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Working with Entrepreneurs and Angels to change the world one deal at a time.

Getting to "No" - How to Efficiently Balance Due Diligence and Term Sheet Negotiation

Many angel investors approach the due diligence process with a focus on "getting to no." The deal flow funnel starts very wide at the top and narrows to a very tiny opening at the bottom -- the typical investor invests in one out of every two or three hundred deals reviewed. Therefore, the faster the investor "gets to no" on any particular deal, the faster he or she can "get to yes" on the deal that gets funded.

To complicate the process, there is a balance that must be struck between: a) spending too much time on due diligence (only to find out that you can't reach a term sheet with the entrepreneur); and, b) spending too much time on term sheet negotiation (only to find out there is a due diligence "show stopper").

This newsletter focuses on efficiently running the due diligence process (so that if we are going to "get to no," we get there as quickly as possible) and balancing it with term sheet negotiations.

When I think about the purpose of due diligence, I am reminded of the "entrepreneur's creed": "Things are never as good as they look, or as bad as they seem." So when conducting due diligence - with the rare exception of a handful of "screening issues" or "show stoppers" - there are few black and white rules about what is acceptable and what is not. Mostly, the answers to the due diligence process end up in *value judgments* (what the particular investor likes and dislikes) or *comparables* (comparing this potential investment with that one). But the due diligence process really serves two functions: first, to identify those deals that are "DOA" where we "get to no" quickly; and, second, to identify weaknesses in an investee company, so that once the investment is made, we can focus on fixing those weaknesses as part of our portfolio management.

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To strike an efficient balance between due diligence and deal term negotiation, I recommend that my clients conduct four levels of due diligence and negotiation; each level involves some legal due diligence, some business due diligence and some key deal term negotiation. The four levels are:

1. Screening – a very high level sifting through of the business plans, to weed out the obvious misses

2. Show stoppers – for those who pass through the screen, to identify those which have issues that are virtually insurmountable and unacceptable

3. Deeper dive – of those that are left, what are the "rough spots" that need to be worked on prior to closing

4. Final – here we take the time to drill down into the fine details of what needs to be worked on post closing.

Approaching due diligence this way allows us to ask some of the key questions up front, so we don't waste our time with the deeper dive or final due diligence issues if there is going to be screening or show stopper problems that make this all moot.

Likewise, at each of these four stages we would get deeper and deeper into the term sheet negotiation, again to identify if there are any term sheet issues that will stop a deal, and to identify those early on.

1. Screening

A. Business. There are five screening issues on the topic of business due diligence:

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- *Wrong stage, pre-revenue, pre-prototype.*

  As an investor, know yourself. Investing in a pre-prototype company involves vastly different skill sets than investing in a pre-revenue company, or - for that matter - investing in a company that has revenues but needs to scale to the next level. Figure out which stage you like best, and then one of the first questions you should ask the entrepreneur is their stage of development. It's an easy, quick screening tool.

- *How soon can we close (we need to close quickly – payroll is due next week)?*

  Realistically, this process takes at least sixty to ninety days. An entrepreneur who needs your money to make this week's payroll is unrealistic. On the other hand, I am constantly amazed how creative entrepreneurs can "stretch payments" to keep their companies alive while waiting for funding.

- *Funding needs - unrealistic, no milestones, will this round provide enough money for the company to get to its next milestone (and enough reserve to run the company while raising the next round)?*

  With the amount of funding requested, can the entrepreneur realistically get to his or her next critical milestone (ideally, even to cash flow breakeven), and still have reserves left to keep the company alive while it closes the next round? If not, further funding will be needed, and that will be very expensive to both the entrepreneur and the investor. Also, how risky will it be to obtain financing in the future?

- *Quality of the Team - inexperienced or not coachable?*

  "People invest in people, not in business plans." Ideally, the management team already has deep domain knowledge about the business and industry along with the necessary expertise in management, marketing and finance. This almost never occurs. Thus, the next best thing is a "coachable" team that will willingly receive the investor's advice (and act on that advice) to fill out gaps in management and be committed to recruiting the strongest team possible. The egocentric entrepreneur, the guy who can "do it all," should be a non-starter for the investor. Even if the team appears to be qualified, you need to be satisfied that they have what it takes to achieve their goals. The answer to the question, "Can they pull it off?" must be yes.

- *Market Opportunity.*

  "Invest in drugs, not vitamins." In other words, invest in things that the potential customer needs to have (drugs) and not just things that the potential customer would "like to have" (vitamins). Although there are profound exceptions (for example, Google), if potential customers don't even know they need your product or service, then it's probably a bad investment idea. The greater the apparent existence and size of a large, unmet need, the less risk there is likely to be. Be assured that the market opportunity is large enough to support the kind of venture being proposed and will allow sufficient value to be created to have a high probability of providing a satisfactory return on investment.

B. Legal. I have identified three "screening issues" for legal due diligence - think of these as "Red Flags" that suggest you should pass on this deal:

- *The patents are owned by me - outside the company; the company has other, material "related party transactions."*

  The investor should not have the critical or irreplaceable means of production (be it a patent, a key source of raw materials, the company headquarters, etc.) outside of the business (or at least outside of the investor's control). A Founder's Agreement, if one exists, can often help identify whether any such assets are outside the company.

- *Pending or threatened litigation (or government investigations) against the company or the management team.*

  Litigation is enormously expensive and is a fatal distraction of the entrepreneur's time; all money and time should be spent on product/service development, marketing and execution.

- *Preemptive rights*

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A "preemptive right" is the right of a prior investor in the company to have first crack at putting more money in. It is fruitless for the new investor to spend time and money on due diligence and term sheet negotiation, only to have a prior investor exercise their preemptive rights and take away the deal. Get those preemptive rights waived (at least for this round of funding). At the same time, find out why the prior investors aren't continuing to fund the company.

C. Term Sheet Issues. Here the term sheet issues are:

1. whether the entrepreneur is willing to give up equity to the investor; and

2. whether he or she will sign a non-compete.

2. Show Stoppers

A. Business. Your client should examine the following six key business due diligence issues:

- *Unrealistic pre-money value.*

  The pre-money value determines how much of equity in the business the investor will receive for his or her investment. Looked at another way, in order for the angel investor to succeed, the companies he or she invests in must grow to a certain multiple in a short timeframe (say five years). Although it's more art than science, investors look at the entrepreneur's projections to determine what the company will be realistically worth in five years. Then, the investor must work backwards to determine the maximum value that the company can have today for the investment to make sense. Example: assume the investor believes his investee companies must grow thirty times in five years. (Thirty times may seem high, but it is the benchmark - to be covered in an upcoming newsletter). If the business plan projections support a value of $30 million for the company in year five, then the value today (the "pre-money value" - the value of the company before the investor invests), can be no more than $1 million. If today's pre-money value (according to the entrepreneur) is $2 million, then the company will only grow fifteen times -- not enough for this investment to make sense.

- *Market too small, too vague, too difficult to access.*

  A business that is built on serving the needs of only a thousand potential prospects must close on an extraordinarily high percentage of its sales presentations in order to succeed. Likewise, if prospects are hard to identify, the sales staff will burn valuable time simply trying to identify and gain access to them.

- *Competition too powerful.*

  Many successful companies do well serving niche markets, deemed too small or specialized to be focused upon by the big players. But, this is clear only with hindsight. It's difficult to tell which markets are truly niche markets that will be avoided, and which will be the next battleground between your investee and Microsoft.

- Product or service - does it work and is it protectable?

  Get a sample. Plug it in. Turn it on. Do the lights go on? Simple stuff maybe. But you'd be surprised.

  Then, find out if others have similar devices (or, if no similar devices exist, could one be easily "knocked off" without violating the company's patents).

- Inappropriate use of proceeds.

  Company plane, bonus to founder, founder wants to "take some money off the table," etc., etc., etc. All non-starters.

- No exit.

  Nice company, but in five years, who will buy us, why, and at what price?

B. Legal. At this stage, consider the following six key legal due diligence issues:

- Cap table - "cats in the wheelbarrow."

  If a shareholder vote will be required from more than, say, four shareholders, you can expect to en-

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counter difficulties and delays, not just in approving your investment, but also in approving each critical decision down the road. Kind of like herding cats in a wheelbarrow. Suggestion: roll-up the "friends and family" investors into one LLC that is managed by the founder (who has authority to cast votes for that equity group).

- *Management team in conflict.*

  Each team member must focus solely on the business at hand. It can be a problem (but not always) if a team member's focus is diverted due to conflict with family (divorce), with other time commitments (another business), or with other team members ("I hate my partner").

- *Unpaid taxes/tax liens/unfiled tax returns.*

  The IRS is not a very accommodating "silent partner." If these problems are not fixed prior to closing, then the investor's money will be used to fix them, instead of growing the business.

- *Excessive current liabilities.*

  What is "excessive?" Good question. The point here is that if the amount of payables that will come due shortly after closing is out of line with the projected cash needs of the business to execute its plan, then the investor's money will be used to pay old bills, and not to grow the company.

- *Non-competes with former employer.*

  It's one thing for an entrepreneur to get basic training at a large company and then start his own business to develop a new and better product or service. It's another thing for an "entrepreneur" to do a breakaway from its employer, taking trade secrets or confidential information and/or starting a new business in violation of a non-compete. Don't invest in <u>that</u> guy!

- *Background check.*

  For a few hundred dollars and about 72 hours, internet wizards can check an entrepreneur's background for: pending and recently resolved civil cases (has anybody else sued your guy? Is somebody suing him now?), motor vehicle violations (does your entrepreneur have a substance problem and/or a lot of DUIs on his driving record?), and an educational background check (did he really graduate from Harvard?).

C. <u>Term Sheet Issues</u>. Here, the <u>term sheet issues</u> continue with five critical aspects: how much equity will be given up, will there be a non-compete and what will it look like, will the founders' equity vest, what control issues will the investor need to have (i.e., will the investor have a Board seat, and over what issues will the investor require a veto right), and what is the exit mechanism for the investor (for example, will the investor have put rights, registration rights, etc.).

3. Deeper Dive

Once the entrepreneur has passed the screening and show stopper stage, it's time to take a deeper dive, spending more time investigating business issues (for example, interviewing third parties about the market, competition, and product or service), as well as legal issues (for example, conducting UCC lien searches and ordering freedom to operate opinions).

Toward the end of this stage, the <u>actual term sheet</u> with all of its provisions, nuances and exact language, should be negotiated and signed.

4. Final

So, at this point the investor has efficiently screened out companies with little potential of being successful investment candidates <u>and</u> has raised the term sheet issues in a natural order and in a way that does not consume a lot of time or resources nailing down some fundamental points. Having done all that, the investor and the entrepreneur have hammered out the rest of the details that typically go in to a term sheet. Now "all that remains" is to prepare the definitive agreements and to conduct the <u>final</u> due diligence (see separately posted legal due diligence checklists and business due diligence checklists, to guide this "final" due diligence). Of course, there is always a chance that a legal provision in the definitive agreements will be a deal buster, or that the final legal due diligence or final business due diligence will turn up an issue that cannot be overcome. All those are possibilities, but frankly not probabilities at this stage.

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Enterprise Law Partners, PLLC helps business owners realize their vision. Connecting entrepreneurs and angel investors, ELP works to bring ideas to market, using creative problem solving to get the deal done. Capitalizing on its extensive legal and business management background, ELP navigates the most complex legal issues, counsels and negotiates all aspects of the deal and produces streamlined, plain English documents.

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He looks forward to helping you and your business succeed.