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Investment Newsletter – March 2007

Who Wants to be an Angel?

In case you were wondering why there was no February newsletter, it is because I spent the time working on the legal aspects of a private offering for Angel investors. This month I will explain angel investing by using the offering for Parco Homes as a case study. My lawyer tells me I cannot distribute the offering documents without direct contact, so let me give the standard disclaimer: what you are about to read is not a solicitation to buy securities. If however, you find the business as interesting and worthwhile as I do, you may contact me for further information.

Angel Investing – The What and Why

The term Angel in the investing world has come to mean an investor who invests money at the start of a new business venture when the risk and return potential are highest. Such investments are usually less than $200,000 and may be as small as a few thousand dollars in the case of friends starting small scale businesses. The money may go in as a straight loan, but more likely it will take the form of partial ownership of the business (equity) so that the investor has the opportunity for a big payoff if the business succeeds. Overall, such investors typically expect their portfolio of start up investments to earn average returns of 26 – 30%, even though as many as a third of such businesses may fail. Of course, this means that some of these investments must perform spectacularly – meaning returns of 10 or more times the investment.

There are several reasons why Angels do what they do. Clearly, one reason is to make higher returns than are available on more traditional investments. But these are risky ventures and it does not make sense for someone to put a large part of their net worth into this type of investment. For those with substantial assets, however, it makes sense to devote 10%, or even 15% of assets to higher risk/return investments. According to The Center for Venture Research at the University of New Hampshire, the average private investor is 47 years old with an annual income of $90,000, a net worth of $750,000, is college educated, has been self employed and invests $37,000 per venture. Notice that these numbers correspond to about 5% of net worth in one investment. So Angel investors are taking a calculated risk that makes sense in the context of their overall portfolio. This is what every investor needs to do, allocate capital to various types of investment so as to maximize returns with tolerable risk. Note that riskier real estate deals such as land for development may play a similar role in an investor's portfolio.

Evaluating an Angel Investment Opportunity

The entrepreneur seeking funds from Angel investors must tell a compelling story of his or her business. It is no coincidence that the key points of this story follow the outline of a good business plan (and probably should be formally written as such). Every Angel (or Venture Capitalist) should evaluate the following aspects of a potential business.

- The problem that the company will solve for its customers.
- The value proposition/solution – how the company provides value to the customer.
- The market opportunity – how big is the market that the company is targeting.
- The competition – what is the company's competitive advantage.
- The business model – how the company makes money.
- The team – do the founders have the expertise and experience to win.
- The financial projections – under reasonable assumptions is the payoff big enough.

I will illustrate the analysis using the company whose offering I worked on last month.

A Case Study: Parco Homes

Let's look at the key points of Parco Homes' story to Angel investors about how they will make money (as shown in their brochure and their business plan).

The Problem

A small but growing segment of the consumer market is embracing environmentally efficient ("green") technologies. While many are willing to pay a premium for modern homes built according to green principals, there are few if any builders who have invested in the designs necessary to serve this market.

Looking at the statistics from the builder survey they cite, we see that a majority of builders say that consumers regularly ask about "green" building and that they will pay 11 – 25% more for "green" building. The 96% of builders saying they want to use more "green" building technology makes it clear that these customers are looking for a solution to their "problem".

The Value Proposition

Parco Homes will invest in superior “green” designs that will integrate the best alternative energy generation and storage technology available so as to create an energy self sufficient housing system. The designs will be implemented as a prefabricated kit of parts that take advantage of the economies of mass production offshore. Parco Homes’ components will be configurable in many different ways. This flexibility will enable us to customize solutions for specific sites and environments - thereby maximizing value to our customers. Our solution is resource efficient, mass customized, “green” housing, using high quality commercial building technology. These unique, high quality products will enhance developers’ reputations, while simultaneously reducing costs, build time and risk.

Unlike most other makers of consumer products in the U.S., housing developers have historically not invested significantly in design. Unsophisticated designs are built on site with much improvisation by the construction crews to make up for the design flaws. The industry has used the same techniques for generations; these methods are anything but green. Parco Homes is therefore proposing a significant overhaul of the home building process to add value via design innovation and a rethinking of the production process. In a world with global production sourcing, modern U.S. companies maximize their value contribution through design, marketing, and supply chain management. This company has a clear strategy for creating value for its customers by helping them build better houses, faster and cheaper. This is the kind of potent value proposition that an Angel investor seeks.

The Opportunity

Every year the U.S. spends $550 billion on housing production. Because labor is such a big factor, building costs vary significantly across states. Our first target markets are California and Hawaii because they have some of the highest costs in the country. We will initially target markets where our advantages are greatest: custom home builders & small developers in California & Hawaii that build for consumers who seek modern, ecologically efficient homes. Potential demand in this niche is $ 1.2 billion annually (2,363 houses). Once the company achieves profitability, we will expand into additional markets.

Clearly there is huge potential for this company and its products. More importantly, they are focused on a specialized niche with strong expected growth. They are defining a market without large well known competitors. Thus they have an opportunity to build dominance in their chosen market.

Competitive Advantage

Parco Homes' competition can be divided into two categories, conventional wood frame housing and custom prefabricated or hybrid housing. The first uses inferior designs and materials to achieve competitive costs in large-scale developments; the later provides higher quality design, but costs too much. The Parco Homes system of metal frame and panels, designed for flat pack shipping and efficient assembly, is uniquely suited for the fabrication model we propose. We are not aware of any other U.S. firm pursuing this technology for residential construction. We expect to be the first to bring this technology to the U.S. market. At launch, Parco Homes will provide customers significant cost savings compared to existing alternatives of comparable quality. The accompanying competitive space diagram illustrates our product positioning at product launch.

Parco Homes will capitalize on its innovations in "green" design and quality control by creating a housing brand recognized by consumers as consistently high quality and environmentally friendly. Even if others try to develop similar products in the future we will exploit the competitive advantage inherent in the unique talents of our design team by continuously improving our products and our process for adding value to client projects. We will also use patents on our fast assembly techniques and exclusive distribution agreements to erect barriers to entry in our market.

The company provides a detailed analysis of the competitive environment in the California and Hawaii housing markets by showing product positioning in terms of cost and quality compared to competing housing solutions (using a graph with quality on the y-axis and cost on the x-axis). It is very important for an investor to understand how a new company is positioning itself versus existing and potential competition. Parco Homes' diagram shows a compelling and clear analysis. According to their market research, their products compete at the high end of the market with significantly lower costs to build than similar quality homes now available. Their analysis also shows that their products can compete with existing houses that have similar costs by providing much higher quality for the money. The company's houses cost too much to be useful for the mass market production builders (who are bearing the brunt of the current market turn down); so instead they focus on the lucrative high-end niche where they have big advantages. This is important to investors because it shows that management understands how to quickly achieve profitability with limited capital resources.

The source of their competitive advantage will initially be their innovative technology. They expect to sustain their technology advantage with their superior design team and by being the first to set up distribution for branded "green" houses. Given the size and fragmentation of the housing market, this company should have no trouble building market share with a successful initial product. The qualifications of the team and their well documented business plan indicate they have the talent to maintain their lead into the future. This is important to Angel investors since the company will need to grow substantially in order for the investors to reap the large returns they seek.

Business Model

Parco Homes sells house kits based on their proprietary building components. In conjunction with these housing product sales, we provide project specific custom design services for fees. Their upfront investment in the component designs allows Parco Homes to use cheaper offshore labor and spread the design costs across a large number of clients. The result is cost savings for customers and 28% gross margins for Parco Homes on the house kit sales and related design services. By outsourcing production of kits and requiring customers to pay production costs as incurred, the company can scale up production and sales without corresponding increases in working capital. The result is internally funded growth and very high returns on capital.

This business model explains how the company makes money and justifies the economics by tracing the value creation to their core competencies: architectural design and cost management. Note that they can ramp up sales without raising additional working capital. Since they are focused on the high-end of the market, they sell very large houses. Their average margins per house range from $288,000 for premium kits in Hawaii to $60,000 for each standard kit sold in California. Thus they generate significant profits at low volumes and their business is relatively insensitive to the problems currently impacting the low-end mass-market builders. These elements of their business model provide a basis for strong growth in company profits and value without recurring dilution of existing owners. Thus the business model meets the key objective of Angel investors: it has the potential for huge value creation for early investors.

The Team

Development of this technology requires extensive experience with commercial building technology, residential design, and management of procurement contracts in China. Parco Homes' founders are at the top of the profession in all these areas. The team also has start up experience as well as financial and real estate investment expertise.

The brochure does not provide much detail about the team's expertise and credentials but the business plan and the company website at ParcoHomes.com both provide extensive background information detailing the experience and achievements of the team. The founders are extremely well qualified to implement the product design and prototype development portion of the business plan. Given that I serve part-time as the Chief Financial Officer of the company, I am very comfortable with the company's financial management. The team is, however, lacking a few key people that will be needed in later stages. In particular they will need to recruit a Vice President of marketing as well as someone to lead the sales efforts. These positions, however, need not be filled at this early stage. In fact, the cost savings and flexibility that come with delay, work in the company's favor. While the team looks excellent on paper, Angel investors should meet the founders in person to properly evaluate their character and drive. Unless the Angel investor already knows and trusts one or more of the founders, he or she will want to observe the team first hand to gain assurance that the team will work effectively together to solve any problems that may come up in executing the business plan.

Funding Plan & Financial Projections

The company will raise $500,000 to design the product and then another $1.5 million 5 months later to source production and build a model home. Once production contracts are signed, the company will work with a development company to build 8 to 9 houses totaling 40,000 square feet. This venture will pay fees totaling $1.4 million over 14 months. This is sufficient to support Parco Homes until customer sales hit the breakeven level of 2 houses per month two years after the initial funding. House kit deliveries start at 2 per quarter and build slowly over time. The following financial statement projections assume house deliveries for 2008 to 2011 are 17, 42, 131, and 251 respectively.

	Summary by Year in $1,000's				
Income Statement	2007	2008	2009	2010	2011
Revenue	270	7,647	30,131	80,879	135,619
Pre-tax income	(909)	(223)	2,514	8,983	15,959
Net Income	(546)	(134)	1,508	5,390	9,575
Maximum cumulative pre-tax loss		(1,323)			
Cash Flow Statement					
Operating Cash Flow	(1,025)	398	2,907	9,183	14,819
Capital Expenditures	(583)	(64)	(396)	(80)	(52)
Capitalized Design Costs	(160)	0	-	-	-
Cash Flow from Investing	(743)	(64)	(396)	(80)	(52)
Cash Flow Before Financing	(1,768)	334	2,511	9,103	14,767
Cumulative C.F. Before Financing	(1,779)	(1,446)	1,065	10,169	24,935
Maximum cumulative cash drawdown			(1,990)		

These projections support a company value in the range of $80 – $220 million by 2012.

Angel investors want to see realistic assumptions driving the financial projections. In this case, the key metric is houses delivered. The underlying assumptions about the buildup of customer orders through time looks consistent with the company's marketing plans and the development timelines laid out in the business plan. In fact, the company has very conservative market penetration goals: projected revenue in their fifth year implies a market share of just 10% in their target niche[1]. They have not provided any projections for expansion beyond the initial market niche and therefore there is upside potential for their revenue.

The company's business plan provides details of expenses and headcounts which show that they have a detailed understanding of the economics of the business and how it should evolve over the first 5 years. Headcounts start in the single digits and ramp up to 33 in 2011. This reflects a focus on core competencies by leveraging outside resources: they are outsourcing manufacturing and a large portion of their sales force (via outside commissions and distribution agreements). Their strategy of outsourcing these resource intensive activities should enable them to limit capital requirements and thereby earn extraordinary returns on invested capital.

The high end of their 2011 valuation estimate implies a price to earnings multiple of 23 times trailing earnings which is clearly justified by the projected growth rate – assuming strong growth can be sustained beyond 2011. Given the size of the overall market, this seems likely. The tricky part here is figuring out what these numbers could mean for investors at this early stage. The key information that is missing is the pricing of the offering and the amount of dilution expected when additional capital is raised in the next round and stock options are exercised by employees. Assuming the first $500,000 buys 11% of the company and the next $1.5 million takes 20% away, then the first round investors would end up with 8.8% of shares. Taking into account the company's stock option plan would likely reduce this to 7.3% of the company's equity. Using the high end of the valuation estimates, we see that first round investors could end up with equity worth $16 million five years later[2] – 32 times their investment. Thus someone putting up $50,000 could end up with stock worth $1.6 million for an annualized

[1] Calculated by dividing $135 million of revenue by the inflation (2.5%) adjusted value of their $1.2 billion market.
[2] Calculated as 7.3% of $220 million.

return of 100% - compounded 5 times. Even the low end of the valuation range produces outstanding returns. This is the kind of upside that makes the risk worth taking for an Angel investor.

Conclusion

Angel investing is not for everyone. You need substantial net worth, tolerance for risk, and the ability to critically analyze the business prospects for a new company. This article is meant to illustrate the analytical exercise one must go through when evaluating such a potential investment opportunity. The Parco Homes offering is an example of a risky venture that seems to have the necessary ingredients for success that make it worth investing for an Angel investor with room for some risk in their portfolio. This investment also has the added benefit of being directly related to real estate - and one of its founders is yours truly. Investors interested in exploring this particular opportunity should request additional information as soon as possible.

Contact Information

RayMeadows@BerkeleyInvestment.com San Francisco phone (510) 367-3280		Single Family Home Investment: RickRife@BerkeleyInvestment.com San Francisco phone (415) 425-3332