Due Diligence Report Instructions

The standard ASC diligence report has 15 topic areas. This document explains each topic and lists some of the questions you should be asking yourself as you consider your evaluation of the company on the topic. For each topic:

> Topic Importance Weight: On a scale of 1 (unimportant) to 4 (critical), how important is this topic in this deal? The management team is always weighted a 4 as a critical factor, but intellectual property may not be a factor at all (weight = 1) for a company whose business model does not include patents or trademarks. Use whole numbers (1,2,3 or 4) for your weights, and there can be many topics that have the same weight.
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> Topic Rating: On a scale of 1 to 10, how well does the Company rate on this topic? 10 means outstanding, 5 means neutral, 1 means failing. Use whole numbers, and there may be several topics on which they rate the same level. For companies at stages where we invest, we expect to seldom see a 10 rating.

The Topic Rating is adjusted up or down in the Scoring Sheet to account for a high or low importance factor. This prevents a poor rating on an unimportant topic from dominating the resulting complete score.

You will be asked to weight and rate each of these areas as part of your participation on the diligence team. Your weights and ratings will be combined with those of the other team members to produce a consensus rating for each topic, and a consensus rating for the deal as a whole, on a scale of 1 to 10. The typical deal invested in by angels will have a consensus rating of at least 6.5, and may range up to 8 or 9 for an unusually well-qualified team and plan.

The ASC Diligence Rating Summary Excel spreadsheet contains additional instructions for completing your weighting and rating of the deal.

Please re-read the ASC Diligence Philosophy prior to filling out your ratings for each deal.

IMPORTANT NOTE: When working on a Research team on these topics, do not hesitate to consult with the ASC staff member coordinating your effort. They have much experience at analyzing and evaluating all of these issues.

Below are questions you should be asking yourself as you consider each topic. If the question has a + after it, you would increase your rating if the answer to the question is Yes. If the question has a – after it, you would decrease your rating if the answer is Yes.

1) CEO & Other Management: (1=poor/undeveloped team, 10=outstanding/complete team)
   a. Team:
      i. Is the team complete? Does it include a good board of directors as well as legal and financial management advice?
      ii. Is there someone on the team with a previous successful entrepreneurial success and exit?
      iii. Is the CEO a good leader, big picture person, people person, culture builder, communicator, story teller, team player, coachable? Does he/she have any current mentors?
      iv. Are there at least 3 people on the team, and are their skills complementary? Do they cover all the skills needed by the company over the next year, or are there complementary skills on the board and outside management team?
      v. Interview at least the top 3 members of management.
      vi. Are there employment contracts in place for key members of management?
      vii. Prepare a list of all management team members, salaries, ownership, incentives.

b. Board:
   i. What is the size and history of the board? Meeting since when? How often? In-person or telecom?
   ii. Are there at least 2 independent board members (including ours)? +
   iii. Are there more than 2 inside board members? –
   iv. Does the board meet on a regular schedule?+ Has the company provided past minutes?+
   v. Interview each board member to determine their role, how long they have been involved, the issues they see going forward, and their view of our involvement.
   vi. Are the outside board members compensated in any way? Options? Stock? Cash?
c. What plans are there for recruiting new team members to fill holes?

2) <u>Product:</u> (1=poor product, 10=excellent product)
   a. Is the product more than a me-too? +
   b. Is this an incremental improvement on existing products, or a revolutionary replacement?
   c. Is it a vitamin (-) or a pain killer (+)?
   d. Is the product scalable to the size needed in the markets that will exist in the time scale of the business plan with the resources the company has or can acquire with this round of funding? +
   e. How will the company develop the product? What is its current state of development? When will the minimum viable version be available?
   f. What are the technical, market window, and regulatory risks?
   g. If a physical product, are there contract manufacturers available? Is the company planning to use them?
   h. Ask the CEO how the customers view their product as to features, strengths, weaknesses, benefits, costs.

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

4) <u>Markets:</u> (1=poor, static markets, 10=attractive, rapidly growing markets)
   a. Are the markets established? Or, will the company have to educate the customer base in order to generate sales?
   b. Are the markets growing rapidly, moderately, or slowly?
   c. Is the market a commoditized one? Or, is there room for a new company to establish a new brand?
   d. Does the market demand support scaling the company up to $15-20 million revenue in 4-6 years?
   e. Are there examples of companies that have succeeded in this market?
   f. 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.

5) <u>Sales & Marketing:</u> (1=no/poor marketing position, 10=excellent position)
   a. How will the company do its sales function? Inside staff? Outside staff? Both? CRM platform?
   b. Is the person who will be the key sales team leader visible now?
   c. How will the company take its product message into the markets? Internal staff? Outside marketing agency? Both? Social media?

d. Does the plan allow for the costs of brand building?
e. Do they have a "closer"?
f. Become a customer of the company, if possible, and test the mechanisms.
g. What is the size of the sales pipeline? Is it growing, static, or declining? Is there a repeatable customer acquisition model?
h. What is the close or conversion rate? The churn rate?
i. Are there strategic partners for distribution?
j. Interview several customers, previous customers, prospective customers provided and introduced by the CEO. Ask the customers how they view the product as to features, strengths, weaknesses, benefits, costs.
k. Interview several you dig up yourself.

6) Competition: (1=no competition, 10=healthy, prosperous competitors)
   a. Who are the primary competitors?
   b. Are they healthy and prospering?
   c. Have any been acquired in recent years?
   d. Is anyone doing a roll-up in the industry segment?
   e. Are there any players outside the industry who could become serious competitors?

7) Competitive Advantage: (1=no competitive advantages, 10=good advantages)
   a. What are the competitive advantages of the company's product?
   b. What barriers to entry are there for new competitors?
   c. What barriers to entry are there for the company to overcome?
   d. Is there a chart showing the comparative advantages/disadvantages of competitive products with the company's product? How does the company stack up?

8) Legal & Regulatory Environment: (1=many legal/regulatory issues, 10=few or no issues)
   a. Will the company and product be subject to any regulatory requirements? Licensing or approval? Reporting?
   b. What is the status of these requirements? Timeline for completion? Risks? Special advantages?
   c. What changes in the regulatory environment have happened recently? are on the horizon?
   d. Are there any legal actions underway or pending?
   e. Do any of these represent a threat to the plan?
   f. Is there a plan to mitigate these threats?
   g. Are any of them a deal breaker?

9) Intellectual Property & Technology: (1=no IP, 10=valuable IP)
   a. Is the company's intellectual property protected or protectable with patents/trademarks?
      i. Review all licenses, patents and patent applications (if not issued.)
      ii. Have company officials explain the technology, outline competing technologies if they exist, and what advantages company technology has over the competition.
      iii. If possible, have a subject matter expert perform a peer review of the technology.
   b. What is the filing status of Trademarks?
   c. What future plans are there for new IP filings?
   d. Does the company have all necessary rights to intellectual property used in the product? Review them. Favorable terms? At risk of termination for any reason?

10) Valuation & Terms: (1=unattractive terms, 10=attractive terms)
   a. What is the current cap table and what does it look like post-investment?

        i. Summarize details of all stock options and warrants. This should include vesting schedules, exercise prices and maturation dates.
        ii. Identify and describe all earlier rounds of financings. This should include amounts, valuations, instruments purchased and sources.
        iii. Review the existing issues for terms that may be adverse to us.
    b. Is the pre-money valuation within an acceptable range?
    c. Do the company principals understand how valuation plays into the return equation for investors?

    d. Are the terms of the deal customary?
        i. Participating preferred with dividend?
        ii. Liquidation preferences?
        iii. Protective provisions?
        iv. Investor rights?
            1. Of first refusal to future offerings
            2. Of cosale with sales by principals
        v. Board seat(s)?
        vi. Founder lock-up provisions?

11) <u>Financials:</u> (1=poor financial prospects, 10=excellent financial prospects)
    a. Is there a complete set of proforma financial projections for 5 years
        i. Monthly for year 1
        ii. Quarterly year 2
        iii. Annual for the rest
    b. Are they detailed enough to provide visibility into expenses for key functions like product development, marketing, sales?
    c. Review the pro forma income statement and understand all major assumptions. Start with the revenue model and make sure that revenue formulas reflect sales plan, pricing and customer attrition. Once the revenue model is verified, make sure that the sales and marketing expenditures support the estimated amount of sales. Then make sure that headcount can support the estimated level of revenue. Then verify that salary expenses and payroll taxes are in line with headcount and salary levels. Lastly, make sure that all significant overhead expenses are accounted for. Pay particular attention to outside contractors (for example-software developers and prototype manufacturer) and professional fees.
    d. Is there a scenario where
        i. Growth is twice what they project? How much additional cash will be required?
        ii. Half what they project? How much additional cash will be required?
        iii. Product development takes twice as long? How much additional cash will be required?
    e. Is the amount of this investment round enough to reach positive cash flow?+ Or, will additional rounds be required?- What dilution might come from those rounds? (See Potential Returns above)
    f. Is the company producing regular monthly/quarterly financial reports?

12) <u>Exit Strategy:</u> (1=poor strategy, 10=excellent exit strategy)
    a. What is the company's strategy for providing liquidity to our investors?
    b. Who are the potential acquirers? How active are they? Does the company have a relationship with any of them?
    c. How active is the industry space for M&A?
    d. Are there some examples of recent and comparable transactions?
    e. How committed is the management team to a timely exit for the investors?
    f. Ask questions like," If you were offered $15 or $20 million for your company 3 years from now, would you take it? If not, why?"; "Where do you see the company in 5 years?"; "How long do you want to be the CEO

of this company?"

13) Potential for investors: (1=low potential, 10=high potential)

   a. What are the key elements in the business model that will build investor value?
   b. How great is the potential for capital appreciation? On the low side? On the high side?
   c. What future rounds of financing might be required, when will they likely occur, how much dilution will they cause, and how likely will it be the rounds can be raised?
   d. Is a 10X return in 5 years or a 5-6X return in 3 years possible?

14) Other Investors: (1 = risky investors, 10 = attractive investors)

   a. Who are the current investors?
   b. Are their holdings reasonable in light of the role they will play in the company going forward?
   c. Are there any unusual aspects to their terms? Non-dilutive shares? Warrants? Options?
   d. Are there any key investors who bring unusual value?
   e. Are there any undesirable investors? Unaccredited investors? Investors acquired via crowdfunding?
   f. Are any of them potential partners for future rounds? This round?

15) Risks: (1 = high risk, 10 = no risk)

   a. What are the key strengths of this deal?
   b. What are the key weaknesses of this deal? Are there adequate plans for mitigation of these risks?
   c. What's the "bet"?