ANGEL CAPITAL ASSOCIATION
THE PROFESSIONAL ALLIANCE OF ANGEL GROUPS

BEST PRACTICES FOR DUE DILIGENCE IN ANGEL GROUP INVESTMENTS

May 2004

A great way to start a heated debate in an angel investment group is to ask "how well do we do due diligence?" Aside from the politically safe response of "we can always do better," there are no easy answers in this critical task of assessing, investigating and evaluating investment opportunities. Hindsight can make the answers appear simple: successful investments had enough due diligence; failures missed key issues. But, it is never simple before an investment is made.

Particularly in the past few years of a cautious investment climate, potential investors have squandered their and entrepreneurs' most precious resource—time—and frustrated each other by stretching the diligence processes well beyond reason. Fear of potential risks can drive investors to near endless questions and long checklists, but are those substitutes for quality? And, how really does creating file boxes of documents help either investor and entrepreneur when so much rests on the assumptions about the future? Or to put it another way, as one member of CommonAngels commented on the diligence process, "Don't forget the difference between precision and accuracy."

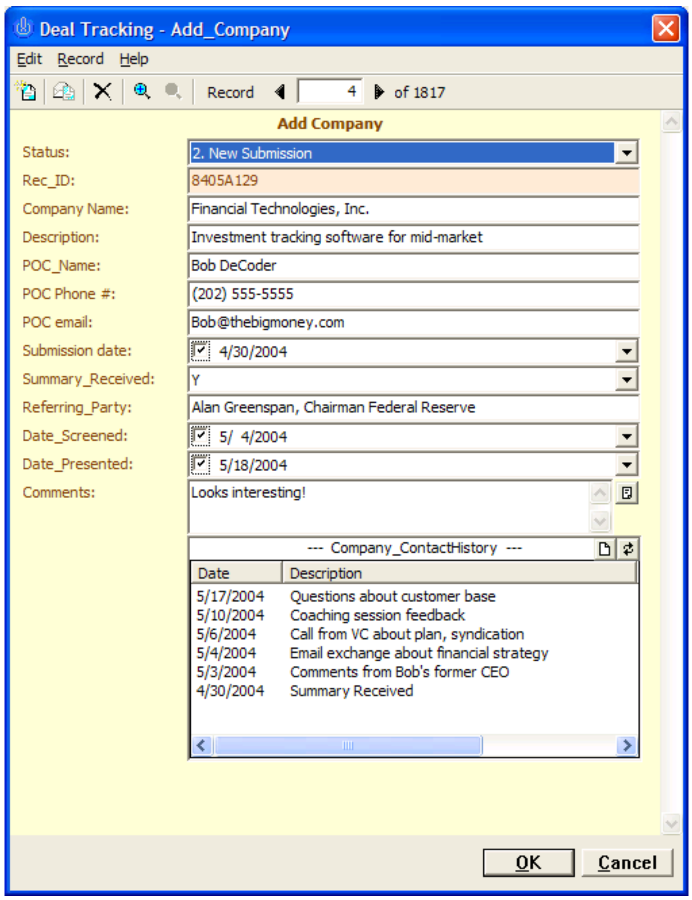
As teams of industry experts and business leaders, angel investment groups can be a welcome friend to entrepreneurs by doing effective and efficient due diligence. Our strength lies in applying lots of practical, operational experience; but our weakness lies in having few, if any, full-time resources to investigate and monitor investments. This paper outlines a framework to pursue a balance of sufficient quantity with high quality that helps both parties in a financing. The diligence process also never ends. There is a visible and necessary process around the time of investment, but periodic updates, investigations and interactions also help avoid future problems as well as take advantage of new opportunities.

Process

Due diligence has both informal and formal processes. The informal ones often occur before an investment opportunity receives official consideration and after the investment has been made. These include how the company and the investment group were introduced, feedback that led to the company receiving formal investment consideration, and reactions and specific comments of each member of the angel group.

There often is valuable information and perspective in each of these elements, and we have found the following useful tools in managing the process:

- **Deal Flow Database.** As soon as the number of investment opportunities increases beyond even a few per month, a relational database helps track and maintain a record of details and comments. One record per company with many subordinate records that contain documents, emails, notes, comments and reflections assembles this data in one place and can allow searching later. See example below.

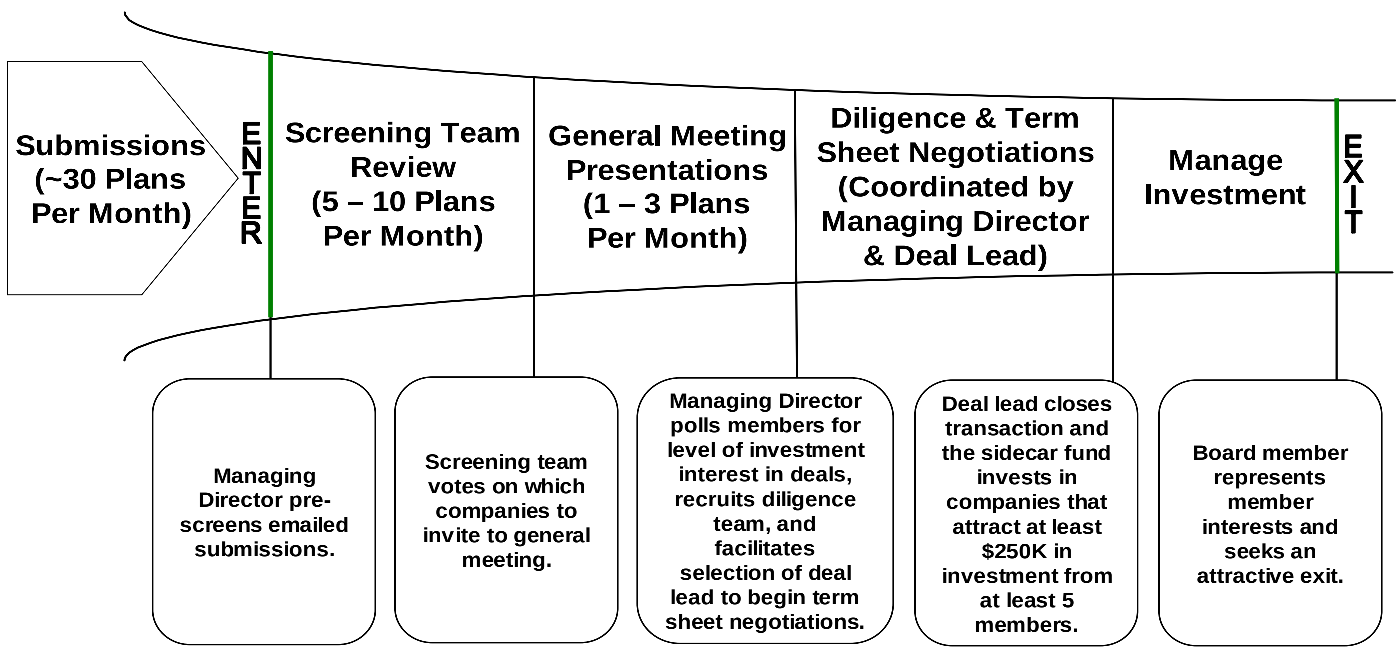


Illustrative example of CommonAngels' deal flow database

- **Obtain a Champion.** Filtering deals also in and of itself is part of the diligence. Within CommonAngels, a potential investment needs to have a champion. If there's not one up front, we assign one through the deal flow process (see below). If we cannot find one, it may be a sign that our angel group is not a good fit with the company seeking investment. Trying to force a deal through without a champion has never worked within CommonAngels, regardless of how many outside investors created a sense that the company in and of itself was a good investment.

- **Record Notes During Discussions.** Designate an angel group member or staff person to record comments during the evaluation and screening process. These notes identify the concerns for subsequent formal diligence and may elucidate key insights.

- **Evaluation Sheets.** Creating a rubric for scoring companies with room for comments gives angel group members a way to express observations and share expertise. They also create a quantitative metric for making comparisons between or across companies. See example in Appendix A.



CommonAngels Deal Flow Process

For the formal process, begin by selecting a leader who will be responsible for coordinating the diligence—and for refereeing the process in cases of disagreement either among the angels or with the entrepreneur. This lead also should select the people for the diligence team. Individuals with great market or otherwise relevant knowledge will speed diligence and be more respected by references, other investment group members, co-investors and the entrepreneurs. Avoid selecting members to lead the deal who want to participate purely for their own education or who are willing to help but profess ignorance. “Well, I don’t know anything but I’ll lead diligence,” often is a sign that potentially weak or worse counter-productive diligence is on its way.

The diligence process also often serves to sell the deal. Having highly experienced and engaged individuals working closely with the company can give your group a competitive advantage against other potential investors. Many times we have found entrepreneurs, particularly experienced ones, frustrated by junior professionals who have to learn about the market, industry or technology while conducting due diligence. In contrast, the decades of experience and industry insight from experienced angel investors can help foster mutual respect and a strong working relationship. CommonAngels, for example, also typically encourages entrepreneurs to do their own due diligence on the investor group and provides references. The reciprocity helps develop a relationship with the investors and provides independent views on the best ways to work together.

Finally, before launching into the formal diligence progress, establish shared goals within your investment group and with the entrepreneur. We have seen many diligence efforts breed mistrust and frustration when one or both sides had strongly differing views on the desired outcome and duration. We recommend highlighting the major areas of focus in advance, outlining what diligence materials will be requested, and setting dates for accomplishing each step.

Due Diligence Areas

There are many checklists for conducting due diligence—a couple are in Appendix B—but each tends to boil down to five—perhaps six—areas of risk: the people on the management team, the product or service offered, the market, competitors current and future, and financial requirements and return. An additional occasional risk is the role of governmental regulations or similar industry standards that could impede the venture or foster competition.

People. A common phrase among early stage investors is “we invest in people.” Our response is: “that’s probably because it’s all you have right now!” Without a finished product, clear market, known competitor or tested financials, there is not much else to investigate. If you have limited time and can only focus on one area of due diligence, this would be it! The future of the venture rests on the management team, and this process not only tests their abilities, it also serves to identify opportunities for the members of your angel group to provide assistance and coaching to help the venture succeed.

While checking references, conducting background checks, interviewing past employees and employers all give insights into the management team’s strengths and weaknesses, we also recommend trusting your instincts. As groups of industry leaders, angel groups can use the members own affinity for the team as a way to judge the potential for success. A statement like “I like these people, they remind me of when I was starting my first venture” from an investor who has been a successful entrepreneur is often a good sign; get 10 of those people to say that, and you likely have identified the next generation of industry leaders.

Product/Service. “Does it actually work?” may be a tough question for an early stage venture, particularly one on the cutting edge of technology. We have seen many new companies, particularly in biotech and materials science but also in software and telecommunications, give great promises only to discover later that surprises lay in completing or scaling the product or service. If your organization lacks people who have tried similar or analogous things before, this is likely a time for syndicating the investment. Finding people with complementary technical or market skills can help make the investment decision and can provide assistance to the company in years to come.

Market. Are customers ready to buy? Who are they and how do they purchase this type of product or service? Answers to these questions not only will help you make your investment decision and but also help the company refine its sales strategy. Knowing the market size and the industry dynamics also are critical elements for estimating the company's prospects.

Competition. This is perhaps the great unknown, particularly for early stage ventures. Current competitors may be small and hard to identify; others may not have yet emerged in the market. Truly innovative technologies may have no immediately apparent competitors, but customers always have alternate ways of spending their money. Understanding customer alternatives (even if the customer's choice is to simply "do nothing") is key to helping the company hone its value proposition. Having a large network of investors with industry experience can give an angel group a competitive advantage here. You may already know who could be a future threat, and you may already understand the mindset of the potential customers. Brainstorm among the group to create lists of companies, organizations or people who could be competitors; this same list may also elucidate business development and recruiting opportunities, so view the exercise as one for both risk management and opportunity creation.

Financial. In addition to reviewing financial projections, consider the consequences of the overall capital requirements for risk in cases of both success and failure. Model the capital table through the company's likely stages of investment to exit. This will help you address how much money you will need in reserve during the life of the investment and how you will make money. Some angel investors view acquiring a large venture capital round as a sign of success, but having that as part of the financial plan may create the risk of diluted ownership and lower returns. Of course, one of the largest risks is running out of cash or going out of business after a large investment. CommonAngels adopted a policy several years ago of investing sufficient capital in the first round to get a company to cash-flow break even, at least according to plan. This has meant syndicating more deals up front but also avoided punitive financings when a company would have been out of money.

Documentation. After assessing each of these risks, we recommend compiling the comments into a written report. Doing so takes more time and effort than just giving a verbal presentation at the next angel group meeting, but it also forces review of each of the above areas and whether they have been considered adequately. Including quotations from members and sources also gives color commentary that helps other investors get a better perspective than just providing a list of data.

Verbally reviewing the key findings with the company's management team can also help created shared expectations or elucidate key differences. Providing a written copy of the report may be less helpful—and possibly harmful—by distributing information that should have been confidential or allowing management team members to focus overly on particular points relevant to them personally. At CommonAngels, we have made this a regular practice of closing deals that often brings up a few additional points and helps clarify the relationship.

After the Investment

The due diligence process is like dating and an engagement; you are evaluating each other and seeing if you want to tie the knot. After the wedding, however, it is hard to get divorced. Rather than wake up one day and realize you no longer know your business partner—or have found they have been running with what you view is the wrong crowd—regular check-ins help maintain the relationship and strengthen both parties.

One of the few outright failed investments within CommonAngels came when a company with a young team had little follow up. The engineering group and CEO were recent college graduates and, among other things, in retrospect had insufficient appreciation for product management. Even though the company sent periodic updates on progress, the words about product development meant two different things to management and the investors. Management's expectation of creating a product was a much lower standard than ours, or the market's. By the time we discovered that the product was still piecemeal and required nearly a month of customization to work—and that we and the market expect a simple-to-install solution—we had lost precious time against competitors that could not be regained. Even after recruiting a new, experienced CEO, there never would have been enough money to win in the market, so we shut the company down. Regular diligence on the product might have helped avoid that failure.

Look also around the market. Designate several official advisors to the company, who periodically go on sales calls. Interview and meet with members of the management team other than the CEO, while still respecting their leadership role. Ask your industry contacts about the company and its reputation.

In Conclusion

These are some of many steps. Pick the ones most appropriate to this venture; mark them on your to-do list and calendar; and report back to the rest of the investment group. Your other members may have suggestions and insights that could help the opportunity.

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CommonAngels
Company Evaluation Sheet

Evaluation of: **(Company Name)** _______, 2004

Please evaluate the company's presentation with respect to the following:

Key Issues (positive/negative)	weak	(Please circle one)			strong
1. Team (ability to run successful venture, mgmt. gaps)	**1**	**2**	**3**	**4**	**5**
2. Product (quality, stage)	**1**	**2**	**3**	**4**	**5**
3. Market (large, growing)	**1**	**2**	**3**	**4**	**5**
4. Position Against Competition (number, type of competitors)	**1**	**2**	**3**	**4**	**5**
5. Financial Management (capital requirements, earnings potential)	**1**	**2**	**3**	**4**	**5**
6. Deal (terms, valuation)	**1**	**2**	**3**	**4**	**5**
Overall score & your level of interest:	**1**	**2**	**3**	**4**	**5**

Level of Likely Investment: $ _______________

How you can help:

Evaluator: _______________________

Appendix B: Sample Due Diligence Checklists

TechCoast Angels Diligence Checklist

1. Prelim due diligence request list

1.1 **Exec summary and business plan and presentation slides**
1.2 **TCA Excel spreadsheet**
1.3 **Financial model and current balance sheet**
1.4 **Management resumes and organization chart**
1.5 **Contact for management and customer reference checks**
1.6 **Social security numbers for background checks**
1.7 **Capitalization table and shareholder roster**
1.8 **Stock option grants**
1.9 **Contact information for:**
- A. TCA Members from screening
- B. Managers
- C. Directors and shareholders
- D. Web site developers, if outsourced
- E. Attorneys
- F. Accountants
- G. Consultants

2. TCA due diligence program

2.1 **Contact information**
2.2 **Due diligence program**
2.3 **Third-party reference checks**
2.4 **VentureOne data base search**
2.5 **Competitive matrix**
2.6 **Risk factors**
2.7 **Reports from independent consultants**

3. Show stoppers

3.1 **Harmful pre-existing agreements**
3.2 **Unsettled management team issues**
3.3 **Disruptive or complex shareholders issues**
3.4 **Inadequate IP protection**
3.5 **Excessive current liabilities**
3.6 **Inappropriate use of proceeds**

4. Funding needs and proposed terms

- 4.1 **Funding objectives**
- 4.2 **Use of proceeds**
- 4.3 **Proposed closing date**
- 4.4 **Adequacy of stock option plan?**
- 4.5 **Board composition**
- 4.6 **Re-vesting for founders and key employees**
- 4.7 **Valuation and price per share**
- 4.8 **Presentation dates for TCA dinner meetings**

5. Management team assessment

- 5.1 **Review resumes**
- 5.2 **Founders history with company**
- 5.3 **Reference checks**
- 5.4 **Third-party background checks**
- 5.5 **Qualities of team:**
  - A. What is motivation? Financial stake?
  - B. Functional expertise
  - C. Professional and personal accomplishments
  - D. Track record in previous positions
  - E. Prior direct selling experience
  - F. Domain expertise
  - G. Extent of financial commitment
  - H. Compatibility of team members
  - I. Prior P&L experience
  - J. Key hires and candidates, if any
- 5.6 **Qualities of CEO:**
  - A. Personal qualities as an entrepreneur and manager
  - B. Experience managing people
  - C. Willingness to share equity
  - D. Integrity, trust and leadership qualities
  - E. Outside activities and distractions
  - F. Ability to attract/recruit advisors and experts
- 5.7 **Who are the advisors and directors? Financial commitment?**
- 5.8 **Why are they willing to join the team?**

6. Current business status

- 6.1 **Cash on hand and monthly burn rate**
- 6.2 **Time table for funding**
- 6.3 **Short term objectives**
- 6.4 **Funding options**
- 6.5 **Strategic milestones**

7. Business plan overview – Key questions

- 7.1 **Who is the customer? Where is the pain or problem?**
- 7.2 **How does the customer make decision about this product or service?**
- 7.3 **How compelling is the decision to purchase?**
- 7.4 **What is likelihood of adoption?**
- 7.5 **How will the product or service be priced?**
- 7.6 **Are margins in line with industry norms?**

7.7 **How will the business reach the identified customer segments?**
7.8 **How much will it cost in time and resources to acquire the customer?**
7.9 **What are the costs to produce and deliver the product or service?**
7.10 **How much does it cost to support a customer?**
7.11 **How easy is it to retain a customer?**

8. Market opportunity

8.1 **Define total available market.**
8.2 **Identify market segments and projected growth rates.**
8.3 **Define the problem or pain for the end user or customer.**
8.4 **What is prevailing industry business model? Switching costs?**
8.5 **What is selling cycle? How is relationship sustained?**
8.6 **Who are first movers and leaders?**
8.7 **Use VentureOne database to identify emerging competitors.**
8.8 **Collect industry articles relevant to available market.**

9. Products and services

9.1 **How well does product and service offering solve problem above?**
9.2 **How well is product and service differentiated from alternatives?**
9.3 **Determine stage of product development?**
9.4 **Define milestones to launch or scale.**
9.5 **Review product and service offerings:**
- A. Value proposition
- B. Proprietary features
- C. Product life cycle
- D. Perceived barriers to entry
- E. Competitive lead times
- F. Patent protection

9.6 **Evaluate product from customer's or end-user's perspective:**
- A. Brand awareness
- B. Perceived value and general reputation vs competitors
- C. Buyer motives
- D. Substitutes and complementary products
- E. Quality trade-offs

9.7 **Assess technology components:**
- A. Role of customer in R&D process
- B. Beta site results
- C. Proprietary technology
- D. Patent protection

10. Competitive analysis

10.1 **Analyze competitor business models for comparative strengths and weaknesses**
10.2 **Review management's competitive matrix.**
10.3 **Confirm competitive landscape? Consider existing and potential entrants.**
10.4 **Determine adequacy of barriers to entry and degrees of protection.**
10.5 **Review and rank competitors by:**
- A. First mover advantage
- B. Product selection and web site features
- C. Capitalization and access to capital

10.6 **Evaluate competitive or comparable web sites for design, functionality and traffic.**

11. Marketing and sales strategy

11.1 **Define target customers.**
11.2 **How clear is marketing and sales strategy?**
11.3 **Contact strategic partners and/or marketing partners.**
11.4 **What is branding strategy vs competition?**
11.5 **Compare offline and online campaigns vs industry norms.**
11.6 **How affordable are marketing and promotional programs?**
11.7 **Who are distributors, intermediaries or agents in various market channels?**
11.8 **Determine customer acquisition costs.**
11.9 **How strategic is customer data base information?**

12. Operations and logistics plan

12.1 **Evaluate IT infrastructure**
12.2 **Adequacy of fulfillment plan**
12.3 **Resources to outsource**
12.4 **Customer service and support**
12.5 **Facilities**

13. Financial model and business economics

13.1 **Evaluate assumptions supporting revenues sources.**
13.2 **Gross profit margins vs. competitive norms**
13.3 **Staffing plan**
13.4 **Monthly expense budgets**
13.5 **Equipment budget**
13.6 **Financial statements projections**
   A. Best case
   B. Worst case
   C. Time to break even
13.7 **Cash on hand, burn rate**
13.8 **Balance sheet and cash flow forecast**
13.9 **Detail for current liabilities**
13.10 **Future funding needs**
   A. Critical milestones
   B. Likely sources and timing for next funding

14. Web site review

14.1 **What is unique vs competitive sites?**
14.2 **Review web site design, look and features.**
14.3 **Determine adequacy of web site development partner.**
14.4 **How is content refreshed?**
14.5 **Beta site launch date and related promotion**
14.6 **What are products and services offered?**
14.7 **E commerce software and infrastructure**
14.8 **Links with other sites**
14.9 **Logistics for fulfillment**

15. Resources to outsource

15.1 **Technical:**

A. Web site development

B. Hosting

C. Software support

15.2 **Marketing:**

A. Logo and branding strategy

B. Public relations

C. Customer support

15.3 **Financial and administrative:**

A. Human resources support

B. Interim CFO

C. Recruiting

D. Payroll services

E. Accounting systems and controls

16. Risk factors

16.1 **Technology adoption rate**

16.2 **Beta site and launch plans**

16.3 **Customer adoption rate and sales cycle**

16.4 **Competitive landscape**

16.5 **Worst case scenarios**

16.6 **Regulatory issues**

16.7 **Series B milestones**

16.8 **Financial projection assumptions**

16.9 **Likelihood of follow-on VC funding**

16.10 **Exit strategy**

17. Legal Review

17.1 **Legal entity and capital structure**

17.2 **Unusual or significant unrecorded liabilities**

17.3 **Stock option plan**

17.4 **Contracts with advisors**

17.5 **Intellectual property**

17.6 **Web site review**

17.7 **Employment agreements, if any**

17.8 **Tax matters**

17.9 **Potential litigation**

18. Conclusions

18.1 **Meeting schedule for due diligence effort**

18.2 **Present summary findings to due diligence team**

18.3 **Present findings to Angels at large**

18.4 **Commence closing documents**

CommonAngels Due Diligence Summary

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<company name>

Prepared by <due diligence team names>

I. Executive Summary

Key Judgments
- Investment characterization and quality
- Nature of the venture
- Outlook

Next Steps
- Financial requirements (this round and subsequent)
- Team requirements
- Additional assistance needed

II. Team Analysis

Management team’s resumes
Current board of directors
Advisors
Professional services
Reference checks
Comments on their ability to support this venture
Willingness to accept outside guidance, direction and changes

III. Product/Service Evaluation

Description
Strengths, weaknesses
Benchmark against nearest competitor
Complimentary goods, inputs

IV. Market Analysis

Size, scope
- Estimated by company
- Analysis/critique

Key customers
- Interviews with current ones
- Important future clients and steps to acquire

Pricing
Revenue model
Selling strategy

V. Competition

Current (include stage, market share, funding and strategic outlook)
- Direct
- Indirect (including substitutes)

Future
- Direct
- Indirect (including substitutes)

VI. Operational Critique

Company structure

- Form and locale of incorporation, if any
- Current shareholders, amount invested
- Existing securities, classes of stock, restrictions

Organizational structure

- Current positions filled
- Additional personnel needed and strategy to acquire them
- External partners, suppliers and complimentary organizations

Production

- Process of providing good or service
- Operational analysis

VII. Financial Evaluation

Pro forma financial statements (from company)
Planned use of CommonAngels' funds
Key assumptions and variables
Follow-on funding requirements
Exit possibilities
Timetable for fundraising and potential exit

VIII. Overall timelines

Critical deadlines/timing

- Internal (e.g., product, recruiting, financial)
- External (e.g., market, seasonal sell cycle)

Overall schedule, key milestones

IX. Critical Risks & Problems

For the venture

- Team
- Market
- Product/Service
- Financial

For CommonAngels

- Company
- Financial

X. Next Steps

CommonAngels assistance
Board seats
Potential synergies with other companies
Strategic partners

XI. Conclusion

Comments or Questions

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