Deal Sourcing, Analysis and Due Diligence

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Venture Capital Learning Series

Darden School of Business

Investment Process

Source Deals
- Direct solicitation
- Business and industry relationships
- Accelerators
- Angels
- Tech transfer offices

Evaluate
- Entrepreneur /Team
- Market Opportunity
- Industry/ Competition
- Financial projections

Structure and Negotiate
- Structure
- Negotiate terms
- Term sheet
- Due diligence

Close Investment
- Documentation
- Fund investment

Monitor
- Financial and operational performance
- Board meetings and management calls
- Quarterly and annual reporting to Limited Partners

Exit
- Form of liquidity event
- Timing
- Valuation

Deal Sourcing

- Network-driven deal sourcing ("deal flow")
- VC partners do everything from deal sourcing, to processing and closing, to monitoring, and ultimately to exit
- Deal sourcing relies heavily on developing a network through meetings with business and ecosystem professionals, attending conferences, trade shows, and other events
- Typically deal sourcing is conducted by the more senior members of the firm
  - Analysis of investment opportunities involves the junior members of the team with oversight from the senior professionals
- CRM tools are helpful in managing your network
- Benefits of a warm lead vs. a cold email

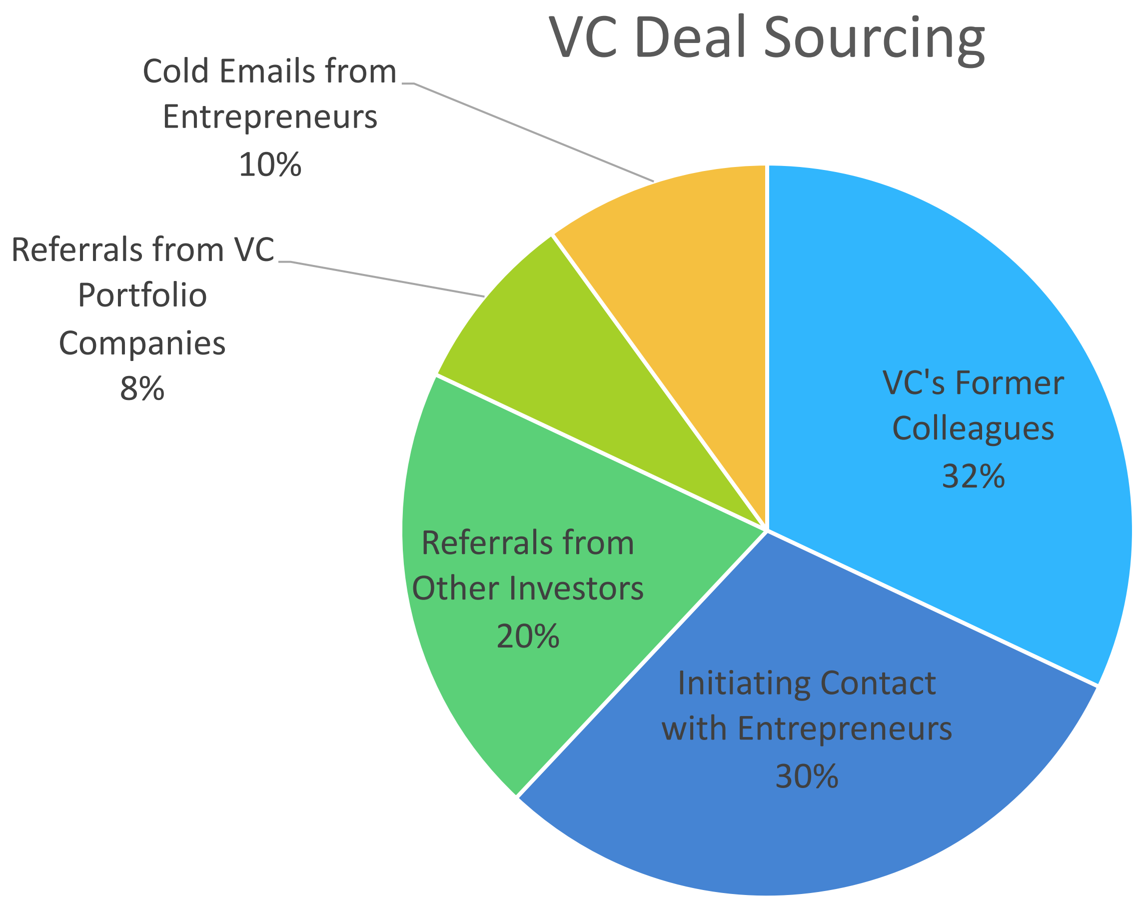
Deal Sourcing

- Inbound sourcing - Venture capital firms spend considerable time building and maintaining networks of business professionals that send them deals
  - Accelerators
  - Angel investors
  - Current and former portfolio executives
  - Other venture capital firms
  - Lawyers
  - Accountants
  - Commercial bankers
  - Investment bankers

Deal Sourcing

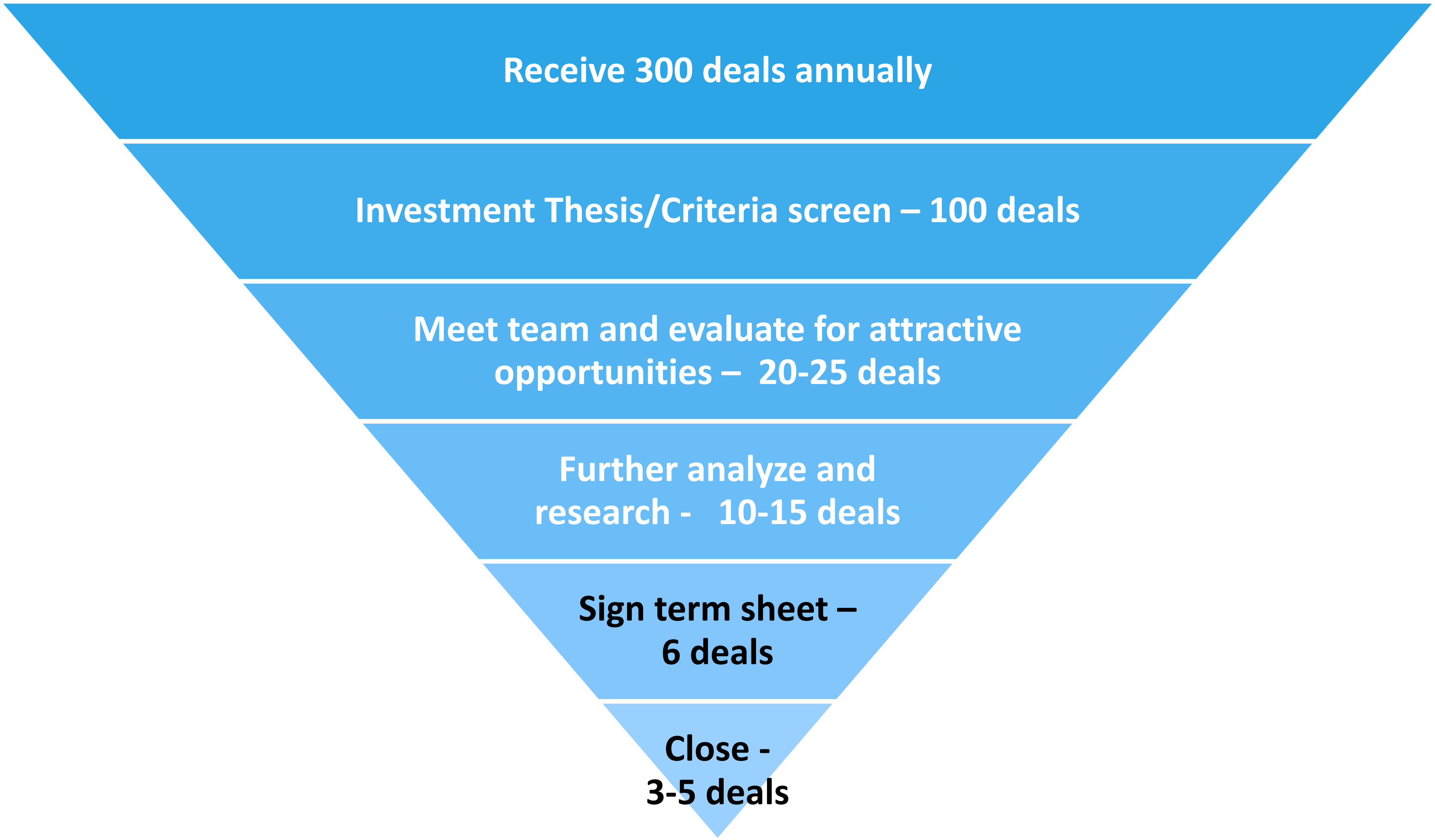
- Outbound sourcing - Venture capital firms can identify attractive industries and proactively contact specifically targeted companies in hopes they might consider accepting an investment
  - Attending Demo Days and Conferences
  - Pitchbook can be a helpful research tool
  - May be able to approach a company before fundraising
  - Chance to build a relationship
  - Benefit of less competitive deals
  - May result in more attractive pricing and terms

Deal Sourcing



Source: *How Venture Capitalists Make Decisions*, Harvard Business Review

Deal Sourcing



Deal Sourcing

- According to an article in the Harvard Business Review:
  - Most deals take 83 days to close on average
    - 118 hours spent on due diligence
    - 10 calls to references on average
  - For every 101 investments reviewed, on average
    - 28 will lead to a meeting with management
    - 10 will be reviewed at a partner meeting
    - 4.8 will proceed to due diligence
    - 1.7 will negotiate a term sheet
    - 1 will close

Investment Thesis/Criteria

- A well-defined investment thesis/criteria helps with deal sourcing
  - Identifies the stage, industry, geography, and other aspects of the types of investments you are seeking
  - Keeps you focused on the most actionable deals for your fund
  - Saves time in deal screening

Attributes of Attractive VC Deals

- Quality entrepreneur / team
- Appealing product or service offering
- Large and attractive market opportunity
- Growth opportunities
- Ability to achieve liquidity through IPO or sale

Initial Questions VCs Ask

- Does this opportunity fit our investment thesis/criteria?
  - Stage of development
  - Investment size
  - Industry
  - Geography
- How should the investment be structured (type of security)?
- What are the primary risks that will affect the company and our return?
- How much more capital will be needed in future rounds?
- How and when do we achieve liquidity?
- What level of return do we expect to achieve?

Analysis and Due Diligence

- Different from start up to early-stage to later-stage
  - Over time you have more information to utilize
    - Startups have limited information
    - Later-stage has more of a track record to evaluate
  - Idea vs. prototype vs. product
  - Projections vs. performance
  - Entrepreneur vs. team
  - Target customer vs. customer data

Investment Analysis

- Review of entrepreneur and team
  - Background and experience
  - Domain expertise
  - Role and value contribution
  - Spend time with management to get to know them better
- Company review
  - Stage of development
  - Lines of business (products and services)
  - Product-market fit (market validation) and timing to achieve
  - Product differentiation (disruptive, innovative)
  - Value proposition (nice to have or have to have)
  - Scalability
  - Target customers
  - Timeline and milestones

Investment Analysis

- Industry analysis
  - Market size
  - Competitors
  - Industry drivers
  - Current and future market conditions
- Financial analysis
  - Projected financial information
  - Historical financial information, if available
  - Investment request and use of proceeds
  - Need for future funding rounds and timing
- Operational analysis
  - Operating data including KPIs, if available
  - Supply chain, production process, and distribution

Investment Analysis

- Particular Investment analysis
  - Size of investment (amount)
  - Ownership
  - Involvement
  - Need for future capital (how much, when, participation)
  - Ability to achieve significant return
    - Ex. $2 million investment at an $8 million pre-money value
    - 20% ownership of a $10 million business
    - At a 5x return, would need to exit at $10 million
      - $2 million x 5 times our investment = $10 million
    - Means company would be valued at $50 million
    - But at a larger $20 million investment, company would need to be valued at $500 million to achieve the same return
  - Exit and timing

Due Diligence

- Review the strategy and business model
- Spend time with the entrepreneur and management team
- Perform industry and market research
- Evaluate the market opportunity (size)
- Review (and validate) information provided by the company
- Check references (management and product/service)
- Identify and evaluate risk (more later)

Due Diligence

Factors Considered	Percentage that said it was important
Quality of the founding team	95%
Business model	74%
Market	68%
Industry	31%
Valuation	< 30%

Source: Harvard Business Review.

Due Diligence

- 20% of all VCs and 31% of early-stage VCs do not forecast company financials when making an investment
- While deal sourcing, deal selection and post-investment assistance are all important in driving value, VCs said deal selection was by far the most important factor

Source: Harvard Business Review.

Risk and Investing

Identify Sources of Risk

- Company
- Industry
- Customers
- Competition
- Suppliers
- Employees
- Management
- Geography
- Regulatory
- Technology
- Economy

Company Risk

- Execution or performance risk
  - Product or service can’t gain traction in the market
  - Company fails to achieve the results expected
    - Can’t achieve milestones
- Financial
  - Investing in companies typically without audited financials before investment
  - Financial performance issues
    - Failure to achieve margins, manage expenses, continued losses
  - Company runs out of funding
- Operational
  - Operations can’t scale, high defect rate, warranty issues
  - Misleading or fraudulent activities

Industry Risk

- Industry conditions change creating problems for the company
  - Declining industry fundamentals
- Commodity or other industry-specific prices increase (or decline if you are the supplier)
- Unfavorable press or media stories
- Seasonal or cyclical industry dynamics

Competition Risk

- Competitors in the market are too large and dominant
- Competitors cutting prices to drive out participants
- Low barriers to entry allows for more competition
- New foreign competition

Customer Risk

- Change in customer attitudes (fads or trends)
- Changes in demographics of customers
- Unsatisfactory customer service issues

Supplier Risk

- General supply chain issues (broad)
- Raw material shortages
- Delivery schedule availability
- Shipping delays
- Contractual issues
- Factory fire (specific)

Management Risk

- Challenge to find the right leader
  - Can they continue to lead as the company grows?
- Challenge to find the right team members
  - Hiring “A” team members
- Illness or death
- Micromanager (control)
- Can’t work well with others
- Criminal record
- “Not as Advertised”
- Misleading or fraud

Employee Risk

- Limited labor market
- Rising labor costs
- Retention issues (high turnover)
- Managing virtual employees
- Safety issues

Technology Risk

- Obsolesce of existing product
  - New technology development by competitor
- Lack of market acceptance
  - Market not ready for new technology
- Failure to develop or scale product
  - Commercialization
- Intellectual property rights issues

Regulatory Risk

- New laws or regulations
  - Can prohibit a product or service
  - Can add additional cost
- Repeal of tax credits or other benefits
  - Changes economics
- Tariffs or taxes

Geography Risk

- Hurricane Ian or other natural disaster
- Taxes and tariffs
- Exchange rates
- Political stability in foreign countries

Economic Risk

- COVID-19
- Recession (2008, present)
- Inflation

Mitigating Risk

- Management
  - References
  - Background checks
  - Meetings with management
- Industry
  - Research
  - Consultants
- Customer
  - Customer calls and surveys
- Operational
  - Consultants
- Financial
  - Testing budgets and assumptions
  - Modeling – downside scenario

Managing Risk

- All deals have risk
- Some deals have more risk than others
- The question is, can you accept/manage the risk or is the risk too great
- If the risk is too great, you should walk away from the deal

Other "Risks" to Watch Out For

- FOMO – Fear of Missing Out
- "Chasing a deal" or "falling in love with a deal"
- "Too high" valuations
- Unreasonably short decision deadlines
- Lack of willingness to provide information
- Inconsistency of information
- Ignoring your "gut"

Financial Modeling

- Projection model
  - Forecasting future results
  - Budgeting
  - Growth and capital needs
- Transaction model
  - Venture and growth financings
  - Acquisitions

Transaction Model

- Prepare a transaction model to evaluate
  - Valuation (ownership)
  - Returns analysis
  - Sources and timing of additional financings
  - Run sensitivities
    - Base case
    - Downside
    - Upside

Assumptions

- Drivers of the financial model
- Garbage in – garbage out
- Income statement
  - Growth rates
  - Margins
  - Breakeven/profitability
- Balance sheet
  - Assess need for access to capital and resources
- Are they realistic and sustainable?
- Be aware of trends, market conditions and cyclicality

Building Your Model

- How far out are you looking to project?
- Monthly, quarterly or annual periods
- Level of detail needed
- Often helpful to have an assumptions page or section
- Flexibility to change/test assumptions
- Make sure your balance sheet balances and columns sum properly
- Impact of income statement assumptions on the balance sheet and vice versa
- Be aware of circular references
- Hardcoded numbers limit ability to test assumptions
- Watch your formulas

Investment Committee

- Venture capital firms make investment decisions through the use of an Investment Committee
- Investment Committee typically consists of the partners in the firm and meets regularly to review and approve investment opportunities
- Investment Committees can be small or large groups
- Allows all members of the Investment Committee to ask questions, raise issues, propose modifications to term sheets and give final approval to close
- Many committees meet weekly, some on an as needed basis
- Deals are voted on to proceed or not
- Can be a one or two stage process

Investment Committee

Source and initial evaluation of investment opportunity, prepare draft term sheet

Investment Committee – Stage 1

Term sheet negotiated and executed, complete due diligence and documentation

Investment Committee – Stage 2

Closing of Investment