trigger Phase II, and as a result Option Co and High-Potential Firm will be obligated as per Schedule II (which is similar to Schedule I in scope but greater in scale); and similarly for Phase III, et cetera.
- (5) For the Effective Period, High-Potential Firm will not engage in another business relationship similar to the one contemplated by the Agreement; sell securities of its company; or sell substantially all of its assets; except in the exceptional situations given herein.
- (6) Certain breaches of the Agreement that would be expected to result in damages will be penalized specifically; beyond such penalties, neither party will be responsible for damages of the other. Notwithstanding the foregoing, High-Potential Firm will indemnify Option Co against any suits brought against Option Co related to the business of High-Potential Firm.
- (7) High-Potential Firm may terminate the Agreement if after the first year of the Effective Period for any consecutive twelve-month period Option Co does not trigger a new phase, as per Paragraph 4.
- (8) The Agreement will have an Effective Period of five (5) years following the Agreement's Effective Date.