

Due Diligence & Valuation

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These slides are available at <http://goo.gl/Ig9vSW>.

Why do Due Diligence?

- To eliminate all the reasons you would NOT want to do the investment
- To uncover everything that is wrong
- To de-risk your investment

How much Time on Due Diligence?

As much as it takes.....

then take another day and think about it.

Negotiating the Term Sheet

- Is the due diligence team responsible
- If it's just you doing the deal then yes
- If it's an angel group, then whoever is the best negotiator should negotiate
- You need to be clear how far you are willing to go to do the deal, and then STOP at that point

Most Important Things

1. Talk to CEO
2. Talk to Business Development team
3. Talk to customers (B2B)
4. Talk to end users (B2C)
5. Get executive team background checks
6. Talk to other investors
7. Is it a frisbee

EXECUTION = SUCCESS

Is this going to happen with this team?

Personnel - Look for Holes in the Team

- Organization chart
- Historical and projected headcount by function and location
- Summary biographies of senior management, including employment history, age, service with the company, years in current position
- Compensation (founders should not get rich and comfortable off of angel funding)
- Key employment agreements (ensure the company owns the IP, not the employees)
- Benefit plans and Incentive stock plans
- Significant employee relations problems, past or present
- Personnel turnover
- Data for the last two years (if they have been around for two years)

Finance - Capital Structure

- Current shares outstanding
- List of all stockholders with shareholdings, options, warrants, or notes
- Schedule of all options, warrants, rights, and any other potentially dilutive securities with exercise prices and vesting provisions
- Summary of all debt instruments/bank lines with key terms and conditions
- Off balance sheet liabilities
- Any verbal agreements or commitments

Finance - Financial Statements

- Annual and quarterly financial information for the past three years
- Income statements, balance sheets, cash flows, and footnotes
- Planned versus actual results
- Management financial reports
- Breakdown of sales and gross profits
 - Product Type
 - Channel
 - Geography
 - Current backlog by customer (if any)
 - Accounts receivable aging schedule

Finance - Financial Projections

- Monthly or quarterly **financial projections** for the next three fiscal years
- Revenue by product type, customers, and channel
 - Full income statements, balance sheets, cash
 - Major growth drivers and prospects
 - Predictability of business
- Risks of **foreign operations** (e.g., exchange rates, government instability)
- Industry and company **pricing policies**
- Economic **assumptions underlying projections** (different scenarios based on price and market fluctuations)
- Explanation of **capital expenditures**, depreciation, and working capital
- **External financing** arrangements and assumptions

Finance - Other

- Summary of current federal, state and foreign tax positions
- Discuss general accounting policies (revenue recognition, etc.)
- Schedule of financing history for equity, warrants, and debt (date, investors, dollar investment, percentage ownership, implied valuation and current basis for each round)

Who is the Customer?

- List of **top 15 customers** (if they have customers) by application (name, contact name, address, phone number, product(s) owned, and timing of purchase(s))
- If they don't have customers, then list who the top 15 target customers are
- List of **strategic relationships** (name, contact name, phone number, revenue contribution, marketing agreements)
- **Revenue by customer** (name, contact name, phone number for any customers accounting for 5% or more of revenue)
- Brief description of any **significant relationships severed** within the last two years
- List of **top 10 suppliers** for the past two fiscal years and year-to-date with contact information (name, contact name, phone number, purchase amounts, supplier agreements)
- **Attrition** rate, abandonment rate, etc...

What is the Competitive Landscape?

- Description of the competitive landscape within each market segment including:
 - Market position and related strengths/weaknesses as perceived in the market place
 - Basis of competition (price, service, technology, distribution)

What is the Go-to-Market Plan?

- Strategy and implementation
- Major customers
- Principal avenues for generating new business
- Sales model and Sales KPI's (this is very important)

Management's own Risk Assessment?

- Anything that management has identified that could have a negative impact on the company
- What they are planning to do about it if it happens
- If the team has actually done their job in thinking through the business model, then this should be a document that they would have readily available
- If its not written down yet, it's fine to ask them to produce a "Risk Analysis" document

Legal

- Is the company free and clear of any legal issues
- Pending lawsuits against the company (detail on claimant, claimed damages, brief history, status, anticipated outcome, and name of the company's counsel)
- Pending lawsuits initiated by company (detail on defendant, claimed damages, brief history, status, anticipated outcome, and name of company's counsel)
- Description of environmental, employee safety and regulatory issues and liabilities
 - Safety precautions
 - New regulations and consequences
 - List of material patents, copyrights, licenses, and trademarks (issued and pending)
 - Summary of insurance coverage/any material exposures
 - Summary of material contacts
 - History of SEC or other regulatory agency problems, if any

Research & Development

- Description of R&D organization
 - Strategy
 - Key personnel
 - Major activities
- New product pipeline
 - Status and timing
 - Cost of development
 - Critical technology necessary for implementation
 - Risks

Who is the Founder, REALLY?

Which face are you getting?

Try to get to know the founder personally as well as professionally.



NDA's

It depends.

As an entrepreneur, I would suggest executing NDA's with everyone you talk to about your idea.

As an investor, I don't sign them. I see too many startups to open myself or my firm to any liability.

Ideal Due Diligence Team?

It's a puzzle you piece together.

It's different for every investor and for every investment.

You have to put in work. There is no easy way around this. It's good to have a team with diverse expertise.

When to start Due Diligence?

Yesterday.

Learning is not only critical, it is also part of the excitement of angel investing and venture capital.

Why do Investors Turn Down Deals?

Too many reasons to list. Here are my top 4:

1. No revenue model
2. Team risk
3. Technology risk
4. Terms are bad

Valuation

“Valuation is and should be guided by comparables with related companies, and then through negotiation. There’s no right, or absolute number - you’re just pricing your startup on the market.”

- Brenden Baker, Greylock

Valuation

“The most challenging task was finding a mutually acceptable valuation. This is more of an art than a science: Historical norms and future expectations serve as guideposts, but the end result results from **what a founder is willing to accept and what a venture capitalist is willing to offer.**”

- Matt Murphy, KPCB

Finally

Look at this as an adventure, not
as a burden

Try to have fun.