
Michigan Angel Summit

Due Diligence Fundamentals

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The Due Diligence Process

Assessing the Risks

Agenda

- Due Diligence Defined
- Why is it Important?
- Value and Risk
- Categories of Diligence
- Questions, Tools and Resources

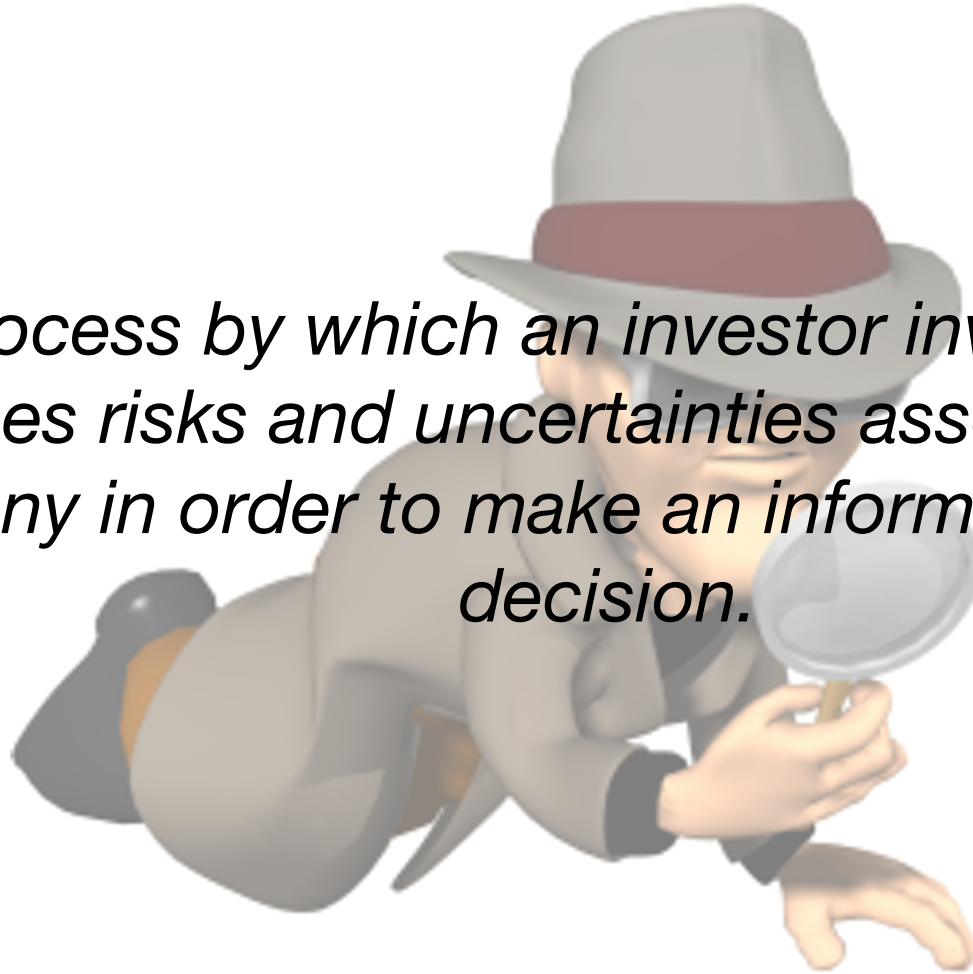
The Investment Process



The investor performs due diligence from the time they decide to consider an investment in the company to when the investment is closed (or rejected).

What is Due Diligence?

The process by which an investor investigates and assesses risks and uncertainties associated with a company in order to make an informed investment decision.



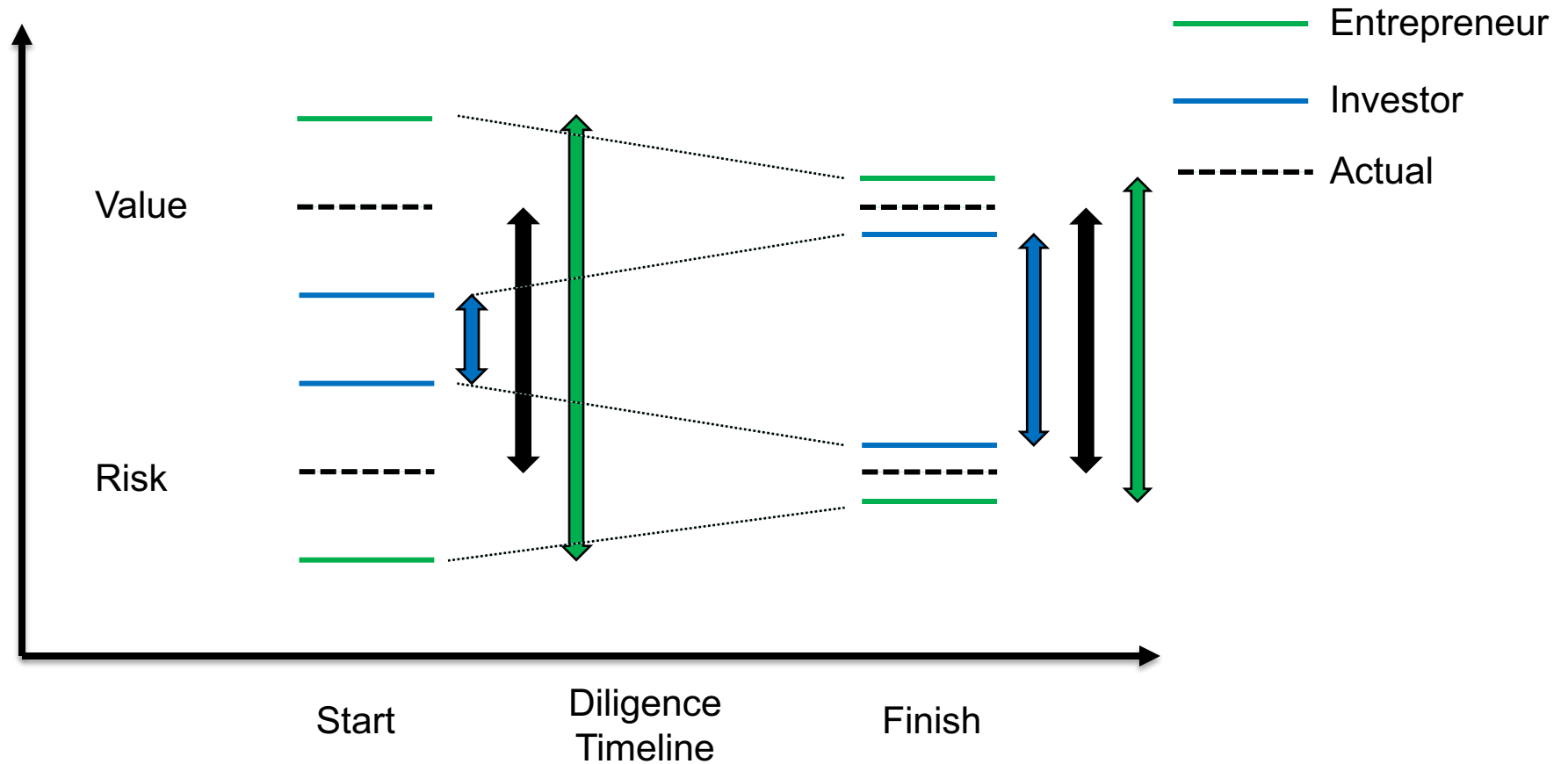
What Else is It?

- A “dating period” for investors and entrepreneurs to get to know one another and determine if there is “chemistry” (compatibility)
- The process that allows investors and entrepreneurs to get on the same page regarding the company’s business plan, go to market strategy ...and its valuation

Why is Due Diligence Important?

- If done properly, it *can* help investors find good deals and avoid bad deals
- It helps avoid “surprises” later on by getting everything out on the table before the investment
- It helps bring the investor and entrepreneur closer in their individual assessments of risk and value

Value and Risk: Investor vs. Entrepreneur



Diligence from the Investor Perspective

- Dimensions of Risk
 - Management
 - Market
 - Technology
 - Competition
 - Business Model
 - Financial Model
 - Returns and Exit Analysis

Diligence Questions

- Management
 - Have they been successful before?
 - Do they understand the market they're pursuing?
 - Are there holes in the team that need to be filled?
 - Are they fully committed? What is their motivation?
 - Are they well suited for the task at hand?
 - Will they take guidance from the board/investors?
 - Are they ethical, honest, reliable, dependable?
 - How do they respond to pressure?
- Tools and Resources
 - ✓ Reference checks (formal and informal)
 - ✓ Background checks (Level 1, 2, 3)
 - ✓ Others: social media, sex offender registry

Diligence Questions

- Market
 - How big is it today?
 - How big could it be in the future?
 - What will drive its growth? Are there tailwinds?
 - Does industry structure allow for new entrants?
 - Does industry structure allow for high returns?
 - How/why do customers buy?
 - How important is regulation?
 - What does it take to be successful?

- Tools and Resources
 - ✓ Industry research reports
 - ✓ Consultants
 - ✓ Customer interviews

Diligence Questions

- Technology/IP
 - How unique is the technology?
 - Is it patented/protected with know how?
 - What is its value proposition? Is it compelling?
 - What does it cost today?
 - What will it cost in the future?
 - Can it scale?
 - Is there an IP pipeline?
 - Is it likely to be leapfrogged?
- Tools and Resources
 - ✓ Technology research reports
 - ✓ Consultants
 - ✓ Legal IP review (ownership, freedom-to-operate, patentability)

Diligence Questions

- Competition
 - Who are the company's competitors?
 - How are they likely to respond to a new entrant?
 - Do they make good margins?
 - Is there differentiation among competitors?
 - Can their value proposition be bettered?
 - Are there other emerging competitors to be considered?
- Tools and Resources
 - ✓ Market research reports
 - ✓ Consultants

Diligence Questions

- Business Model
 - What is the company's business model?
 - Is it scalable, extensible, sustainable and defensible?
 - Where in the value chain do they fit?
 - What dependencies do they have on suppliers, resellers, distributors, etc.?
 - Are there barriers to establishing supply and distribution channels?
 - How much capital does it imply?

Diligence Questions

- Financial Model
 - What are the company's revenue, EBITDA and net income projections?
 - What assumptions are baked into those projections?
 - How realistic are those assumptions?
 - Which are the most critical assumptions?
 - How much financing, and of what type, will it take to realize their projections?

Diligence Questions

- Returns and Exit Analysis
 - What is the company worth?
 - What are the options for exit?
 - How long will it take to exit?
 - Given the capital requirements and timing to exit, can investors achieve risk-adjusted return objectives?

Diligence Questions

- In general:
 - What can go wrong?
 - How likely are bad outcomes?
 - How big could it be if things went right?
 - Are the challenges in front of the company surmountable?
 - Do they have what it takes to get there?
 - Do I believe they'll be able to do it?
 - How much am I willing to risk on this?
 - How should I structure the deal terms to address the key risks?

Questions?

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