



ANGEL CAPITAL ASSOCIATION

The Basics of Due Diligence

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Who Is Here?





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The Agenda





What is it?

- Reasonable steps taken by a person in order to satisfy a legal requirement, especially in buying or selling something.
- Things we can do to help all interested angel investors have a higher level of comfort than they could reach by themselves,
- by taking advantage of the broader set of skills, domain knowledge, and time availability of others in the group.

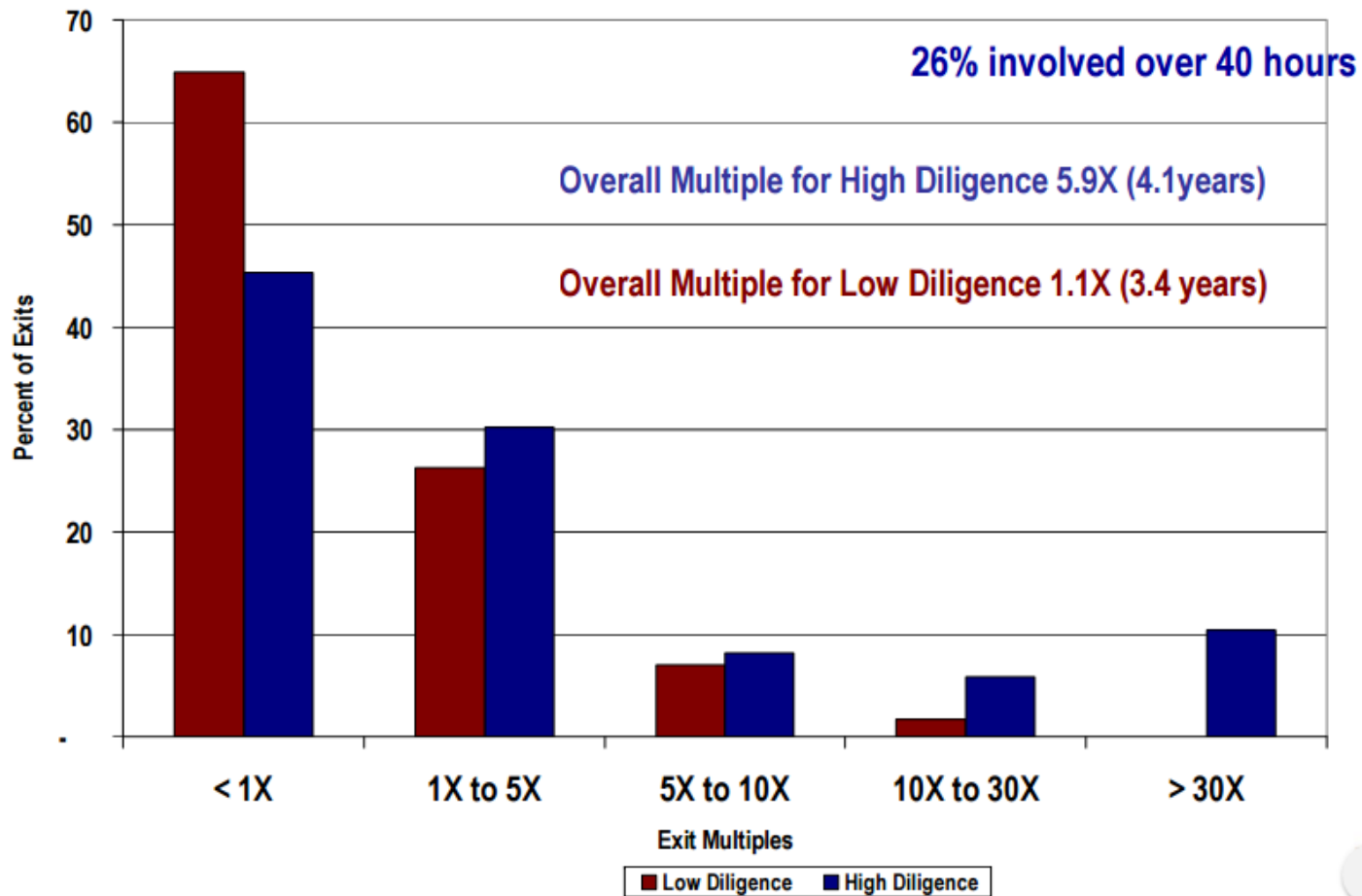


Why Do It?

- Enable us to have members who have zero experience at this, and to bring them along over time to a higher level of competence.
- Enable our members to have some written material they can take home to discuss with a spouse or partner who could otherwise veto the deal.
- Enable our members to invest in a much more diverse set of deals than they could by themselves.

The Impact of Time in Due Diligence

Median: 20 hours





Some Realities

- Most angel company failures are caused by factors outside the control of the management:
 - Recession
 - September 11
 - Hurricane Sandy
 - Divorce
 - Disruptive competition



What various approaches are there?

1. The loudest, most persistent voice leads the pack.
2. Combine the skills and knowledge set of volunteers from the broad group with a set of diligence-specific skills and knowledge set of the volunteer angel group leaders.
3. Have a well-paid set of partners and staff that devote themselves to a deep focus on a small number of potential deals.

How long should it take?





What Should My Philosophy Be?

- **Seek to make many small investments across a diverse set of deals, rather than picking and choosing among those we think will be the winners.**
- **It is far more important to successfully invest in a company that goes on to become a winner, than it is to avoid investing in a few losers.**
- **It is far more important to avoid excluding a company that goes on to become a winner, than it is to avoid investing in a few losers.**

How much effort should it take?

- A committee of 4 – 5 members
- 6 - 8 hours time commitment from each member over 2-4 weeks
- The best committees tend to be those that work together on multiple deals over an extended period
- Some groups have domain-specialized diligence committees



What topics should it cover?

1	CEO & Other Management
2	Product
3	Business Model
4	Markets
5	Sales & Marketing
6	Competition
7	Competitive Advantage
8	Legal & Regulatory Environment
9	Intellectual Property & Technology
10	Valuation & Terms
12	Financials
13	Exit Strategy
11	Potential for investors
14	Other Investors
15	Risks



How should we organize the effort?

- Teams of 2-3 people per topic or group of related topics
- Leader keeps members involved and moving, collect results
- Use online meetings to make it easier to keep a schedule
- Members rank the importance of topics and rate the company on each topic
- Leader(s) should be the best writer and should consolidate the work of members into a cogent, jargon-free, topic-by-topic 3-4 page summary

Prompt the Members With Questions

- Business Model: (1=unattractive model, 10=attractive model)
 - Is this a “demand pull” model or a “technology push” model?
 - How does the company make money?
 - Will there be recurring revenue from customers, or will this be a one-time sale?
 - What are the costs of customer acquisition?
 - What is the lifetime value of a customer relationship?
 - Can the company have a sustainable business model after paying the costs of customer acquisition and product distribution?
 - Is this a repeatable and scalable business model?
 - What margins are needed for positive cash flow? Profits? Rapid growth?
 - Are there any strategic partners on the team? What do they bring? Are they recruited?

Prompt the Members With Questions

- Markets:(1=poor, static markets, 10=attractive, rapidly growing markets)
 - Are the markets established? Or, will the company have to educate the customer base in order to generate sales?
 - Are the markets growing rapidly, moderately, or slowly?
 - Is the market a commoditized one? Or, is there room for a new company to establish a new brand?
 - Does the market demand support scaling the company up to \$15-20 million revenue in 4-6 years?
 - Are there examples of companies that have succeeded in this market?
 - Have you looked at the product and markets free of your own prejudices and practices? You may not be in the target market, and do not want to miss a viable business that addresses people other than you.



How should we present the results?

1. A 1 or 2 paragraph summary
2. A 1 paragraph discussion of each info topic, plus consensus numeric rating
3. A table showing the names of committee members and their individual overall deal numeric rating



What products are needed?

- A 10 minute summary that can be delivered to a membership meeting.
- A 3 – 4 page report that summarizes the deal that the member can use to sit down at the kitchen table with their spouse or partner and make a decision.
- A deeper collection of data that the member with time and interest can dig into for their own satisfaction.




Resources from ACA

- Search the ACA website and you'll find a wealth of information on all aspects of the diligence process.
- Recognize that no one size fits all, and that groups with specially skilled members can often get by with less.
- Every Summit contains a session or two on this topic where you can pick up the fine points from others.



Examples of a popular report format

<p>Company TextRequest, Inc.</p>	<p>CEO Brian Elrod</p>	<p>Consensus Rating 8.8 on 1-10 scale</p>			
<p>Company Description</p>	<p>Text Request is a cloud-based business tool that enables customers and businesses to directly engage each other in real time, two-way text conversations with complete organizational control from a desktop or mobile app. It gives each business a local, 10-digit number, and a web-based dashboard from which they can send and receive text messages to and from customers. With Text Request, businesses can spark conversations, follow up with leads, or respond to incoming inquiries to shore up business, provide a better customer experience, and bring in more revenue. .Per CEO Elrod: The average person spends 1.2 hours a week waiting on hold. Only 86% of phone calls to businesses are answered. Roughly 20% of emails are ever opened, and those have a 6-hour average response time. <u>Text messaging is the most prominent form of communication for people under 50, and 95% of all texts are read within 3 minutes.</u> TextRequest gives businesses a tool to take advantage of this phenomenon. The company was established in early 2014, and introduced its product to customers in early 2015. The business uses a subscription-based model, giving the subscriber a quota of text messages per month for a fixed price. In the first 12 months of operation in 2015 TextRequest generated \$40,000 in revenue from 164 paying customers, and is growing at 12% month-over-month.</p>				
<p>Summary Proforma Projections (Thousands of \$)</p>					
<p>Year</p>	<p>Year 1: 2015</p>	<p>Year 2: 2016</p>	<p>Year 3: 2017</p>	<p>Year 4: 2018</p>	<p>Year 5: 2019</p>
<p>Revenues</p>	<p>\$50</p>	<p>\$373</p>	<p>\$1,690</p>	<p>\$4,823</p>	<p>\$12,130</p>
<p>Pretax Profit</p>	<p>(\$67)</p>	<p>(\$633)</p>	<p>(\$518)</p>	<p>\$1,180</p>	<p>\$6,150</p>
<p>Cash Flow</p>	<p>(\$67)</p>	<p>(\$633)</p>	<p>(\$518)</p>	<p>\$1,180</p>	<p>\$6,150</p>
<p>Capital Needed</p>		<p>\$650</p>	<p>\$1,000,000</p>	<p>Total Needed</p>	<p>\$1,650</p>

Ratings Key →	9-10 Very Positive	6-7-8 Positive	5 Neutral	3-4 Negative	1-2 Very Negative
Rating 1-10					
8 Positive	CEO & Other Management	<p><u>Inside team:</u> Brian Elrod, Co-founder and CEO; Jamey Elrod, Co-founder and COO; Rob Reagan, Co-founder and CTO. Brian and wife Jamey have a 15+ year long history of founding and bringing to success various businesses in diverse fields. Their greatest success has been Educational Outfitters (http://www.educationaloutfitters.com), a 15-year-old supplier of custom designed school uniforms and related products. Educational Outfitters uses a franchise model, and has 26 franchisees and stores in 15 states, and has produced more than \$140 Million in revenues over its history. Rob Reagan, CTO, has been developing websites for 15 years, and leads the company that produced the TextRequest.com website under contract. Reagan thinks so highly of the TextRequest business model prospects that he is planning to join the company full-time upon closing of this capital round. This is a very mature team.</p> <p>Note: CEO Brian Elrod typically spends 80% of his time on TextRequest and 20% on Educational Outfitters, where he is President. COO Jamey Elrod also splits her time between the two companies. Both companies are collocated in the same office space.</p> <p><u>Outside Team:</u> Board of Directors has not functioned to date, but will do so at closing. Brandon Kruse, a member of the diligence team, has agreed to serve as ASCs representative on the new board to bring his deep telecommunications industry knowledge to the company.</p>			
7 Positive	Product	<p>TextRequest's product is built on a cloud-based technical platform provided by Twilio, a national company based in San Francisco that provides voice and text messaging capabilities to companies like TextRequest that build software interfaces between the user and Twilio. The TextRequest product instructs Twilio to intercept text messages addressed to a customer's phone number and send them to TextRequest, aggregates a customer's messages on a website that can be viewed at the customer's place of business, and provides software functions to manage that flow of messages, make certain each caller gets a timely answer, and keeps a history of the traffic with each of the customer's clients and staff members. The same communication tool that is vital to the success of Uber and Airbnb, TextRequest will provide to businesses of all sizes.</p>			
7 Positive	Business Model	<p>TextRequest's basic model is to sign a month-to-month contract with the customer that provides a certain number of text messages per month for a fixed charge, and then to charge the customer per message for any overage. (See rate chart on page 4). Currently, most new revenues are coming from a 2-person inside</p>			



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7 Positive	Risks	A faster, better financed competitor might come along and take over the market, but also might come along and roll TextRequest up into their existing distribution channels.	
Due Diligence Committee Members		Rating	Committee Member Background
Tony Lettich		8 Positive	Angel Roundtable Managing Director (Johnson City, TN), Managing Director Excalibur Investment Group, former member Corporate Ventures and M&A teams at Eastman Chemical.
Dick Reeves		9 Very Positive	ASC Managing Partner, serial IT industry entrepreneur, >10 angel investments in 25 years, 8 years as Huntsville Angel Network organizer/manager, member Angel Capital Association board of directors.
Adam Pearson		10 Very Positive	ASC Managing Partner, former Director of Operations for MDT, Inc., a leading medical device manufacturer of prostate ultrasonic equipment, co-founder and CEO of LearningEarnings, led the company as it deployed its suite of education technology applications throughout 46 states and thence to a successful exit.
Chip Manning		8 Positive	ASC Managing Partner, Director Babson Center for Global Commerce at University of the South (Sewanee, TN), ten years with a \$1.2B NYSE company serving in multiple roles, ultimately serving as CEO, President and Director; member Huntsville Angel Network..
Consensus Rating of the Committee		8.8 Positive	Note: Deals successfully invested in by ASC syndicates typically have a consensus rating ranging from a low of 5 to a high of 8. Companies at this stage of development always have incomplete teams, some unknown or unknowable aspects of their circumstances, complexities that cannot be sorted out in the limited time available, and other warts. The ASC diligence process is conducted to size up these warts, determine how well equipped the team is to manage them, and to make certain, above all, that we do not inadvertently exclude a company team that is likely go on to be a winner in spite of their many warts.
<p>Note: each member of the diligence committee rated the company on each of the topics above on a scale of 1-10 (1=very negative, 10=very positive), and then ranked each topic on a scale of 1-4 for its importance to this deal (1=unimportant, 4 = critically important). The ratings you see above are the consensus of each member's ratings, adjusted by the importance factor that prevents a low rating on an unimportant topic from having undue negative influence on the final rating.</p> <p>Note: the following served as domain experts to the diligence team: Brandon Kruse founder – at age 16 – of DialMaxx, a long distance service aggregator and distributor to call center operators, bought by MajicJack in 2010 for “multiple millions”. Now a serial entrepreneur, mentor, and funder of multiple businesses in related fields.</p> <p>Note: members of the diligence team found the TextRequest team to be very receptive to coaching and advice.</p> <p>Note: at closing, the company will be converting to a C corporation.</p>			
			Report date: 1-25-2016

Committee Member Name:		Reeves		Example	
Topic	Importance for this Deal 1 - 4	Company's Rating 1 to 10	Importance for this Deal 1 - 4	Company's Rating 1 to 10	
1 CEO & Other Management	4	9	4	8	
2 Product	3	7	4	7	
3 Business Model	3	8	4	8	
4 Markets	2	8	4	6	
5 Sales & Marketing	4	7	4	7	
6 Competition	3	7	4	7	
7 Competitive Advantage	3	6	3	4	
8 Legal & Regulatory Environment	2	7	2	7	
9 Intellectual Property & Technology	2	6	1	4	
10 Valuation & Terms	4	8	4	7	
12 Financials	2	8	4	5	
13 Exit Strategy	4	8	4	7	
11 Potential for investors	4	9	4	8	
14 Other Investors	1	7	3	7	
15 Risks	3	7	3	7	
Your raw rating		7.466666667	3.47	6.6	
Rating with importance factors		8		7.5	
	1 = unimportant	10 = Outstanding	Note: the Importance Factor adjustment compensates for the fact that a less-than-4 importance rating skews the possible range of the topic rating downward. This adjustment is made team-wide in the final spreadsheet.		
	2 = Important	9 = Excellent			
	3 = Very Important	8 = Very good			
	4 = Critical	7 = Good			
		6 = OK			
		5 = Neutral			
		4 = Less than expected			
		3 = Poor			
		2 = Very poor			
		1 = Failing			

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Due Diligence Scorecard Summary

TextRequest

	Topic	Raw Ratings								Individual Topic Weights								Weighted Ratings							
		Scale 1 to 10								Scale 1 to 4								= Raw * Topic Weight							
		Raw AVG	Lettich	Reeves	Pearson	Manning	Kruse			Lettich	Reeves	Pearson	Manning	Kruse			Lettich	Reeves	Pearson	Manning	Kruse				
1 CEO & Other Management	8	7	9	8	8			4	4	4	4				16	28.0	36.0	32.0	32.0	0.0	0.0	0.0	0.0	128.0	
2 Product	7	8	7	7	7			3	3	3	4				13	24.0	21.0	21.0	28.0	0.0	0.0	0.0	0.0	94.0	
3 Business Model	7	7	8	8	6			3	3	3	2				11	21.0	24.0	24.0	12.0	0.0	0.0	0.0	0.0	81.0	
4 Markets	7	7	8	7	5			4	2	2	3				11	28.0	16.0	14.0	15.0	0.0	0.0	0.0	0.0	73.0	
5 Sales & Marketing	8	7	7	9	7			4	4	4	4				16	28.0	28.0	36.0	28.0	0.0	0.0	0.0	0.0	120.0	
6 Competition	6	5	7	7	6			4	3	3	4				14	20.0	21.0	21.0	24.0	0.0	0.0	0.0	0.0	86.0	
7 Competitive Advantage	6	5	6	6	6			4	3	3	4				14	20.0	18.0	18.0	24.0	0.0	0.0	0.0	0.0	80.0	
8 Legal & Regulatory Environment	6	6	7	7	5			3	2	2	1				8	18.0	14.0	14.0	5.0	0.0	0.0	0.0	0.0	51.0	
9 Intellectual Property & Technology	6	4	6	8	5			2	2	2	1				7	8.0	12.0	16.0	5.0	0.0	0.0	0.0	0.0	41.0	
10 Valuation & Terms	8	8	8	8	7			3	4	4	3				14	24.0	32.0	32.0	21.0	0.0	0.0	0.0	0.0	109.0	
12 Financials	7	7	8	8	6			3	2	2	3				10	21.0	16.0	16.0	18.0	0.0	0.0	0.0	0.0	71.0	
13 Exit Strategy	8	8	8	8	7			4	4	4	3				15	32.0	32.0	32.0	21.0	0.0	0.0	0.0	0.0	117.0	
11 Potential for investors	8	7	9	8	6			4	4	4	2				14	28.0	36.0	32.0	12.0	0.0	0.0	0.0	0.0	108.0	
14 Other Investors	7	8	7	6	5			3	1	1	4				9	24.0	7.0	6.0	20.0	0.0	0.0	0.0	0.0	57.0	
15 Risks	7	5	7	7	7			3	3		2				8	15.0	21.0	0.0	14.0	0.0	0.0	0.0	0.0	50.0	
Total		99	112	112	93	0	0	0	0	0	0	0	0	0	180	339	334	314	279	0	0	0	0	1266.0	
Average		6.6	7.5	7.5	6.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	12.0	7	8	8	6	0	0	0	0	7.0	
Normalized																8	9	10	8	0	0	0	0		
Weighted Score					6.93						Average Topic Weight		3.00												
# of committee members		4																							

Weighted Consensus= **7.1**
Weighted Normalized Consensus= **8.8**