Due Diligence - Demystified

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What Angel Training is "Needed"

Core Subject / Concept	Advanced Version
Screening & Community Roles	Management of angel group process
Due Diligence *	Deal lead, diligence process & syndication management
Deal Terms	Deal structure, valuations and cap tables, legal terms
Coaching, Advising, Board Member	Board member handbook
Portfolio Review	Portfolio & Exit Management

- Everyone should understand the basics
- Each investing unit needs to cover most of these issues
- Each person can/should play a role
- Green items tend to be group specific

Agenda

- Due diligence process
- Things to assess
- Where diligence fits in
- Handouts
- Q&A

Does Due Diligence Change the Outcome?

- Maybe: There is not a great deal of data about whether more due diligence leads to better outcomes. However, in a study (Wiltbank and Boeker; 86 groups, 539 investors):
  - The median time for DD was 20 hours (collectively)
  - 26% of groups spent more than 40 hours on DD
  - The exit multiple for "High Diligence" was 5.9X (4.1 years)
  - The exit multiple for "Low Diligence" was 1.1X (3.4 years)

- However, thousands of angels ask their own questions and do not rely on written materials

Basic Definition of Investment Due Diligence

The process of:

- Uncovering and assessing the details of a business to understand the risk involved in the investment
- Identifying the factors most critical for company to be successful, so informed assessments can be made
- Understanding and documenting the key business metrics to allow each investor to assess a deal's potential and potential risk
- Legal diligence *minor and 'light'* at early stage

Discussing critical factors with company management so goals are aligned around use of funds and key activities

Due Diligence Process

- Due diligence begins after a company presents to an angel group, and garners enough interest to learn more about the business
- Due diligence will typically take anywhere from .5-5 months
- Volunteer teams are formed, and a deal lead emerges
- You don't have to be interested in a deal to join a deal team, though most team members are interested
- Some groups start with a two hour "Deep Dive" which is either an on-ramp into an exhaustive process, or results in a no-go decision
- Responsibilities are divided
- Weekly calls often scheduled so team is always aware of how the deal is moving along

Components of Due Diligence

Management Team

Market Opportunity

Market Entry Strategy

Customers/Prospects

Intellectual Property

Competition and Barriers to Entry

Technology Assessment

Business Model Assessment

Financial Analysis

Potential Exits

Weighing the Components of Due Diligence

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Business Model Assessment

Financial Analysis

Potential Exits

- Wow – That list looks a lot like the factors we are going weigh to set the valuation for the company
- We better spent more time on the most important ones
- And we need to know our co-investors, are they:
  - "completeness folks" or
  - "focus on the important stuff" or
  - "I know from my interactions with the team"

Due Diligence: Management Team

- Reference Checks from Past Employers, peers and employees
- Trying to understand:
  - How do they think through problems
  - Have they "done it" before?
  - Do they have any experience building companies?
  - Do they have the expertise to build a company in their space?
  - What are their strengths/weaknesses
  - Where will advisors need to add support?
  - ARE THEY COACHABLE?

Due Diligence: Market Opportunity

Market Opportunity

- Size of the target market opportunity
  - Most angel groups want to see a market size of at least $500 million, and few will look at a market less than $100 million)
- Barriers to entry
- Competition

Market Entry Strategy

- Positioning
- Distribution: Direct, channels, partners?
- Marketing Plan
- Understanding of Customer Acquisition Metrics

Due Diligence: Business Model

- Business model consists of two components; a **revenue model** and a **cost model**
- **Revenue model** breaks down all the sources of revenue
- **Cost model** identifies how resources will be spent to make money. It has two elements:
  - Cost of Goods Sold (COGS) and
  - Operating Expenses
- Key is to understand the "drivers" of both revenue and costs, and to assess the natural margins of the business.

Due Diligence: IP & Technology

Intellectual Property

- Does the company have any patents?
- Are the patents granted? Provisional?
- Get copies of the patents and have them reviewed. There are extensive resources in our community to provide support in this area
- Find a tech expert to look at the product

Technology Assessment

- Is this product truly different? Disruptive?
- Is this a science experiment, a technology, a product feature, or a product that can sustain a company?
- Find a tech expert to look at the product

Due Diligence: Competition

Competition

- Who are the competitors, and what is the company's competitive advantage?
- What are the barriers to entry?
- Is there room in the market for a new entrant?
- Ask for competitive information that the company has gathered.

Due Diligence: Financials

Financials

- Review the company's financial plans to date, and ask for three to five years of future plans (they will change, but this is a good starting point for a discussion around assumptions)
- Review the cap table and look for any anomalies
- Determine if the company has any payables, bank debt etc. Both of these will factor into how the deal is structured
- Understand the full funding requirements beyond the current round

Due Diligence: Exits

- How does the company believe it will exit?
  - IPO
  - Early Acquisition
  - Acquisition
- Are there examples of other companies that were acquired in this space?
  - Create a table of similar companies/dates of exit/price
  - Key is to be able to explain the value prop a company represents to acquirers – what the deal rationale would be?
- Who are the potential acquirers, and how will the company engage with them? Partners?
- Is a 10X or more return possible with this company?

Due Diligence: Customers

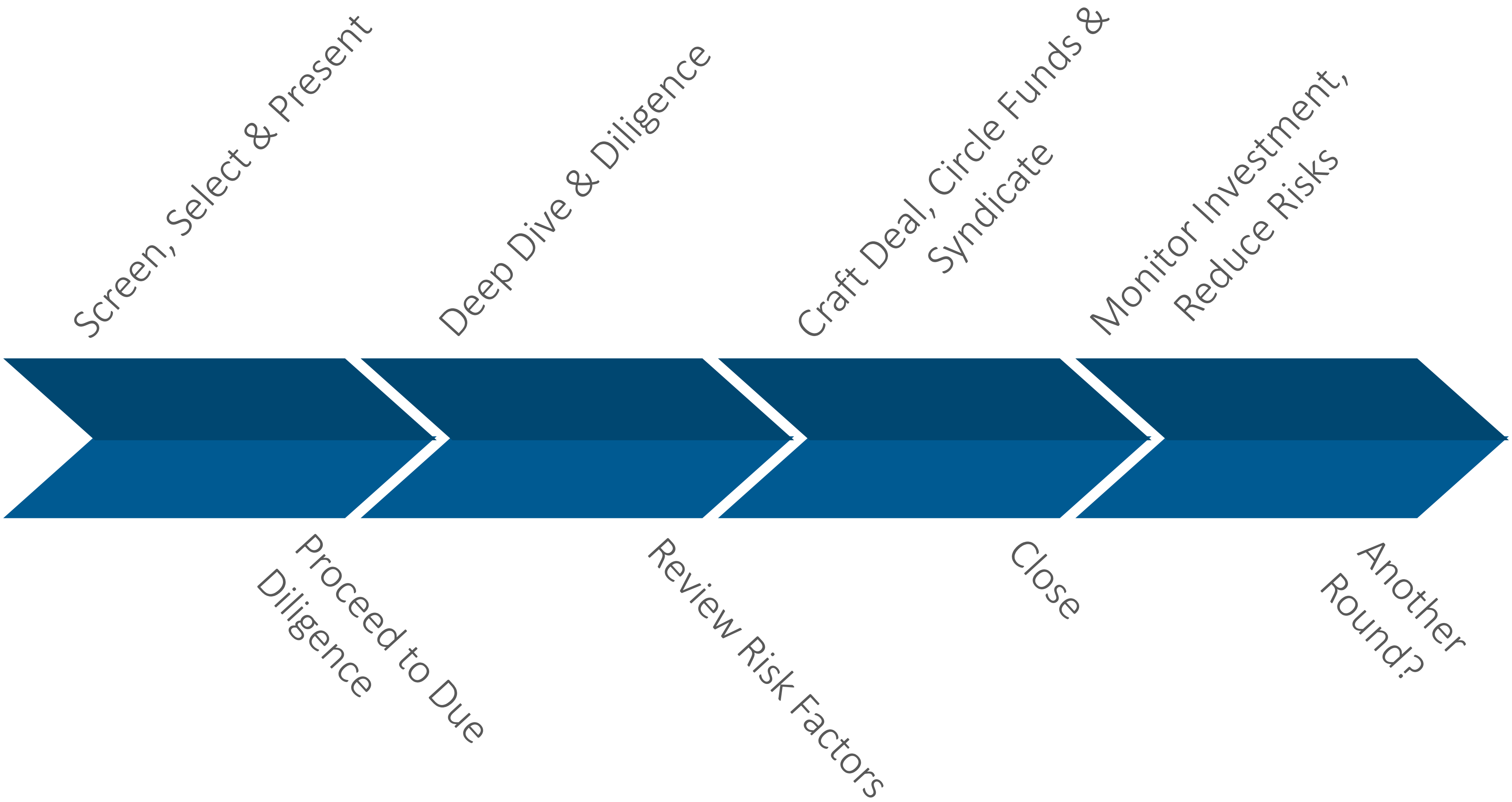
Customers/Prospects

- Does the company have any customers? Who are they, and why have they purchased from the new company?
- You can do checks with customers, or, find companies that reflect the characterization of their customer
- Is the customer a traditional early adopter, or one that does extensive analysis of new products or technologies?
  - There is a significant difference between these two types of customers
  - Note: Customer checks should come last … when you 90% sure the deal will happen

Deal Memos

- For many groups, due diligence results in a Deal Memo or Diligence Memo
  - Ideally critical success factors are key focus not long listings of things that don't affect business success
  - Anything from five pages to 45 pages depending on the group
    - Some just have conclusions others gather most of the background data
  - Full summary of group findings
  - Deal memos are often shared between groups for syndication, assuming treaty is signed

Where Diligence Fits in



Risk Assessment / Valuation Match

- Diligence is a “rational” way to assess risk
- Goal is not to find company wrong but agree:
  - “This is Important” or “this needs to be fixed” ..
  - Because this is hard to fix our risk adjusted price is lower
- Finding the most important critical factors allow the valuation to be agreed by the company and reviewed by co-investors

Risk Factor for Summation Method

Risk Factor	Rating (-$500K to +$500K)	Comment
Management	+$500K	Done it before
Stage	+$250K	Prototype works
Funding Risk	-$250K	International markets tough
Regulatory	0	Unregulated market
Manufacturing	+$250K	Nothing new
Sales & Marketing	-$500K	International markets
Competition	+$250K	Few in target market
Technology	+$250K	Off shelf parts
Litigation	0	None expected
International	-$500K	All revenue international
Reputational	-$250K	International issues
Exit	+$250K	Likely early
	$250K → Start at $1.75 Million +$250K = $2.0 Million	

Goals Alignment

- This is the most important activity during diligence
  - You must set up communication patterns with the company that will be productive going forward
- Goal is not to find company mistakes but to agree with the company .. "This needs to be fixed" .. "that will be our key focus"
  - Fraud .. That is a different matter
- Often the deal lead becomes the board member
- Finding the most important critical factors may be structure for future board and investor update reports

Sample Board Dashboard

Highlighting Critical Success Metrics for XYZ Company

Item	Rating	Current Status	Explanation
Cash		$XXXM	Ok for no
Biz Dev/Revenue		3 pilots in progress Launched email campaigns	Need more pipeline volume Adjusted budget down (rev & bookings)
Product Dev.		New release addresses some data/accuracy issues Setup still occurring outside tool	Need more/better input data Proactive plans in place for both
Pilots/Services		Y R S underway	Product issues = delivery more manual No consulting hire yet
Marketing/PR		Gearing up for Sept launch PR RFP in process	Analyst, blogger attention rising Very positive response to email campaign
Funding		$XXXM Still 3 ongoing conversations	Round not filled Strong interest from ABC
Hiring/Ops		xxxx staff ~xx contractors	Need developer Need junior and senior consultants

Due Diligence is Critical to New England's Angel Ecosystem

- Innovation in our region is unique & dynamic
- Angel investing is growing in quantity and quality
- Angel groups are becoming more sophisticated
- Syndication among groups is growing, and is a critical component of the angel industry's development
- Syndication should reduce the amount of time and effort involved in raising capital for an investment opportunity (angeltreaty.com)
- **Successful investing, within groups and syndications, has some level of due diligence sharing at its core.**

Diligence Process in Summary

- Diligence is the process of understanding the details of the business and the riskiness of the investment
- Good diligence reports help members of angel groups make up their own minds on an investment without each person having to do it all
  - Diligence teams can have fun learning new things together
- Diligence process can often bring alignment between entrepreneurs and the investors on critical success factors

My 2 Cents – Diligence Process

- Diligence is the process of understanding details of the business
- Business model is key:
  - Find critical success factors … target key milestones … shoot for them
- Diligence process should bring alignment between entrepreneurs and investors on critical success factors ….. and ideally exit possibilities

Resources for Additional Information

- Information is available from the Angel Capital Association
- Ask to follow someone else's process in order to make yourself a better angel
- Templates can easily be accessed

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Q&A