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# Why Due Diligence?

Fall 2013 ACA Leadership Workshop  
October 18, 2013





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## Get Ready to Answer These Questions!

- What is your single biggest issue with Due Diligence today?
- What has been your most successful tactic for filling your DDTs? What has been your least successful tactic?
- What screen(s) do you have in place to stop DD in process if the DDT identifies a “showstopper”?



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## What is Your Definition of Success as an Angel?

- Help entrepreneurs succeed
- Beat index fund returns
- Build relationships with like-minded investors
- Other????



## Why Angels are Different

### Angels

- Investing my own money
- Lifestyle will not change if make or lose money
- Help entrepreneurs achieve financial success
- Country club bragging rights

### VCs

- Investing money for my LPs
- Success = raise another fund (if this one succeeds)
- Management fee = orthodontia & tuition
- Carry = wealth building



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## What is Your Definition of Success for DD?

- Higher returns
- Increase odds of success
- Increase number of deals done
- Increase total dollars invested
- Assist entrepreneurs with insights



## How About *Avoiding Anosognosia*?

- Anosognosia is viewed as a deficit of self-awareness, a condition in which a person who suffers certain disability seems unaware of the existence of his or her disability.
- Angel Anosognosia: "Hey.....I've made lots of money in business, so obviously I already know what an angel needs to know!"



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## Due Diligence Survey

- Conducted via e-mail in September 2013
- Eight respondents
- Geographic diversity
- Mixture of groups and funds





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## Survey Results

- More uniformity than diversity
- Few surprises
- No controversial answers or practices







## Size & Composition of DDTs

- Average # of participants is 4
- Leaders recruit to get industry knowledge required
- No standing DDTs evident
- No requirement for minimum # of DDTs per member





## Rewards and Incentives

- DDT members much more likely to invest
- DDTs often contain a future BOD member
- Best incentive for DDT participants:  
recognition and a bottle of wine at the  
annual dinner





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## Orientation of DDT Members

- DD on behalf of group: unanimous
- DD on behalf of self: varies





## Indemnification

- Most groups do not see the need for this.
- “We don’t make recommendations; we just gather data.”
- Funds build indemnification into their fund documents.





## Conflicts of Interest

- All ask DDT members to self-disclose conflicts
- One does not allow current investors to join DDTs or to vote





## Unanimity and Dissent

- All encourage dissenting viewpoints
- Many give dissenters the floor in writing or in person
- None require unanimity; some require "consensus"





## Contentious Issues

- Valuation
- Lack of members' comfort with industry
- Ineffective DDT leader (timeliness, perceived conflicts)
- Follow-on investments without full DD process





## Ease of Syndication

- All willing to share deal memo with others
- Sierra Angels holds regular syndicate calls
- Seven Ohio angel funds have signed hold-harmless agreement to share DD materials via Basecamp







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## Due Diligence Manual

- Checklists
- Standard questions
- Process documents
- Guidelines





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## So...What's a DDT to Do?

- What evidence do we have that great diligence produces better returns?
- Why don't we keep up this level of work after we invest?





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## Why Due Diligence?

- Improve your performance two ways:
  - Increase your current knowledge
  - Apply your current knowledge consistently by following a process

Dr. Atul Gawande; *The Checklist Manifesto*

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## The Ultimate DD Checklist

- Dr. Tom McKaskill's *Ultimate Exits* + *Workbook*
  - Free downloads:  
<http://www.drexit.net/page6/ultimateexits.html>

Superb checklists on pages 54 – 59:

- Awareness and Alignment Index
  - Premium on Sale: Factors which increase final sale price
  - Strategic Exit Strategy Index
  - Discount on Sale: Factors which reduce final sale price
  - Operations Management Index
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## The OTAF Playbook for DD

- Kickoff meeting
  - DD manual
  - Showstoppers
  - Designated Skeptic role
  - Pre-mortem
  - Standard format for PPT deck at member presentation
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## Kickoff Meeting

- DDT members only, no entrepreneur
  - Held by phone
  - Less than 30 minutes
  - Assign each of the eight roles to one or more DDT members
  - Brainstorm "Showstoppers"
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## Designated Skeptic

- Examine exogenous variables (the uncontrollables)
  - Check DDT's embrace of unstated premises or assumptions
  - Ensure adequate time spent discussing non-confirmatory information and encouraging dissent
  - Reveal obvious biases on the DDT
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## Showstoppers

- Management team
  - CEO
  - Founder
  - Capital
  - Exit
  - Miscellaneous
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## Pre-Mortem

- Assume the deal has gone bad
- Choose the three to four factors that made it go bad
- What can we learn about structuring or even avoiding the deal?





## The Tough Questions

- How many person-hours do you spend on DD versus the amount spent on PIM (Post-Investment Management)?
- Which one most increases the odds you will reach your Definition of Success as an angel or group of angels?





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# Questions?

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