How to evaluate Alternative Investment Opportunities

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What are Alternative Investments?

- Investments in asset classes other than Stocks, Bonds, and Cash.
  - Precious Metals,
  - Options, Currency, Commodities, Futures, Derivatives
  - Real Estate Partnerships,
  - Private Placement Memorandums (PPMs), e.g. Private Equity and Debt
  - Hedge Funds,
  - Venture Capital
  - Collectibles, Wine, Art

Why Invest in Alternatives?

- Key motivations to Invest in Alternatives:
  - Better Risk Adjusted ROI
  - Diversification
  - Predictability of Returns / Less Volatility
  - Tax Planning / Tax efficiency / Tax Deductibility / Tax deferred or free returns
  - Self-Directed IRA advanced strategies
  - Relationship / Network benefits
  - Smart Leverage

Risks of Alternative Investments

- Loss of Principle Value
- Small Business Risk
- Key Person Risk
- Poor Performance
- Limited Regulation
- Investments maybe illiquid
- “Bleeding fees”
- Lack of control / transparency
- Fraud

Key Investment Evaluation Considerations

- Public vs. Private
- Understanding of the business model
  - How does it make money and is the business sustainable?
- Confidence in key executives
  - Track record & Integrity
- How your investment going to be used
- What is your security / collateral (if any)
- Risk to Principle
- Liquidity
- Risk Adjusted ROI and Volatility
- Tax Implications
- Convenience

Risk Adjusted ROI

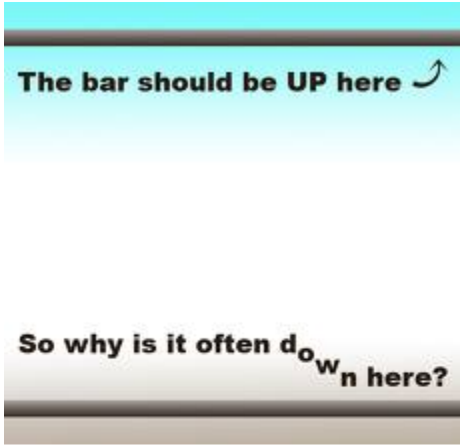
- Example 1 – high tech start up:
  - 17 in 20 chance of losing your entire investment
  - 2 in 20 chance of making breaking even in 4 years
  - 1 in 20 chance of making 28X multiple on your money in 4 years
  - Risk adjusted ROI (annualized) = (28X + 2X – 20X)/20 = 50% in 4 years = 12.5% per year on average without compounding

  NOTE: The big problem – upside is difficult to estimate – it's a gut shot usually.

- Example 2 – Loan backed by 1st lien on Real Estate at 65% LTV
  - Yield on performing Note = 12% annually
  - Assume effective lost of 2% per year on Defaulted Paper – Loss Reserve.
    - Note: It's unlikely that defaulted files will lose money at 65% LTV. But for the sake of this example, it's a small loss.
  - Risk adjusted ROI (annualized) = 12% - 2% = 10%

How much potential annual return should you get?

- It truly depends on the risk.
- Examples of “Risk Levels” & corresponding ROI goals
  - “Very Conservative”, e.g. Debt at LTV < 40% → 5-8%
  - “Conservative”, e.g. Debt at LTV < 65% → 8-12%
  - “Moderate”, e.g. Debt at LTV < 75% → 12-18%
  - “Aggressive”, e.g. Small company Equity → 15%++
    - Safest: Established business with strong track record ~ 15-20%
    - Moderate Risk: Established business going through expansion ~ 15-30%
    - High Risk: New Business – 25++%



Valuation

- Pre-money Value + Cash Infusion = Post-money Value
- Valuation Metrics are very different for different businesses, e.g.
  - Price to Earnings, Earnings Growth, Free Cash flow
  - User Base / Subscription Growth
  - Book Value, Intrinsic Value
- Use Industry standards, comparable, and 3rd party valuation services when negotiating on the value
- Milestone driven valuation, e.g.
  - Investor get 10% equity for 100K, and an option to buy another 5% if the business doesn't achieve 10% top line growth in the next 12 months.

Volatility

- Compare High Tech investment vs. Loan back by Real Estate
  - In High Tech, over 90% of the time – it's a money loser
  - In RE back loan, over 90% of the time – it's a steady income producer

- Can you emotionally and financially tolerate high volatility?

Where to find Good Opportunities?

- Your immediate sphere of influence
  – Look for successful people
  – Look for successful businesses
- Your Trade/Profession opportunities
  – Retiring Owners that need to sell
  – Distressed Assets or Distressed sellers
- Network
  – Masterminds
  – Conferences
  – Educational Events

  Note: Be careful there is a lot of “junk” out there
- Invest with Friends and Learn from every opportunity!!!

Few words about Real Estate Opportunities

- Predictability
- Leverage
- Land of Opportunities:
  – Equity, Debt, Options, creative partnerships
  – Distressed Properties and Distressed owners
- Tax Advantages
- Lending on RE deals is suitable for self-directed IRA investors
- Fairly common to make strong risk adjusted returns
  – double-digit return with relatively low risk

Typical Investment structures

- Non-convertible Debt
- Shared Appreciation Debt
- Convertible Debt
- Debt with Warrants/Options
- Convertible Equity
- Common Equity
- Partnerships and LLCs

Note: Structure will likely have a huge impact on Taxes and Investment control. Consult with your tax and investment advisor.

Few words on Tax Implications

- Self-Directed IRA best ideas for tax free or deferred income:
  - Loans, Options, Capital assets (not generating partnership income)
  - Avoid equity partnerships, with likely income flow, as they may trigger UBIT

- Special tax investment “write-off” considerations.
  - Some investments allow partial or complete “write-off” for the tax purposes in the year of the investment. Consult your tax professional.

- Tax efficiency strategy:
  - Invest IRA funds generating passive income – it’s tax free or deferred
  - Invest Taxable capital for appreciation

Due Diligence

- “Diligence is the mother of good luck”, Ben Franklin

- Key persons back-ground search and past track record review
- Corporate back-ground search
- Collateral Value Appraisal / inspection if applicable
- Financials Review (audited financials if available)
- Business Model research & testing
- Understanding exit strategy
- Competitive landscape review
- Legal review
- Closing Agent due diligence (attorney, escrow, title)

Common sense considerations

- Invest for your risk tolerance
- Set a hard limit of 5-10% of your investable capital per opportunity
- Invest in what you understand
- Invest in who you trust
- Are you Investing Passively or Actively?
- Are you Learning to Invest or Investing to Learn?
  - If you are Investing to Learn, be prepared to pay the price
  - If you are Learning to Invest, set your expectations conservatively

I hope that every investment that you make is both a learning and a profitable experience ☺.

Thank you!