Due diligence questions for a startup. V3

What is the purpose of this article
1) Provide a framework for founders and investors to identify due diligence questions.

This article does not provide legal, tax, financial, or investment advice.

What are the critical learnings in this article?
1) Due diligence begins before a startup asks for funding. Due diligence is not a one-time event.
2) Due diligence is based on more than the information a startup provides.
3) Detailed due diligence questions depend upon where a startup is in the investors' analysis and decision-making process. Due diligence increases the further along a startup is in the funding process.
4) Due diligence is done for every kind of startup, including investment funds and angel investment groups.
5) Three overarching due diligence questions apply to any company or fund at any stage: How many cash paying customers are there with urgent problems and needs they are willing and able to pay for? How does the company enable customers and users to achieve more value than the competition? How is the leadership team competitively differentiated?

What is a startup?
A startup is a temporary organization designed to search out a repeatable, scalable, and profitable business model with lots of potential customers who are willing and able to pay to solve their problems and needs.

Startups are not building a solution. They are building a tool to learn what solution to build.[1]

A business model describes how a company creates more value for C&U (customers, users) than the status quo and competitors. Who are your target C&U (Customers and Users)? What C&U problems are your solving? What C&U needs are you addressing? What benefits and value are you enabling C&U to achieve? What are the human and technology resources needed? What are the channels and partnerships?

What are the startup stages?
1) You have some assumptions about an urgent problem or need that C&U have.
2) You meet with C&U to hear from their lips: that this is an urgent problem or need that they have, and the value to them of meeting this urgent problem or need.
3) Within a few months you have something in C&U hands which delights them. This is not the whole solution, but something which provides noticeable value.
4) You keep adding customers while enhancing your solution to provide more value to more customers. You may be changing direction several times during this phase.

A startup is no longer a startup when it has successfully searched out a repeatable, scalable, and profitable business model with lots of potential customers who are willing and able to pay to solve their problems and needs. The startup has learned what solution to build. The temporary organization structure must change to one that can grow rapidly.

What are the three key sets of questions an investor asks throughout the life of the startup?
1) How many cash paying customers are there with urgent problems and needs they are willing and able to pay for?
2) How does the company enable customers and users to achieve more value than the competition?
3) How is the leadership team competitively differentiated?

The number of detailed questions in each of the three sets increases as the startup progresses through the due diligence process.

Your due diligence supports a series of decision that you, as an investor, make.
1) Why should you open (rather than immediately delete) a cold call email or introductory email from someone you know?
2) Why should you read the content of the mail?
3) Why should you read any attachments?
4) Why should you have a brief call with the startup?
5) Why should they have a meeting with you?
6) Why should they start a due diligence process with you?
7) Why should they start to negotiate terms and conditions with you?
8) Why should they decide to give you cash?

Due diligence begins before there is a funding deal to consider.

1) Early-stage funds encourage startups to: enter information into the funds' databases at the pre-revenue stage and before asking for funds; update the data regularly; provide month updates to the fund; etc. Software tools analyze the data to identify high potential startups.
2) Early-stage funds are using software to build large databases of startups based on existing third-party databases and their own tools to scan the web. Analytic tools identify high potential startups.
3) Many funds are now using software to determine which startups to actually contact. InReach Ventures in Europe has built custom software which created a database of over 95,000 startups. The software identified 2,000 candidates for management contact.[2] Framework Venture Partners (Toronto Canada) has a 20,000 startup database with about 100 datapoints per startup. Startups from the pre-revenue stage on can submit information and receive benchmark feedback.[3]

Due diligence also occurs at the deal sourcing stage

Only 12% of deals arise from companies applying to VCs. Each of the deal sources does some degree of due diligence.

Where do VCs source early-stage deals?[4]

31% Generated through professional network
23% Proactively self generated
22% Referred by other investors
12% Inbound from company management
09% Referred by portfolio company
01% Quantitative sourcing
02% Other

Once there is a deal, each step of the deal process has due diligence.

Harvard Business Review published the findings from a survey of 885 venture capitalists at 681 firms.[5]
For each deal that closes, on average:

1) 101 deals are considered;
1) 28 deals proceed to a meeting with company management;
2) 10 deals are reviewed at partner meeting;
3) 4.8 deals have detailed due diligence;
4) 1.7 deals result in negotiation; and
5) 1 deal actually closes.

What is one example of the questions asked at the screening stage?

Going VC has pass/fail factors in their one-page screening test:[6]

1) Fit with the fund themes and areas of focus.
2) Addressing problems in the fund's target industries/sectors.
3) Startup stage aligns with the fund's target stages.
4) Startup target geography aligns with fund's target geography.
5) Quality of the referral.
6) Strengths of the startup's partnerships, customer traction and suppliers.
7) Startup's market size aligned with fund's target market size.
8) Other.

What are the most important factors for VC investment decision making?[4]

What do VC's say is the most important factor when they make the final investment decision?

53% team
13% fit with the fund
12% product/technology
07% Business model
07% Market
06% industry
02% fund's ability to add value
00% valuation (not a typo - 00%)

Why is the team the most important factor at investment decision time? Capital is unlimited but the talent to search out a large market and supporting business model is very scarce. The team must have demonstrated that: they can work together, learn a variety of skills very quickly, build relationships quickly, make fundamental changes in direction when required, have integrity and trust worthiness, maximize the results from careful cash management, etc.

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Andreessen Horawitz looks for three things in a startup: huge market, differentiated technology, incredible people.[7]

What are the three areas I assess when hearing someone making a pitch?

#1 What is the market risk and value proposition risk

How many potential customers have an urgent need or problem they are willing and able to pay to address?

Red flags for me are:

1) Focusing on customer and user "needs". Everyone has lots of needs. Not every need is urgent enough to warrant spending money.
2) Market size is based on a chart from a consulting firm.
3) Market size is focused on users i.e. not the cash paying customers
4) Not knowing who the cash paying customer is.
5) Not having interviewed and surveyed potential customers to understand the problems and needs they are willing and able to pay to address.
6) Market size is based on the founders' opinions and hopes rather than the understanding of potential customers.

#2 What is the technology/solution risk?

1) Can the founders explain the competitively differentiated technology/solution so that anyone can understand? Albert Einstein supposedly said "If you can't explain it to a six-year-old, then you don't understand it yourself."
2) If I have current and relevant knowledge of the technology/solution, what is my assessment?
3) If there is someone who I trust, and who has current and relevant knowledge, what is their assessment?

#3 What is the talent risk?

1) Is the CEO presenting or some else?
2) Do I understand what the CEO is saying?
3) Does the CEO understand the customer and market place metrics?
4) Do I trust the CEOs answers to questions?
5) What does the CEO (and team) know what competitors do not know?

What are your next steps

If you're an investor:

1) Ensure you have an investment thesis.
2) Define your due diligence process and questions. You'll need several stages of due diligence to quickly screen out companies for which you'll put in the time and resources for detailed due diligence.

If you're a startup:

1) Write down your answers to the three overarching due diligence questions apply to any company or fund at any stage: How many cash paying customers are there with urgent problems and needs they are willing and able to pay for? How does your startup enable customers and users to achieve more value than the competition? How is your leadership team competitively differentiated?
2) Define how you communicate these answers to investors and your team: in person or video calls, in presentations, in seminars, in your newsletter, on your website.
3) Research your target investors to understand their due diligence process and detailed questions.

If you're a company past the startup stage:

1) Follow the same steps as a startup, described above.

If you are a company that is not planning at any point to raise capital:

1) Follow the same steps as a startup, described above. Note that you need to communicate with any existing capital providers

Footnotes

[1] Alistair Croll, Benjamin Yoskovitz , *Lean Analytics – Use data to build a better startup faster,* (Sebastopol California: O'Reilly Media ,2013) Page 41

[2] Maija Palmer, "Artificial Intelligence is guiding venture capital to websites", *Financial Times*, https://www.ft.com/content/dd7fa798-bfcd-11e7-823b-ed31693349d3

[3] Framework Venture Partners, "What is world class – how do we benchmark venture companies?", https://www.framework.vc/blogs/what-is-world-class-how-do-we-benchmark-startup-companies/

[4] Paul Compers, Harvard Business School, Will Gornall, University of British Columbia Saunder School of Business, Steven N. Kaplan, University of Chicago Booth School of Business, Ilya A. Strebulaev, Graduate School of Business Stanford, "How do venture capitalists make decisions", *Medium*, https://medium.com/vcdium/venture-capital-decision-making-c3258bc1b09c

[5] Paul Compers, Will Gornall, Steven N. Kaplan, Ilya A. Strebulaev, "How do venture capitalists make decisions", Harvard Business Review, https://hbr.org/2021/03/how-venture-capitalists-make-decisions

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[6] GoingVC Team, "Screening Scorecard", GoingVC, https://www.goingvc.com/post/venture-capital-due-diligence-the-scorecard
[7] Corporate Finance Institute, "How VCs look at startups and founders", Corporate Finance Institute, https://corporatefinanceinstitute.com/resources/knowledge/other/how-vcs-look-at-startups-and-founders/

What further reading should you do?
How do venture capitalists assess teams?
http://koorandassociates.org/selling-a-company-or-raising-capital/how-do-venture-capitalists-assess-teams
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