

THE 10 COMMANDMENTS OF CROWDFUND INVESTING

A Reference Guide to Investing in Start-Ups

“Risk comes from not knowing what you’re doing.”
– Warren Buffett

With President Obama’s recent signing of an historic piece of legislation called the JOBS Act, everyday citizens can reap the rewards of investing in early-stage private companies. They call this new opportunity Equity Crowdfunding – and along with the potential rewards come unique risks. Here are Ten Commandments to help you navigate and conquer this new world.

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I. INTRODUCTION

For years, wealthy investors, typically called “Angels,” have had the right to invest in private companies at their earliest stages. In some of the boldest changes to U.S. securities laws in nearly 100 years, the SEC is about to give the rest of us the same access. They call this opportunity Equity Crowdfunding. And as it democratizes what was once reserved for the privileged few, many on Wall Street and Main Street call it a revolution.

Imagine having invested in Google before it was a publicly traded company: its early investors earned more than 3,000% in five years. Or what if you’d written a check to Facebook just when it was getting started? Even with its rocky post-IPO performance, the angels and venture capitalists who invested before it was public made... well, they’re probably pretty happy with their return. (If you’re not going to get too jealous, try estimating the return based on a \$10,000 investment. Hint: add four zeroes!)

Equity Crowdfunding allows everyday citizens, not just the wealthy, to make small investments – as little as \$25 or \$100 – in companies they believe in, and receive a stake in the business in return. When hundreds or thousands of us (in other words, the “crowd” in “crowdfunding”) each invest a little bit, all those dollars start to add up. They can provide enough capital for an early-stage private company to grow into a bigger company.

Investing in private companies can be exciting and lucrative, but without the right plan, diving into this new investment pool can break your financial neck: it’s different, and can potentially be riskier, than investing in stocks like IBM or GM.

Many early-stage companies have little or no operating experience, and there’s no proof that there’s a market for their product or service. Beyond that, investors in private companies receive less regular updates on a company’s performance, and generally need to hold their investments for a long period of time.

A Framework for Investing in Early-Stage Companies

The authors of this guide have founded, operated and grown start-ups – and have successfully sold them to bigger companies, providing a financial return for ourselves and our investors. We’ve also mentored, run and invested in countless other high-growth companies across the globe, from New York City to Istanbul to Moscow.

In this guide, we'll share with you the framework for looking at startups we've developed during our 30+ combined years of experience. Essentially, we'll look at the big questions we ask before we start, advise, or invest in a new business.

As you'll soon discover, some questions may be easy to ask, but difficult to answer. The fact is, when contemplating an investment in an early-stage company, you'll need to do a little legwork – whether that means doing a Google search on a company's founders, or learning more about how companies make money on the Internet. (Numerous studies have found a direct correlation between the time an individual spends researching a private company before making an investment and his returns from that investment. With early-stage investing, you're rewarded for doing your homework!)

In the end, we hope you'll have fun learning about new companies and finding your way in this new world – and we hope you'll make some money, too. As Mr. Buffett says, "Risk comes from not knowing what you're doing." So let's get rid of some risk by looking at the 10 Commandments of Crowdfund Investing!

II. THE 10 CROWD COMMANDMENTS

1. Thou Shalt Only Invest in Simple & Easy to Understand Businesses

Many of us have so much fun dreaming about the money we can earn on potential investments, sometimes we forget to look at the basics of a company's business!

So before we take out our checkbooks, let's make sure we have a good handle on a few things:

- What exactly does this company do?
- Who is the company's customer and how does it provide them value?
- How does the company make money?
- How big is the market for the company, and how fast is the market growing?

As an example, let's take a look at Facebook.

Facebook is the world's largest online social network. More than one billion people from across the world use it to connect with their friends and families. Many of those people find so much value in Facebook that they log in several times a day.

But these billion people aren't Facebook's "customer" in the traditional sense of the word. Why? Because they don't pay Facebook to use its service!

Facebook's customer is the advertiser who wants to reach us. Advertisers pay Facebook to feature their products on Facebook's website. The ads are "highly-targeted," meaning they're only shown to a specific group of people – like 18-to-21-year-old men in New York and Los Angeles, or mid-western women in their 30s. That's very valuable to advertisers because it's very efficient, so they pay a premium rate to be there!

What about the size of Facebook's market, and its growth rate? Well, Facebook started as a service for college students, but quickly proved that people in their 20s, 30s, 40s – even their 90s – liked it, too. Facebook discovered a huge market, and it was soon clear that they, and the overall market for social networking, were growing extremely quickly.

To recap, Facebook has users from across the globe who use the service for free. And they have advertisers (the "customers") who pay Facebook to reach those users. The market is huge and is growing like crazy. Now that sounds like a pretty good business – and it's relatively easy to understand!

PRO TIP

To get your feet wet in early-stage investing, consider sticking with businesses that are in industries you know, or businesses where you'd be a potential user or customer. If you were buying stock in a public company, maybe you'd buy stock in McDonalds because you like fast food; or maybe you'd buy shares of Prada because you have a soft spot for fancy shoes. It's the same thing with private companies!

In my case, not only do I use Facebook as a user, but one of my businesses is an advertiser. So I've seen first-hand how the company creates value for both groups.

2. Thou Shalt Respect Thy Founders

It's important for a new business to have a great idea, but it's even more important that it has great people!

There are many reasons for this. Here are two you should always keep in mind:

First of all, since most early-stage companies have limited financial resources and a small staff, the founders often work nights, weekends, and everything in between. Not only that, but since there's no standard roadmap for building a startup, and new roadblocks pop-up almost every day, the founders need to be able to deal with setbacks and adversity.

Try to invest in people who have a track record of reaching difficult or seemingly impossible goals: maybe they've been entrepreneurs before, or mastered the game of chess, or reached the summit of Mount Everest. These are the people who'll be more likely to survive the journey.

Secondly, many early-stage companies have to throw out their initial business idea and start from scratch. Some founders need to change directions many times before finding a winning formula. In the start-up world, we refer to this as "pivoting."

The popular website Groupon is a classic case of pivoting. They started as a site called "The Point," and their mission was to gather groups of people who cared about social causes. The Point was interesting, but it wasn't catching on. The founders, one of them a seasoned entrepreneur, decided to take a small feature of The Point that still had potential – something they called Group Buying -- and use it as the basis for a new business.

It worked. Today, you probably know Groupon as the place to get cost-saving deals on everything from restaurants to air travel. The company is worth nearly \$5 billion.

When founders can be honest that their business isn't working, and be flexible enough to switch directions, investors are well served. So research the backgrounds of the founders. Understand what their experiences have been, and try to determine whether they've got the grit and gumption to keep on keepin' on in good times and bad.

3. Thou Shalt Be A Follower

As important as the founders are to the success of a business, there's another group that can be just as critical: their investors, advisors, and employees.

When you see well-known people signing up to be involved with a start-up – people

who are known to be “start-up whisperers” – review your 10 commandments and warm up your checkbook. If these people are willing to be advisors, investors or employees, the company might be worth a serious look. Never follow blindly, but if you still like the company after reviewing your commandments, consider following these people by making an investment.

As an example, let’s look again at Facebook. In retrospect (yes, hindsight is 20/20!) it was a good sign that Sean Parker was involved as an advisor, and that Peter Thiel was an early investor.

Parker was founder of early internet sensation, Napster; not only was Napster “social” in the way that Facebook wanted to be, but Parker survived the wrath of the powerful music industry and thrived. He had grit, and recognized grit in others. And Thiel is the co-founder of PayPal, one of the most successful internet companies in the world.

So did Facebook have good advisors and investors? You bet they did! Even though their founder hadn’t graduated from college and was a first-time CEO, he surrounded himself with a group of people who had “been there, done that” many times before.

PRO TIP

Unlike the public equities markets, it’s possible to follow the “smart money” in private investing and get into deals on the same terms. For instance, if you see that one of the other investors in a company is famed venture capitalist Fred Wilson, you should seriously consider trying to invest alongside him at the same price. Embrace being a “follower” in crowdfunding!

4. Thou Shalt Look for Quick Progress

Companies raising money on crowdfunding platforms will be at various stages of development.

Although a small handful will be generating significant revenue, most will only have an early version of a product, and some may simply have an idea that still needs to be built.

You might like the idea of what a company is doing, but since it hasn’t yet proven itself

as a business, how do you evaluate its merit as a potential investment? One way is to look for evidence that the founders are creating momentum, or have had some recent success. Here are some clues that might help you recognize progress, and hopefully reduce uncertainty.

- **Idea validation.** Has the company signed partnerships with more established businesses? If so, that's a sign that bigger companies have given them a stamp of approval. If the company makes a physical product, do they have any pre-orders? If so, that indicates demand, and future revenues.
- **Traction.** This is always the preferred measure of progress. Are people using the product or service? Are they paying for it? Is traffic or revenue growing? Does the company have a consistent, repeatable method for acquiring new users? If you can answer "yes" to any of these questions, some initial risk in a new business is reduced.
- **Significant Milestones.** If there aren't any external signs of progress, look for internal signs. Keep in mind that getting a company off the ground is like pushing a rock up a hill! Has the company been able to build a product? Has it been able to recruit and hire key staff members to build the team? Has it raised an earlier round of financing? Look for a company that's been able to push an idea forward!

5. Thou Shalt Look for Marketing Expertise

When you invest in start-ups, here's a situation you'll come across often: An entrepreneur has a great idea for a product, but has no idea how to find customers!

Good entrepreneurs identify a problem and build a new solution for it. Great entrepreneurs know how to attract potential customers – and can convince them to try a new solution.

PRO TIP

The best entrepreneurs will explain to investors how they'll consistently and profitably attract new customers. When you hear an entrepreneur talking about "Customer Acquisition Cost" and "Lifetime Value of a Customer," you're dealing with someone who, at the very least, isn't in denial about the challenges of finding customers!

6. Thou Shalt Know Thy Competition

If someone has a good idea, assume that other people have already come up with the same idea – or are thinking about copying it later, once it’s proven to be a good idea.

I’ve rarely seen a company develop a product that didn’t have existing competition, or new competition shortly after launch. This isn’t necessarily a problem – as long as the company is going after a big, fast-growing market!

For any business you’re thinking about investing in, you’ll want to know:

- Who are the *direct* competitors? These are the companies with *similar* products and similar value propositions. For example, if you’re thinking about investing in a new toothpaste company, it will likely compete with such brands as Crest and Colgate, and will likely promise the value of whiter teeth.
- Who are the *indirect* competitors? These are often referred to as “substitute products.” They might look different on the outside, but they serve a similar need. Here’s an example: JetBlue, the airline, is a direct competitor to Delta, but due to its low cost, it is an *indirect* competitor, or substitute, to Amtrak. Basically, flying from New York to Boston on JetBlue is now a cost-efficient substitute to taking the train.

When evaluating a new business, think about how they’ll compete. Will their product be, for example, better, cheaper, or faster? Or maybe their product will be specialized for a specific market segment, like kids, or Hispanics, or college students.

If there isn’t something unique about the product – what’s called a “unique selling proposition (USP)” – it’s possible that the investment opportunity might not be very attractive. Ideally, the company will have a something that is unique and protectable. For example, patents in such areas as technology have proven to be quite valuable.

7. Thou Shalt ask “Why Now?”

When life gets bumpy, some people ask, “Why me?” To avoid a bumpy ride when doing early-stage investing, ask “Why now?”

Here are some related questions you can ask: *Why didn’t this idea exist 5 years ago? Why will it work today? Does this idea have the wind at its back to help push it forward naturally? If this idea is so good, why hasn’t it been done before?*

Sometimes, new companies and business sectors emerge due to new laws and regulations. Equity crowdfunding, for example, only became possible when President Obama signed the JOBS Act. Within a matter of months, hundreds of crowdfunding platforms and companies catering to this emerging market started up. (Crowdability isn't the only one; just the one that helps makes sense of it all!)

Or perhaps a technical breakthrough or hardware platform has emerged, and a new ecosystem pops up to support it. The iPhone is one such example. Before the iPhone, "apps" and services like FourSquare or Twitter would have been difficult, if not impossible, to get off the ground.

Without a compelling reason why *RIGHT NOW* is the right time to launch a company, you run the risk of either being too early to the party – or too late. To reduce risk, wait until the wind is at your back!

8. Thou Shalt Determine if the Numbers Smell a Bit Fishy

You don't need an accounting degree to recognize that a company's financial projections – their estimates about how their business will perform in the future – are too optimistic.

For instance, let's say you were considering an investment in a website that sells tennis racquets. Since you play tennis and spend hundreds of dollars on racquets, this is an opportunity you understand. In the company's business plan, you see that they're building a special \$100 racquet for left-handed redheads who were born before 1931. Their financial documents project \$100 million in annual revenues within 3 years.

Ask yourself: Do I believe that 1 million left handed, redheaded 80-year-olds will buy a \$100 tennis racquet every year?

Something smells a bit fishy, right?

OK, that's an easy one and an extreme example, but you get the point: if a company is projecting financials that don't make sense, run away!

PRO TIP

If you need to gather data to help you make a decision, look at similar companies that are publicly traded. Why? Because public companies are legally required to publish their financial statements for any one to see. Let's look at an example.

Let's say that XYZ Private Corp. plans to make money by selling advertising on their website. Their financial projections indicate that each of their visitors will be worth \$10 per month.

To see if the \$10 number seems about right, identify a publicly-traded company that also sells advertising on their website – for example, Facebook or Yahoo. Then do a little research to figure out how much they earn per user per month. Nowadays you can access this information online, for free. To give this a try, search on Google or your favorite search engine for “Facebook Form 10-K.” The “10-K” is a financial form that contains tons and tons of information.

9. Thou Shalt Look for Goal-oriented Entrepreneurs

Some entrepreneurs need to raise money just so they can pay their salaries and keep the lights on – in other words, just to survive. That's a risky investment!

To reduce risk, try to invest in entrepreneurs who've figured out how much they need in order to hit specific business goals, or to reach the point where their business will make enough money that it can sustain itself.

Start by looking at a part of the business plan called “Use of Funds.” This should specify exactly how the company plans to use your investment dollars. Then ask critical questions, such as:

- What goals does the entrepreneur expect to reach with this money?
- Do the goals seem realistic?
- Are the founders raising too much money compared to “easy” goals?
 - Often, that can mean an entrepreneur doesn't have a clear vision or operating plan.
- Or maybe they're raising too little money.
 - If that's the case, they might be doomed to fail even if you do write a check!

- And finally, if they fall short of their goals, what will happen? Will the business grow more slowly, need another round financing – or will it fail completely?

Think of it like taking a cross-country car trip. You need to plan your gas budget and daily driving goals in advance. If you're running out of both gas and money, you won't reach your destination. Companies are the same way. Make sure they have enough gas in the tank to get where they're going!

10. Thou Shalt Diversify

Many of the age-old rules that you use for investing in the stock market are the same for private company investing. The most important rule of all? Diversify. Don't put all your eggs in one basket!

When an early-stage company disrupts a big competitor, or discovers a big unmet need, or creates something brand new, it can build a big business and do well. Very, very well.

Unfortunately, for every company that succeeds, many others will struggle or eventually go out of business. Maybe their product or team wasn't good enough, or their timing wasn't quite right. Regardless of the reasons, common sense (as well as long-term data) indicate that a better risk/reward ratio can be achieved through diversification.

So, if you're planning to invest, say, \$5,000 a year in private companies, consider investing \$1,000 into five companies, rather than \$5,000 into one company. Diversify!

EARNING A RETURN

A word about Valuation

There are two ways to earn a return on your crowdfund investment:

- **Capital Appreciation.** This happens if the business is acquired by another company, or if the business becomes so large and successful that it goes public in an initial public offering (an IPO) and starts to trade on a stock exchange like the Nasdaq.
- **Dividends/Distributions.** This happens if a company becomes profitable, and decides it doesn't need all its profits to grow the company's operations. At that point, it can start to return money to shareholders.

If you're investing in technology start-ups that are trying to get as big as they can, as fast they can, they'll likely use any revenues or profits to further grow the company. In other words, it's more likely that you'll be rewarded via capital appreciation than via dividends.

As you evaluate an investment opportunity, here are some important numbers to look at:

- What is the company worth today, according to the entrepreneur? In other words, what is the company's valuation?
- How much capital is the company raising?
- If the company is acquired in the future, what ballpark price, or range of prices, is most likely?
- What percentage of the company will you own if/when it sells?

For example, let's say you're considering an investment in a financial news website, similar to thestreet.com or Yahoo Finance. You think it's better than the competition, you respect the team, and you believe it's targeting a big, growing market.

Let's say that the company has been around long enough to make some progress. They raised money from friends and family 18 months ago to build their team and launch a website. Now people seem to like it: many people visit the site every month, advertisers are paying to be there, and traffic is growing quickly because of a recent partnership with a bigger company.

The entrepreneur has set the value of the company at \$800,000, and he is raising \$200,000 in new capital. \$800,000 is what's called the "pre-money" valuation, because it's the value of the company PRE, or before, they raise the \$200,000. The "post-money" valuation is the valuation of the company POST, or after, the cash infusion. In this case, the post-money would be \$1 million, so you can see that company's value increases by exactly the amount of cash that's invested.

To make the math simple: If you personally invested \$100,000, your share of the business (which is based on a "post-money" valuation) would be 10%. That's \$100,000 divided by \$1 million.

Now let's say a few years go by and the company is doing very well. It used the \$200,000 to hire salespeople and strengthen its website. It reached profitability and didn't need other outside investment. A bigger company decides it wants to acquire it, and is willing to pay \$5 million.

In this case, you would potentially realize a profit of 5 times your initial investment (before taxes and closing costs, etc.). Since you invested \$100,000 and own 10% of the company, you would receive 10% of the \$5 million acquisition price, or \$500,000.

The question then becomes one of probability. In other words, how likely is it that a bigger company will come along and acquire the business you're thinking of investing in? If the company is in a fast-growing sector, the odds of success are increased. Or maybe you've read about similar companies that have already been acquired. If large companies are buying smaller companies in the sector, that can be a good sign!

III. THE WRAP UP

Start Swinging But Keep Your Guard Up

We're big believers in equity crowdfunding.

We believe it has the power to create a new breed of entrepreneur in this country – and that entrepreneurs can help solve big problems, create new jobs and transform society.

We also believe that private investing is an exciting way for investors to generate wealth, and we're thrilled that more people will now be able to participate in this form of wealth creation.

But it won't be easy, and it won't be without its risks.

You'll need to understand and believe in the businesses you're putting your money into. Ideally, the business's goals will be aligned with your own. And you'll need to make sure you're getting a fair deal.

As you dip your toes into the equity crowdfunding waters, use these 10 Commandments as a reference guide – and consider creating your own set of commandments as you go!

And if you'd like to learn more about how professional investors are approaching crowdfunding, you can find other educational reports and whitepapers at:

<http://www.crowdability.com/resources>

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Actual results may differ significantly from the results described.

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ABOUT CROWDABILITY

Crowdability provides individual investors with education, information and insight into opportunities in the crowdfunding market.

Our free website and email newsletter aggregate and organize deals from an ever-expanding universe of crowdfunding platforms. We aim to save people time and simplify the process of discovering and evaluating crowdfunding opportunities.

BENEFITS OF JOINING CROWDABILITY

- Never worry about missing an opportunity - we track them all for you
- Gain access to education and resources that remove the confusion and anxiety about early-stage investing
- Hear from professional venture and angel investors to help you better understand the mechanics of early-stage investing and how to identify the best opportunities

Crowdability's goal is to become your primary resource for navigating the equity crowdfunding landscape.

Visit www.crowdability.com to join for free today.

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