Best Practice Guidance for Angel Groups – Due Diligence

David Eyler, Columbia University

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Due diligence in the venture industry is the investigation and analysis the investor performs to see if an investment opportunity meets the investor's criteria for funding. For angels as well as venture capitalists, the primary objective of due diligence is to mitigate investment risk by gaining an understanding of a company and its business as well as determining the suitability of the investment for the portfolio.

Defining the Risk of the Investment Opportunity

It is extremely important to identify the risks of a venture because even in optimal conditions, many elements are required for success. Take the following scenario:

• Management is capable and motivated	90%
• Market demand is as expected	90%
• Production is scaled up as planned	90%
• Competition is held at bay and IP is defendable	90%
• Liability and litigation is avoided	90%
• Company has sufficient capital	90%
• Existing customers are able and willing to pay	90%
Success Probability	48%

In the event that even one of these risks is not assessed correctly, and the chance of success is actually 50 percent, the overall probability success is reduced to 27 percent. Clearly every risk must be kept to a minimum.

As an example, Matthew Cherry of Intelex writes:

"[Due diligence] issues cannot be glossed over, as evidenced by [1999's] "hit" of Hitsgalore.com. Hitsgalore.com, an Internet company whose market value soared from $53 million to $1 billion in three months, didn't disclose its founder was accused of cheating customers at a previous job. As a result of a lawsuit, this information became public and Hitsgalore.com shares plummeted 53% cutting the company's market worth by $534 million. It was the largest percentage loss of any U.S. stock. Perhaps the most unnerving aspect of this story is that all of the problems could have been completely avoided with proper due diligence."

These issues are even more important to angel investors than to venture capitalists, because of the early nature of the ventures. While most deals that VCs see are fairly far along, angels and angel groups bear a much greater risk of catastrophe.

When to Start Due Diligence

Criteria for investment can vary widely between angel investors. Some examples:

- *Investee has a defensible plan to reach $100 million in ten years*
- *Scaleable concept, yielding revenues of US $100 million by Year 5*
- *You can demonstrate that the business is likely to grow rapidly and reach at least $15-30 million in revenues in the next 3-7 years*

- Ottawa Capital Network's Web site, "Winning Angels" by Amos and Stevenson, and ACEF, respectively

Other considerations before beginning the due diligence process include:

- **Do you feel comfortable with management?**
  Angels need to like and trust the entrepreneur in order to have a chance of success. They will be working together a lot and if there is friction or the slightest whiff of a lack of integrity it will probably not work.

- **Have you narrowed the field of potential deals down to a manageable number?**
  Your group probably doesn't want to do full due diligence on more than one or two deals a month. If you try to do too many at once you risk spreading your members too thinly, which could result in deals being approved that should not. Preferably at least one member should have experience in the relevant domain so that he or she can take the lead.

Creating a Due Diligence Plan

The first thing to do is identify the assumptions that need to be confirmed in order to validate an investment:

- **Viability of IP**
  Dennis Fernandez, Managing Partner at Fernandez & Associates, lists some common pitfalls to avoid. You can see the rest at www.angel-investor-news.com/ART_topten.htm

  "1. Too Late To Start Filing US and International Patent Applications.
  Unfortunately for many good technology companies, it may be too late to file for patent protection. The current U.S. rule generally provides applicants with a one-year grace period during which a patent application must be filed after certain public or private disclosure of the invention.

*2.   **Too Narrow Legal Scope Of Claiming Patentable Inventions.***
Many issued patents are not commercially valuable because the scope of their submitted claims are particularly narrow, and can be relatively easily avoided by determined competitors.

*3.   **Internally Mismanaged Patent Infringement "Willfulness" Exposure.***
Under U.S. patent law, one's awareness or willful state-of-mind about the existence and infringement of a competitor's issued patent may significantly affect subsequent legal liability. Thus if a party is proven to be a willful infringer of a known patent, then for punitive policy reasons, economic damages may be awarded to the patent owner up to three times normal recovery amount."

- **Demand for a new technology**
  It is important to make sure that customers are actually feeling pain from an unresolved problem. Many startups are based around the idea of a marginal improvement or a new concept that customers "should" like. The successful idea's application will be obvious.

  Also, customers need not just the will but also the ability to pay. If the venture targets organizations without sufficient budget for the product, it won't matter how badly they want it.

- **Existence of a market for the product**
  Even if the idea passes the above demand tests, a more rigorous market analysis might be a good idea. Dedicated firms such as Guideline (www.guideline.com) can provide professional market research. Catherine Mott of BlueTree Allied Angels also notes that Forrester Research (www.forrester.com/rb/) can provide a professional report on a market for between $30,000 and $60,000.

- **Customer relationships**
  Having established customer relationships is vital. The venture that promises many customers but has none may end up with none. Generally having two established customers who will confirm that they are buying or will buy the product is a good hurdle.

Angel groups also need to take the time to separate elements that might not be confirmable from deal breakers that must be confirmed.

- **Defining acceptable risks**
  It may be impossible to confirm if every risky aspect of a venture is within acceptable limits. Before due diligence begins the team should determine what aspects of the venture will not be deal breakers if they can't be completely confirmed.

  For example, if the firm is developing a new technology, there is a risk that it won't work or, more likely, that it won't work in time to be relevant. However ruling out every venture with this risk would eliminate some of the best deals.

Conversely, there are some risks that the angel investors will not want to take. These potential deal breakers should also be enumerated beforehand.

Investors should also be ready to shoulder the cost of the due diligence process, which may prove to be considerable.

- **Lawyers** Many angel groups have standardized processes and term sheets, which reduce legal fees. Make sure to reuse as much legal material as possible to avoid reinventing the wheel.

- **Industry experts** Hiring industry experts is not free. For example, www.Bioability.com lists a cost of $4,900 for their Investor Due Diligence Report Service, which takes 4 – 6 weeks.

- **Site visits** Also make sure to take into account travel expenses for your angels to visit entrepreneurs and customers.

Non Disclosure Agreements

There are a wide range of opinions about NDAs in the angel investing industry.

Rick Segal of JLA Ventures writes:

> *"So some [entrepreneurs] are now including an NDA when they send a plan to an investor. Last week I saw the most creative attempt yet. After reading a business plan given to me by an entrepreneur last week at an angel conference, I note a page of gobbledygook at the beginning that effectively said "by reading this you have agreed to this NDA" -- no request for a signature even.*
>
> *Enough already. Entrepreneurs need to understand that investors aren't looking to steal ideas, but we see enough that we'd be foolish to sign such a document. Too much exposure. And at the end of the day it all comes down to execution anyway."*

Paul Allen of Provo Labs offers a slightly different opinion on his blog:

> *"Angels and VCs don't sign NDAs. Business plans and exec summaries don't need to disclose secret sauce. If there is secret sauce (like source code or a patentable idea), a very specific NDA can be signed when it is disclosed."*

Cam Crawford offers yet another opinion on angel-investor-news.com:

> *"Prior to being provided with a detailed business plan you may be asked to sign a confidentiality and non-disclosure agreement. This is a standard practice, but if you are not sure exactly what you are signing, ask your lawyer to review it with you and get a legal opinion."*

The best policy is probably to shy away from them unless you are in an exceptional situation and have the go ahead from an attorney.

Reasons Deals are Rejected

The one thing that everyone in the venture industry is in harmonious agreement on is that management is absolutely critical and the single most important aspect of a deal.

Here are a few things to look for or avoid in management:

- **Credentials**
  It is important to make sure that they have the necessary skill set and experience to lead the proposed venture. If they don't, do they have contacts that do or do they plan to add new people to fill the proposed gaps?

- **Legal background check**
  Is there any past or pending legal action such as lawsuits, tax liability, or criminal or civil convictions?

- **Mindset**
  David and Laura Gladstone offer some advice in their book, *Keys to Successful Venture Capital Investing:*

  > *"Many entrepreneurs work long hours, week in and week out. So some of the questions a VC should ask an entrepreneur are, Why do you want to do all of this, knowing it is going to take time out of your life? Why is it you want to get involved in this difficult situation? The wrong answer to this question is, "I want to be my own boss. My current boss doesn't understand me. I just want to get out on my own." Investors should not be solving the personal or psychological problems of entrepreneurs. The right answer to this question is, "It is a great opportunity for us both. If you will invest in the company, we can make a lot of money."*
  >
  > *What most investors look for in a management team is a high level of energy. Being an entrepreneur is tough. Every VC has the greatest respect for all entrepreneurs. Entrepreneurs work long hours. Most of us have worked only a few 70-hour weeks, and there are few people who like them. Your entrepreneur will have to be one who can accept the long hours and the grinding pace. Creating a great business is 1 percent inspiration and 99 percent perspiration.*
  >
  > *Your entrepreneur must, therefore, be in good health and of sound mind."*

- **Leadership Ability**
  Do you find the CEO to be inspiring? If not, then how will he inspire future employees whose stake in the business is much less than yours or his executive teams?

- **Honesty and Integrity**
  This is absolutely critical, as so much of a new venture is based on trust. If you detect any lack of these traits, run away.

- **Intelligence**
  Most likely the entrepreneurs will have to switch gears at some point. Do they have the brains to figure out a new course?

- **Good Judgment**
  Stephanie Hanbury-Brown of Golden Seeds remembers busting one deal because the founder had hired her husband as the head of marketing. While this in and of itself wasn't a problem, he *"had no sales DNA and didn't like to travel"*. CEOs will need to make countless good decisions to be successful, and if signs of poor judgment like this show up during due diligence, that should be a big warning sign.

Market and competitive risks also are the reasons for ruling out many investments.

- **Market Size**
  James Geshwiler of CommonAngels makes the important point that the process of determining market size should be looked at as a journey, not simply as the means to find one correct number that the group will eventually arrive at. He remembers a company they funded that was creating business tools for musicians so that they could act as their own independent music label.

  > *"We needed to figure out how many independent musicians might be interested in this product. One pessimistic member pointed out that only 7,000 people listed musician as their occupation on their tax returns. Another pointed out that there were 3,000,000 people on MySpace who described themselves as musicians. Clearly neither of these 'numbers' was correct, but in the process of talking about them we came across a web site called CDBaby that had 100,000 users and was similar to what we were trying to do."*

  Of course 100,000 isn't an exact number either, but the point is that the more research you do, the more information on the market you gather and you begin to hone in on what the potential market for your product or service is.

- **Market Dynamics**
  Even if the market is big enough, does the management team understand it on a deep level? They should know who the customers, end-users, key influencers, and channel members are. They should also have a concrete revenue model – i.e. who is going to pay whom?

- **Competition**
  Do the entrepreneurs understand the competition? The Heartland Angels checklist says angels should ask about their:

"Five or ten largest [competitors] and their market share, financial health, strengths and weaknesses, features that distinguish each, expectations of or growth or changes, the company's relationship with them."

- **Barriers to Entry**
  Is there a competitive strategy? The Sand Hill Angels' Web site suggests the following approach:

  > *"Current & Sustainable Competitive Advantage — IP is helpful, but usually not sufficient. Strong know-how, network effects, high switching costs, long term contracts, learning curve benefits, and capturing key distribution channels can all be used to build powerful competitive advantage and entry barriers for others. First mover advantage in itself is usually not sufficient unless it can be used to accomplish some of the above mentioned entry barriers."*

The firm's business model must also be sound.

- **Value Proposition**
  Does this venture create economic value for both the firm and the consumers? If all the value accrues to the former, customers will likely depart en masse after their first orders.

- **Distribution**
  The Sand Hill Angels also have a strong opinion on how entrepreneurs,

  > *"Plan to cross the [market] chasm, obtain [their] first reference customer(s), first 500,000 users, etc. Discuss target market strategy, sales & distribution, partnering, pricing, & promotion."*

- **Differentiation**
  The successful new venture will not make it on cost leadership. New products need to address a market segment in a way its competitors are not.

- **Growth Strategy**
  Many otherwise promising ventures have failed because they "grew themselves to death". The entrepreneurs must have done a thorough cash flow analysis and make sure they have enough working capital to grow at the projected rate.

- **Recurring Revenue**
  Does the business plan show recurring revenue? If not, it will be tough to create a company with a terminal value high enough to justify investment. The financial risks of the investment may be too great to proceed.

- **Capital Requirement**
  If the management team needs to do another raise to succeed, what makes them think they will be able to? In the future will there be enough of the company to go around and enough revenue to attract later stage investors?

- **Deal Structure**
  The terms of the deal must split up equity to keep management motivated, provide an adequate return to the angels, and grant options to future employees.

- **Exit Strategy**
  Is the target exit an acquisition? If so the management team should be able to identify the likely buyers, why they would be interested, how they will get in contact with them, and comparable acquisitions that have already happened.

  Is the plan to do an IPO? Then they should be able to cite comparable offerings and give reasons why the opportunity will still be around in the future.

  There also should be a provision to allow angels to get as much of their money back as possible if the firm fails.

  Keys to Venture Capital Investing also mentions a third method:

  > *"The company can simply buy out the VC by refinancing the company out of cash flow. Although this last exit is an unusual way for VCs to make money, it happens more often than most VCs will tell you. The point here is this: Make sure there is a way out of the deal (a liquidity event) before you get into an investment."*

  If this can happen to VCs, then it can certainly happen to angel investors, who typically have much less to be paid back.

There might also be problems with the financial projections.

- **Realistic Assumptions**
  Are the assumptions in the projections reasonable? They may not be. One example from Paul Allen of Provo Lab's blog:

  > *"Sales Cycle is a key issue that is too often neglected by angel investors. For example, if the plan calls for selling to government and the financial model shows sales closing in 2 months, then the model is unrealistic because government orders take 6-12 months."*

  However Carol Sands of The Angels' Forum makes the important point that one has to distinguish between managers who are super enthusiastic, which is a good thing, and managers who are being deceitful or who have lost touch with reality. Entrepreneurs are going to need to convince many people along the way why they are unstoppable, and they won't be able to do that without getting excited.

- **Avoid Hand Waving**
  Stephanie Hanbury-Brown points out that entrepreneurs should focus on how they are actually going to realize their projections.

> *"Blanket statements that start like, 'If we conservatively estimate that we get 10% market share…' are meaningless. They should be talking about how they are going to get customers and how they are going to get distribution."*

- **Cash Flow Timing**
  The angel investor must make sure that the cash flow from the business plus the angels' investments is enough to run the business. Make sure that the numbers are reasonable in that they don't expect immediate payment from customers or highly delayed payment to suppliers.

  John Huston of Ohio Tech Angels Fund states "I believe the focus should be on how much capital is needed to attain CFBE (cash flow break even)."

- **Reasonable Expenses**
  All the expenses must be appropriate for a cash strapped startup, especially salaries. There should be no line items for sub-zero fridges and plasma TVs in the office.

- **Realistic Revenue Growth**
  Charlie Thomas, Executive Officer, NISCO Solutions, gives the following advice to potential entrepreneurs:

  > *"A "hockey stick", or overly rapid revenue growth, is something you want to avoid when outlining your financial projections. This type of miscalculation occurs when the revenue curve starts off slow and ramps up too quickly. Rapid growth like that is generally not realistic and will immediately discredit your plan with venture investors. In most cases, it's impossible to go from zero revenue to $200 million in revenue in 3–4 years. Your financial model needs to be based on achievable milestones and defensible assumptions that can be spelled out. Historical evidence of comparable companies is a good resource to use in devising your financial projections."*

- **Management Salaries vs. Equity**
  Entrepreneurs need to live, but their salary should not consume an inordinate amount of resources.

  Stephanie Hanbury-Brown of Golden Seeds believes that,

  > *"A proven entrepreneur with 10 years experience and a great idea* [with little or no revenue] *is worth $100,000 per year."*

  Jim Pinto, former CEO of Action Instruments and angel investor, offers another opinion:

  > *"Finally, the deal structure should be right. My money should be going into product development, marketing and revenue generation – not into paying the founders' hefty salaries. I like deals where the founders are betting a lot more*

than I am – which keeps them working hard and running fast. If the company makes it, I'll be rich – and they'll be richer! No company cars and expense accounts until AFTER the company is profitable. My first question (after I've decided the people, product and market are worthwhile) is: What are your salaries? If my investment is contributing to salaries and director's fees, count me out."

- **Slim Margins**
  Finally, are the margins in the projections fat enough to justify the investment? WebVan showed that no amount of advertising will make up for business model that isn't profitable.

- **Balance Sheet**
  The angel investor should make sure that the entrepreneurs have already raised some friends and family money so that they have skin in the game. It's also important to check that illiquid assets are valued properly.

  The liabilities side of the balance sheet should be relatively clean. If management has given any personal "loans" to the company they should be prepared to convert them to equity.

- **Cash Flow Management**
  Does management have a good plan to manage cash flow and meet the burn rate? They should be able to grow faster or slower depending on how long it takes to raise the next round of capital.

Creating a Due Diligence Plan

Once the due diligence process has officially begun, the first step is a thorough examination of the business plan.

- **Vision**
  Management should immediately communicate a clear and concise vision for the company. If it takes too long to explain the firm's core mission, that is a bad sign.

- **Business Model**
  There should be a realistic business model with a clear description of who is going to pay whom. Recurring revenue type business models are particularly attractive.

- **Marketing**
  Susan Ward of Cypress Technologies outlines an approach that entrepreneurs should take when writing the marketing section of a business plan:

  "Before writing the Market Analysis section of the business plan, use these general questions to start your research:

  How old are they?

What gender are they?
Where do they live?
What is their family structure (number of children, extended family, etc.)?
What is their income?
What do they do for a living?
What is their lifestyle like?
How do they like to spend their spare time?
What motivates them?
What is the size of your target market?

But don't stop here. To define your target market, you need to ask the specific questions that are directly related to your products or services. For instance, if you plan to sell computer-related services, you need to know things such as how many computers your prospective customer owns. If you plan on selling garden furniture and accessories, you need to know what kinds of garden furniture or accessories your potential customers have bought in the past, and how often."

- **Financial Plan**
  Do the financial projections make sense as outlined above? Angel-investor-news.com displays a chart which shows an equity allocation from seed financing to IPO:

Site visits are an invaluable part of due diligence. It is vital to pound the pavement and see what is going on at the firm and hopefully, if it's not consumer facing, at the customers' offices as well.

- **General Impressions**
  Does the office look professional? Are there employees working and does it seem like a reasonable work environment? Chances are management has briefed everyone that angels are coming (if they're smart) so any plainly visible problems are probably significant.

  In *Keys to Venture Capital Investing*, David and Laura Gladstone related a relevant anecdote:

  "One VC tells about touring a plant with a group of VCs and stopping for a moment to watch a lady at a drill press. He happened to ask her what she was making. She replied, "Oh, nothing. I was hired just for the day. I was told there were some big shots coming through and that I should look real busy." At that moment, management's credibility (and that of others in the plant) was gone. As a result of that one incident, the company never raised the money it needed. The news of its actions went flying through the venture capital community and killed all hopes of raising cash."

- **Organizational Culture**

A small company should have a relatively flat hierarchical structure where there is an open exchange of ideas. They should be focusing on innovating, not on politics and who is more highly ranked.

- **Talk to employees**
  You may be able to get the straight dope from employees. Paul Allen of Provo Labs writes,

  > *"Before meeting the CEO, go ten minutes early, backdoor, talk to people along the way. You can learn more in that ten minutes than in the next 2 hours."*

- **Ask Questions**
  Catherine Mott of BlueTree Allied Angels remembers visiting the warehouse of a firm which they were considering for an investment. She noticed a big empty space in the factory that looked conspicuous and asked, *"What goes here?"* It turned out it was a 2nd line of products that they had outsourced to a Japanese firm. Once that was revealed they were able to perform due diligence on the Japanese firm as well.

Once you've seen the office it's important to check the references of management, customers, any other investors, advisors, and competitors.

- **Management**
  David Rose of New York Angels suggests talking to the references that management provides and then asking the references for more names. John May of New Vantage Group takes this one step further and asks those people for more names as well. He expects to have around 30 conversations during this process.

  LinkedIn (www.LinkedIn.com) is also a natural tool for this process as it allows you to see who knows who as well as who already works for the startup in question.

  An article by Lisa Ann Thompson on www.FundingUtah.com actually encourages entrepreneurs to set up a LinkedIn profile.

  > *"To address the intangibles, FundingUtah encourages participants to create a profile on LinkedIn.com, a business networking site based in Palo Alto, California. Through LinkedIn, investors can learn more about the entrepreneur's background, read endorsements for the individual, and find personal connections through their networks of contacts."*

  One can also consider gaining the consent of the members of senior management to both a credit report and a background investigation.

- **Customers**
  Angel investors should talk to customers in as much depth as they can. One useful trick is not to blindly agree to interview only those customers that the entrepreneurs offer up

first. Getting in touch with the customers further down on their list and former customers is even better.

- **Other Investors**
  Angels should talk to the other investors and get background checks on them. Having too many unaccredited investors is probably a bad idea.

- **Advisors**
  Don't forget to talk to the advisors and check their references as well.

- **Competitors**
  If possible, angels should use their network to get information about the competition. This will be especially useful when compared against the claims made about the competition in the business plan.

Remember that some of your greatest assets are the networks of your own angel group members. Sometimes the only way you will get the information you need is through knowing the right people. Make sure the people you accept into your angel group understand this principle.

David Rose of New York Angels recalls a deal that they were very excited about. The CEO was a serial entrepreneur with a previous high profile business under his belt. He was starting a new venture which was related to the first one with the same team, which included an investment banker as COO and several young MBAs.

While performing due diligence he noticed an article saying that a lawsuit had been filed against this firm, and he happened to know the plaintiff, who was their last angel investor. He called the guy and got a story about how the CEO basically took his money, refused to return it, and gave him some non-sense about how the *"statute of limitations of the deal had expired"*.

Without this personal connection, it might have been difficult to dismiss the CEO's inevitable characterization of the lawsuit as trivial and unwarranted.

Now that they are armed with information about management, employees, customers, and competitors, angel investors should revisit the business plan and make sure that the previous assumptions still hold.

- **Competitive Analysis**
  Is the plan realistic about market share? Will the firm be able to build momentum and take advantage of network effects, cost of switching, or other barriers to competitors? Will there be demand at the planned prices?

- **Financial Analysis**
  Do the financial projections fit with the actual performance of the firm since its inception?

- **Capital Structure Analysis**
  Is there a justified valuation that will motivate entrepreneurs, reward investors, and have remaining equity for options?

Gut vs. Brain: What Level of Detail and How Much Time is Appropriate?

There is quite a bit of debate in the angel investing community about what level of analysis is appropriate when deciding whether or not to invest. One investor might deliberate for months over a deal while another might watch a presentation and cut a check on the spot.

- **More may not always be better**
  New York Angels' David Rose points out that while some have tried, nobody has been able to show a correlation between the length of time spent on due diligence and probability of success.

- **Analysis should be proportionate to the stage of the deal: Later = More**
  John May of New Vantage Group says that late-stage venture capital-type deals use a lot of analysis, and that they should. The longer a company has been around and the bigger it is, the more good it will do to create projections, do market research, get approval from CFA's (Certified Financial Advisors) and perform what he generally terms, "Papering the file".

  He thinks angel groups need to rely more on "gray hair" and wisdom gained from experience on past deals. It doesn't do a whole lot of good to do monthly projections out ten years if you have only one or two customers in a new market. The flexibility inherent in being able to make quick decisions can be an advantage that venture capitalists don't enjoy.

- **Know yourself and know your group members**
  You probably have some idea where you and your group fall in this spectrum. The best policy is too keep an open mind, be flexible, and don't let yourself or your group fall too far outside the norm of what your colleagues in the industry are doing in terms of how much analysis to do.

Conclusion

An ImpactLab.com interview conducted by Dave Taylor with Kevin Johansen, the head of the Entrepreneurial Standards Forum, neatly sums up the aim of this document:

> ***"Q: Tell me how you think the process of doing "due diligence", of fairly evaluating the strength and probability of success of a startup, can be improved?***
>
> *There is no mystery to due diligence. It's just work. Like most processes that are "just work", it can be made more efficient through standardization. The problem with standardization, however, is that the validity of a standard is tied directly to the number of people using it. A standard is only a standard to the people who have agreed to work*

> *with it as a standard. So the question then becomes: "How do authoritative standards develop?" In markets they evolve through two processes. One is through accretion of market share - you buy & earn your way through to being the dominant service provider and then dictate the standard to which everyone else conforms. The other is through open source in which the community of Users makes decisions collectively about what the standards should be. Autocracy works well with simple systems. Democracy works well with complex systems."*

A democratically developed standard can reduce the amount of work and improve the success rate for all angel investors.