



ANGEL CAPITAL ASSOCIATION

EVALUATING INVESTMENT OPPORTUNITIES

Essentials of Due Diligence

Part 2 of a 2 Part Series

ACA Webinar
May 15, 2019

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- Use chat to submit questions
- Yes, you'll get the slides and video
- We're recording, so come back and listen again
- Contact Heather Krejci with questions:
hkrejci@angelcapitalassociation.org

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Welcome Message

Seraf's Philosophy

We believe investors in early stage companies should have access to best practices and professional tools to support the entrepreneurial community worldwide and achieve superior outcomes.

Insights and education, combined with powerful portfolio management tools allow investors to understand their investing better, learn faster and make necessary adjustments to select the highest quality opportunities and drive superior returns.



About the Authors

Ham is Co-Founder of Seraf and the Chairman of Launchpad Venture Group, a Boston-based angel group. Through his involvement with Launchpad, Ham has built a personal portfolio of 50+ early stage investments. In addition, he is a board member or board observer with 5 early stage companies.

Christopher is Chair Emeritus of the Angel Capital Association and Managing Director of Launchpad Venture Group. He helps manage Launchpad's portfolio of 70+ companies, he has personally invested in over 65 start-up companies, and is a limited partner in four specialized angel funds. Christopher is a board member, advisor and mentor to numerous start-ups, and a frequent panelist and speaker on entrepreneurship and angel-related topics.



Seraf Co-Founders
Ham Lord & Christopher Mirabile



Presentation Overview

1

REVIEW OF PART ONE

Concepts Covered in First Webinar

2

PRODUCT

Evaluating Product / Technology / IP

3

MARKET

Evaluating Market Opportunity / GTM Strategy /
Competition

4

FINANCIAL

Evaluating Financial Models

5

LEGAL

Spotting Legal and Regulatory Issues

6

CONCLUSION

WNTBB / Investment Thesis / Lessons
Learned



In Part One We Covered

- Why Due Diligence is Important
- Basic Due Diligence Activities
- Main Areas of Focus
- Three Guiding Principles of Due Diligence
 1. Identify Key Risks
 2. Develop the Investment Thesis
 3. Acknowledge “What Needs to Be Believed” to Invest
- Evaluating Teams
- Importance of Understanding Exit Options

EVALUATING PRODUCT, TECHNOLOGY & INTELLECTUAL PROPERTY



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Can you find enough people who are hungry to buy your product at a price that leaves you with a good profit?



Every Product is Oxygen, Aspirin or Jewelry

Oxygen: Necessary to Sustain Life

Asprin: Pain relief

Jewelry: Nice to have

Customers in the oxygen category are usually a small subset of the Asprin category.

It costs less to sell a “Need-to-have” product than a “Nice-to-Have” product.



How to Determine if a Product is Oxygen or Aspirin

Reach out to current customers and prospects and ask:

- What problem does the product solve for you?
- On your list of top problems in your organization, where does solving this problem fall on your priority list?

The answers to these two questions will go a long way in determining whether the product “Is a ‘Nice-to-Have’ or a ‘Need-to-Have’?”

What must you understand to determine if a company has breakthrough technology?



Is the Product Differentiated?

Ask customers and prospects the following:

- How are you solving your problem today?
- Have you used similar products before?
- Did you look at any competitive products?
- Are you considering any alternative ways of solving the problem?

Your job is to figure out differentiators that actually matter to the customer and make sure they are in the product.



What's Needed for a High Level Technology Assessment?

Assuming the product works and is in the hands of customers, you should ask the following:

- Is the new product significantly better/faster/cheaper than the incumbents?
- Will the benefits described by the CEO and verified by customers result in significant value for the customer?

The inertia of “good enough” is an enormous force to overcome - if it isn't 10X better, faster or cheaper, it may cost too much to sell.

What About a Product Roadmap?

Markets evolve constantly. Successful companies need strong product management to navigate in this environment.

- Is there a product roadmap?
- Who wrote and owns it?
- What's on it, what was left off, and why?
- How far does it go into the future?
- What are some specific examples of things that the team said “no” to upon arriving at this roadmap?

A company that can really hold their own in a detailed product roadmap review has a lot less technical risk than one that can't.



How do you evaluate the importance and strength of the company's Intellectual Property?



Is the Product Defensible?

Does the company have a compelling offering that will allow them to keep their customers and maintain their pricing power?

Can they keep competition out with some form of IP (e.g. patents, trade secrets)?

Can they keep customers hooked through high switching costs?

They are going to have to find a way to either keep competitors locked out or keep customers locked in.

What About the Technology Team?

If a company is tech-centric, tech skills need to be part of the founding team

Tech can be outsourced when it's an enabler of company's solution, but not when it's core to company. Beware the following:

- Outsourced tech tends to move slower than in-house tech
- Cost savings are rarely achieved due to communication and coordination issues
- Potential acquirers often place a lower valuation on a company using outsourced tech

A tech company with no tech team is going to get worse gas mileage with your money and fall behind the competition over time.



Are Patents Required?

Patents take a long time, cost a lot of money, distract founders and require public disclosure of innovations

In a lot of cases, **Trade Secrets**, which arise automatically, may be a better strategy

However **Patents** can help a lot in the exit context, especially where the buyer is infringing or afraid of the patents falling into a competitors hands

Silly patents are worse than none at all because they gobble up time, money and attention. Focus on patents a potential acquirer would fear falling into their competitors' hands.

EVALUATING MARKET OPPORTUNITY, GO-TO-MARKET STRATEGY & COMPETITION



Is there enough of a market to build a big business when using reasonable market share projections?



Characteristics of an Investable Market Opportunity

A market worth going after offers an opportunity to build a steep growth curve

- **Established Markets:** Look for companies that can disrupt the market to grow faster than the overall market and take market share from the leaders
- **New Markets:** Look for companies that can educate and acquire customers for a cost less than the lifetime value of those customers

Startups are like hang-gliders. They are looking for market “thermals” that allow them to gain altitude despite gravity pulling them down.



What's the Minimum Size in a Potential Market?

Early stage investors are looking for 10X returns

For a \$100M market size, really aggressive assumptions are required:

- Angels own 25% of the company after \$4M in investment
- Company achieves 40% market share
- Company acquired for 4X multiple of revenue

It's hard to make the math work on less than a \$100M Market



Accurately Sizing a Market Opportunity

Assess customer buying priorities

How much are the customers willing to pay?

Market size is really a question of sales and marketing spend - at your price, how many customers can you get for a price that is more than you spend acquiring them?



Timing is Everything

Is this the **right time** for this idea?

- Are you going to catch a big wave or a little wave?
- Where is the wave... far away, nearby or just past?

If you start paddling too early, you will run out of steam before the wave arrives. If you start paddling too late, the wave will pass under you and not propel you forward.

Applying the 3 “P”s to Selecting Investments

Potential - How big is the potential theoretical opportunity?

Probability - How likely is the company to achieve breakthrough success?

Period - How long are you going to have to wait?

All things being equal, we want companies most likely to be the biggest in the shortest amount of time.



Does the company have the right initial strategy for selling to the customer and a plan for doing it at scale?



Evaluating Go-to-Market Strategies

How is the company selling the product?

- Direct sales force
- Over the web
- Through partners or distributors

Choice of distribution channel is a significant factor in sales and marketing costs.

Evaluating Go-to-Market Strategies

Where are the customers and how will they locate them, talk to them, and bring them on board cost-effectively?

What is the customer acquisition cost (CAC) going to be relative to the lifetime value (LTV) of the customer?

You can't spend \$1000 acquiring a \$500 customer. Ideally, LTV to CAC will be at least 3:1 or 4:1 to achieve profitability.



Evaluating Go-to-Market Strategies

For startups, **focus and prioritization** are everything

Resources should be **spent wisely** and in a targeted way

Companies **over extend** limited resources by going after any opportunity

More companies die from overeating than starvation.



Evaluating Early Stage Sales Teams

What does a **startup sales team** look like?

- Expect a small team where the CEO might be the chief salesperson
- A VP Sales should have a startup company background and the ability to carry a sales quota in the early days

Early stage sales is all about figuring out what produces results before you spend big bucks scaling the sales organization

Evaluating Early Stage Marketing Teams

Where are the marketing team's resources focused?

- **Market Segmentation:** Who is the target customer(s)?
- **Market Opportunity:** How many customers are out there?
How much are they willing to spend?
- **Marketing Channels:** Where will you find them? How will you reach them?

Early marketing programs should involve lots of experimentation and testing before the spend is scaled up.

Product / Market Fit

Does the company have a product that meets the needs of a large market?

Are leads growing, sales cycles shortening, and revenue per customer climbing?

Limited data in early stage companies makes it tough to determine product / market fit. Anyone can sell to the small percentage of the market that consists of early adopters.



**What is the competitive environment including but not limited to the set of competitors that the company identifies?
What will the competition be in 5 years?**



Four Fierce Competitors for All Startups

Ignorance about the product

Alternates/substitutes from other categories

Fear of change

The inertia of “good enough”

Show me an entrepreneur “with no competition” and I will show you a company with no market!



Is the Product Differentiated?

Look for distinctions that matter to the customer

- How are you solving your problem today?
- Have you used similar products before?
- Did you look at any competitive products?
- Are you considering any alternative ways of solving the problem?

Founders love features; customers care about benefits.



Is the Product Defensible?

Retaining customers and protecting margins requires a strong value proposition

- Can the hard won customers be retained?
- Will pricing power hold up over time?
- Are the margins in the business likely to be squeezed by competitive or environmental factors?

No point in fighting to take a hill if you can't stay on top of it long enough to take in the view.

How Does Competition Affect Market Opportunity?

Not necessarily the way you might think...

Here are 4 ways that competition can be helpful:

- Helps **bear cost** and workload of **educating the market**
- Legitimizes and **reduces perceived risk** of new product category
- Attracts **enabling services** and technologies
- Attracts analysts and an **ecosystem** around product

It's not whether your product has competitors, it's whether your product is competitive.



EVALUATING FINANCIALS, FUNDING PLAN, LEGAL ASPECTS & EXIT OPTIONS



After digging into the financial model do you feel the key assumptions are reasonable and the near term milestones are achievable with this current round of financing?



Financial Plan: Key Assumptions and Milestones

A well thought out financial plan needs two elements:

FIRST:

Key assumptions that are both **rational** and **verifiable**

If the assumptions don't pass the sniff test, the financial plan won't hold together.



Financial Plan: Key Assumptions and Milestones

A well thought out financial plan needs two elements:

SECOND:

Achievable milestones which **significantly increase** the company's **value**

Will new investors be interested in continuing to finance the company at a higher valuation after this round of funding is spent?



What is the long term funding strategy of the company and how will different strategies impact the early investors?



Long Term Funding Plan

A well-thought-out funding plan needs:

- A clear understanding of **how much runway** the company has before it runs out of cash
- The **long term capital requirements** before the company has an exit

Do you understand how much future financing risk you are taking by making this investment?



What legal issues are critical with an early stage company in areas such as regulation, contracts, IP and employment?



Legal Issues

Early stage investors undertake legal diligence in these 4 areas:

- Intellectual Property
- Corporate Capitalization Structure
- Third Party Contracts
- Employment Agreements

Don't take shortcuts here... get help if necessary and put in the time so you don't miss an issue that could severely impact the company's long term value.



EVALUATING INVESTMENT OPPORTUNITIES

Conclusion



Develop the Investment Thesis

Potential - How big is the potential theoretical opportunity?

Probability - How likely is the company to achieve breakthrough success?

Period - How long are you going to have to wait?

All things being equal, we want companies most likely to be the biggest in the shortest amount of time.



Acknowledge “What Needs to Be Believed”

Core of this exercise is a test... we must ask ourselves:

- Have we identified the key risks?
- Do we understand the premise of the deal (i.e. the investment thesis)?

Are we fooling ourselves, or is there some kind of balanced logic to this deal?

Learning the Hard Way

A handful of avoidable due diligence mistakes

- **Team:** Confusing likability or prior accomplishments with the competence needed to pull off the current task
- **Market:** Confusing early adopter excitement with true market pull
- **Timing:** Is this the right time for this idea?
- **Product:** Incomplete understanding of the dynamics in the target market

Experience is what you get when you don't get what you want.



EVALUATING INVESTMENT OPPORTUNITIES

Appendix



Resources - Due Diligence Checklist

Designed as a quick reference guide to help steer you through the various aspects of diligence. This due diligence checklist covers key items such as:

- Information and documents you need to request from the company
- Tasks your due diligence team needs to perform
- Questions you need to ask of management, customers, references and partners

Due Diligence Checklist for Early Stage Investors

The Due Diligence Checklist for Early Stage Investors is designed as a quick reference guide to help steer you through the various aspects of diligence. By using this checklist, you can ensure that your process covers the major areas of diligence. The questions here are optimized for evaluation of very early stage technology companies; supplemental questions may be appropriate for use with later stage companies and life sciences companies. This Google Sheet offers suggested guidelines. It does not purport to be comprehensive, so use your judgement when conducting your due diligence.

Anyone is free to use this Google Sheet. It is designed to be used in conjunction with our companion eBook: [Stones Unturned: An Investor's Guide to Due Diligence in Early Stage Companies](#)

If you want to learn more about angel investing, check out these other resources: <https://seraf-investor.com/compass>

If you like this checklist, share this link! <http://bit.ly/215fyfn>

Diligence Topic	Information Request	Tasks	Key Questions
Leadership Assessment	Resumes for key leadership team members	Review resumes	Does the CEO possess the experience and leadership abilities to succeed?
	Professional references for key team members	Interview references (see interview guidelines)	Do they have skills for where they are going, as opposed to where they have been?
	Resumes and contact info for board members and advisors	Gather additional information from network as available (asking around, checking LinkedIn - anything to find blind reference checks)	Do the CEO and team have a proven track record?
		Assign team member(s) to spend time with CEO	Does the team possess the appropriate balance of experience and skill sets?
		Assess CEO and team for leadership, integrity, track record, required competencies	Are the board members and advisors suitable and committed?
Technology, IP and Product Roadmap	Descriptions of technology and product	Review information and meet with technical team	Is the technical team qualified and experienced?
	Relevant technical publications	Assess critical technologies, tool choices, software architecture choices, scalability of solution	How strong are the technology and IP positions?
	Patents and patent applications	Assess IP defensibility	Is the product roadmap achievable?
	Related IP info (defense: Freedom to Operate, etc.)	Conduct additional secondary	What are the remaining risks related to technology, IP and



[Download Checklist](#)

bit.ly/Due_Diligence_Checklist



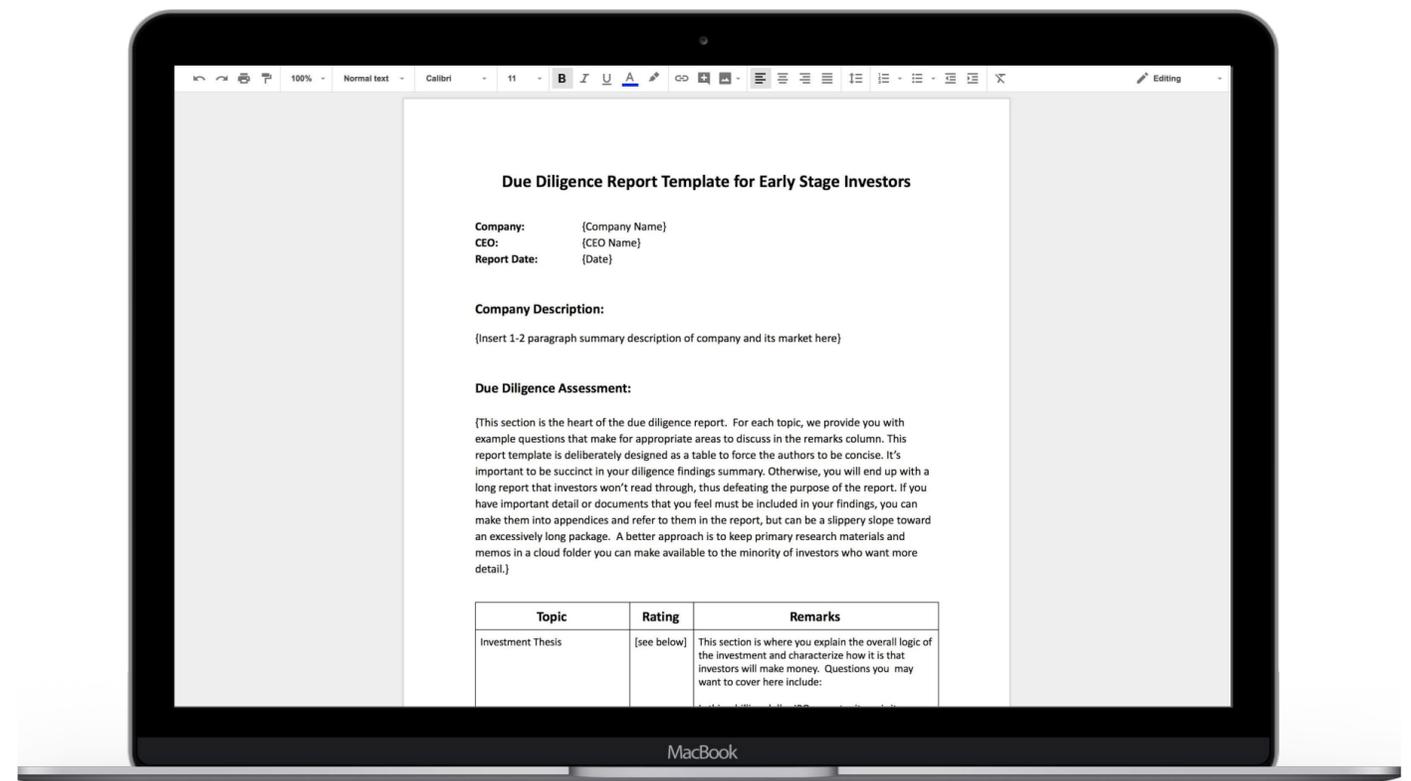
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Resources - Due Diligence Report Template

The due diligence report template is focused on 11 major topics that should be researched and understood when performing due diligence on an early stage technology company.

For each topic, we provide you with an explanation of the topic as well as example questions that may make sense to discuss in the remarks column.



Download
Report Template

bit.ly/DueDiligenceReportTemplate



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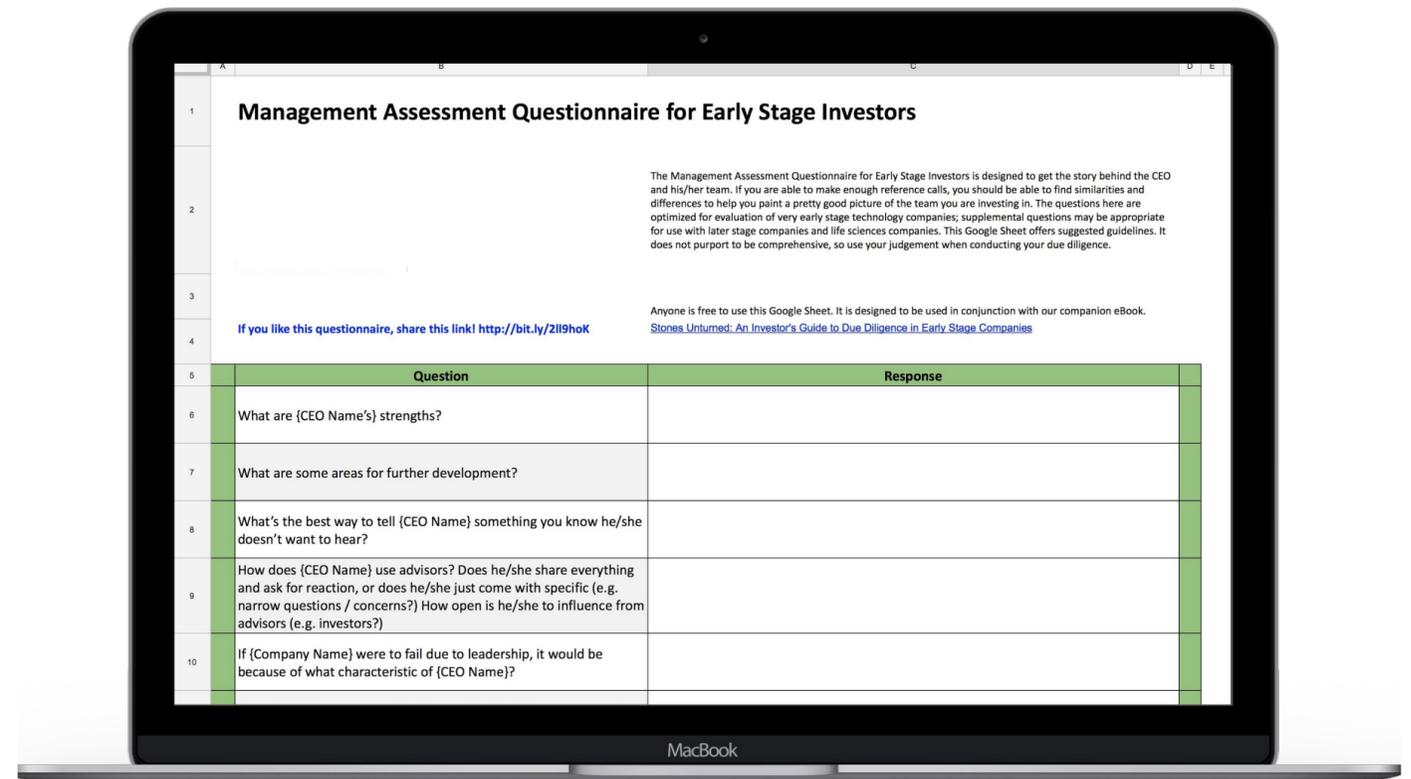


Resources - Management Team Assessment

Questionnaire designed to help guide you through your team reference checks

Focus on questions related to the CEO's:

- Strengths and Weaknesses
- Communications Skills
- Coachability
- Stability
- Domain Expertise
- Complementary Skills on Management Team



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Questionnaire

bit.ly/ManagementQuestionnaire

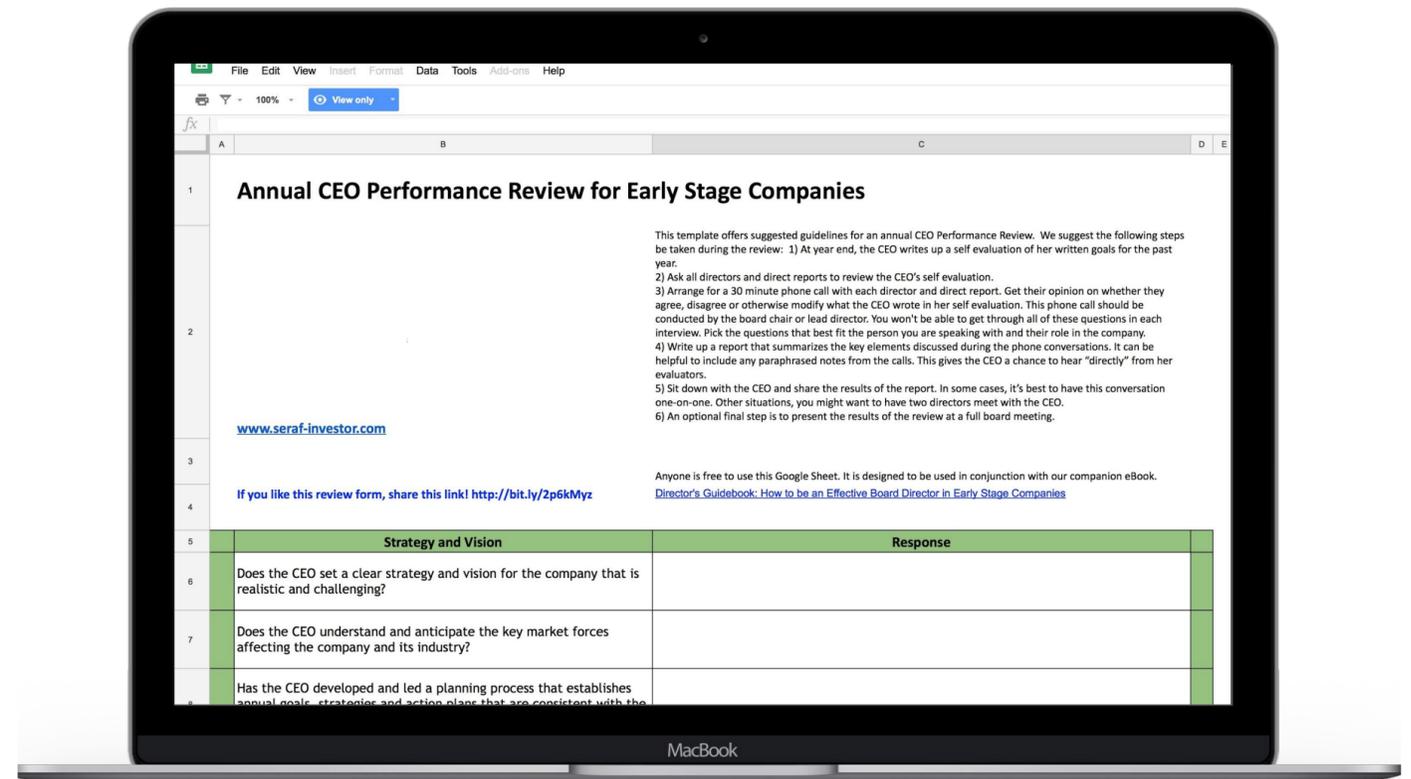


Resources - CEO Performance Review

Questionnaire designed to facilitate the CEO's annual performance review

This best practice is one of the corporate board's most important responsibilities

- Helps build alignment between board members and the CEO
- Improves Board/CEO communications
- Facilitates the future growth and success of the CEO



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Performance Review
bit.ly/CEOPerformanceReview](http://bit.ly/CEOPerformanceReview)

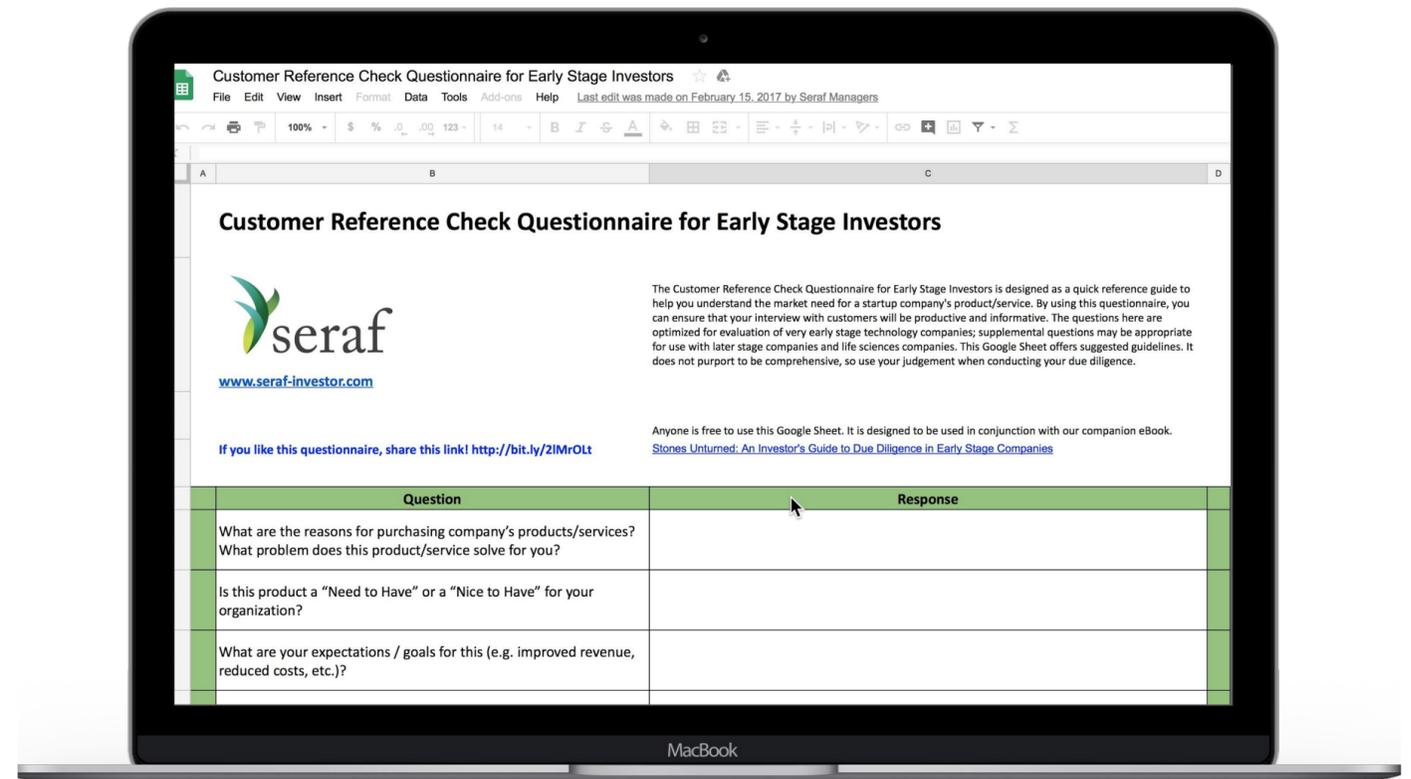


Resources - Customer Reference Checks

Questionnaire designed to help guide you through product-related questions

Focus is on questions related to solving a customer's key problems:

- Problem Being Solved and Priority for Solving
- Purchase Reasons and Goals
- Expected ROI and Value to the Customer
- Competitive Factors
- Impressions of the Company and Its Product



Download
Questionnaire

bit.ly/CustomerReferenceChecks

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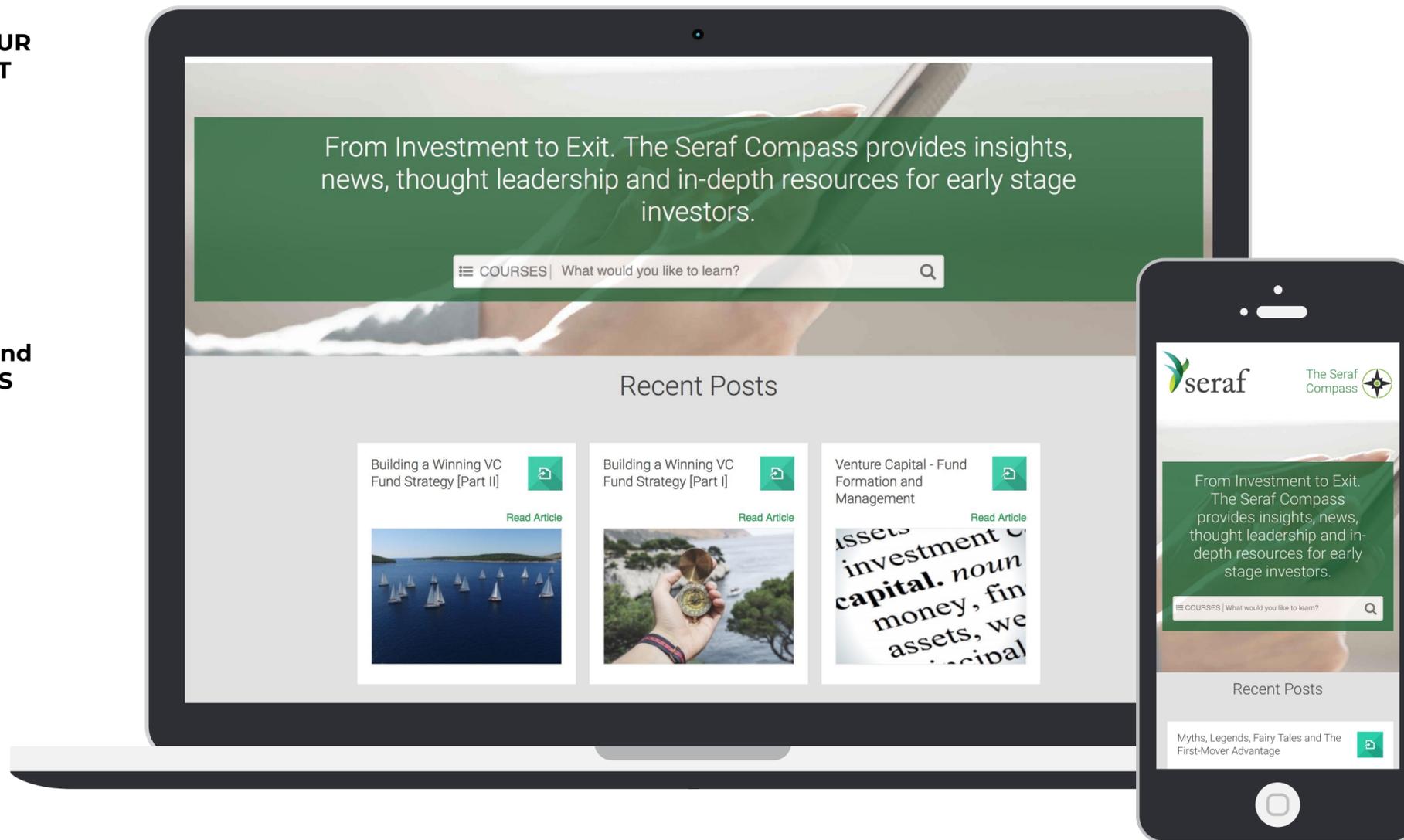
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Leaders Wanted: Making Startup Deals Happen

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Guide, Advise and Inspire: How Startup Boards Drive Growth and Exits

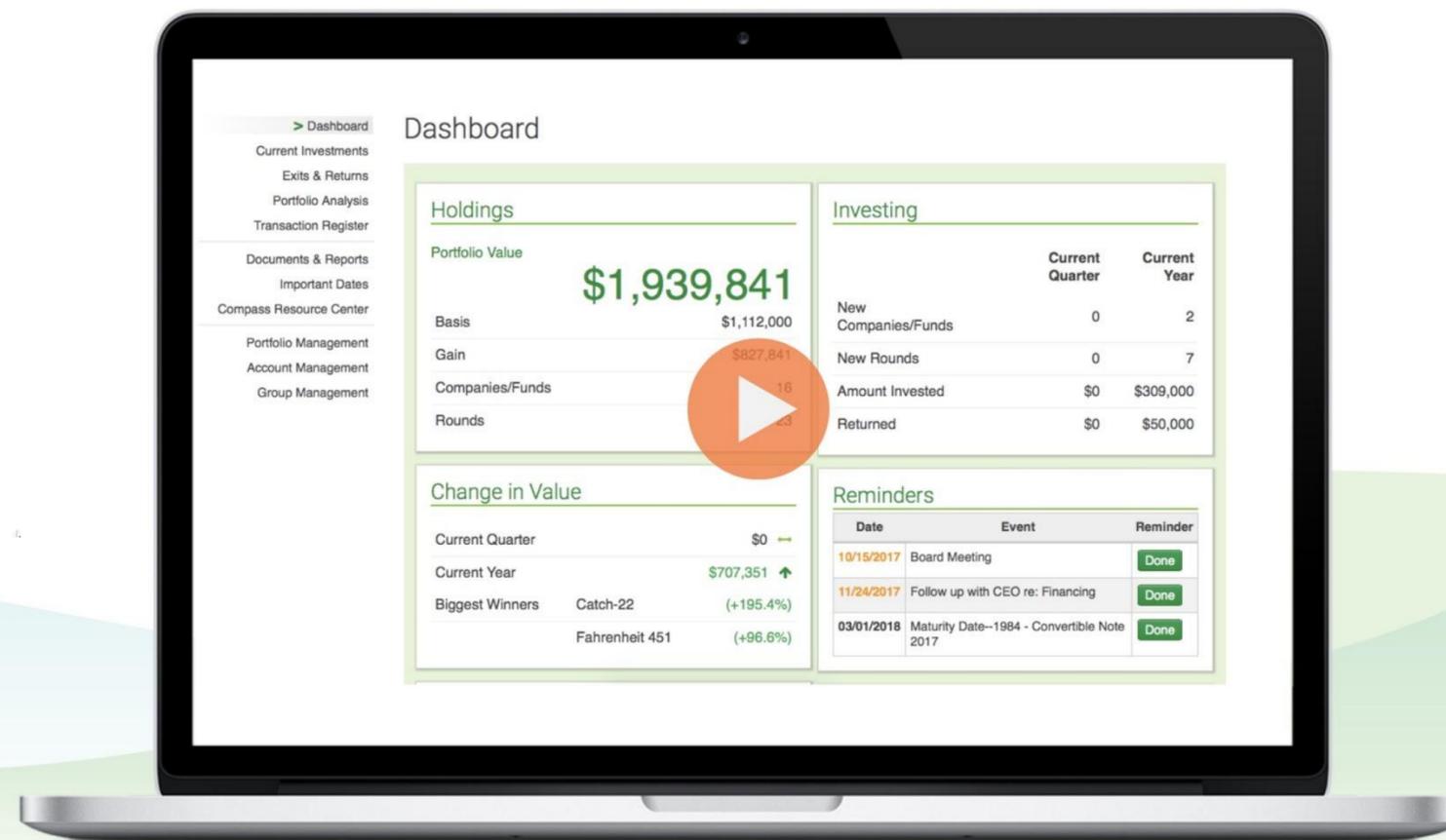
An Overview of the Principles, Skills and Concepts Every Early Stage Company Board Member Needs to Succeed

Venture Capital: A Practical Guide

A Guide to Fund Formation and Management

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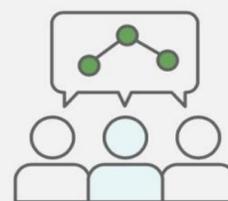


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- May 12-14, 2020, 2020 ACA Summit (*Westminster, CO*)
- <https://events.angelcapitalassociation.org/2019summit>

