

Executing the Due Diligence Plan

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Kauffman Fellows Program
October 25, 2012

The Substance

■ Key Issues

↘ The Market

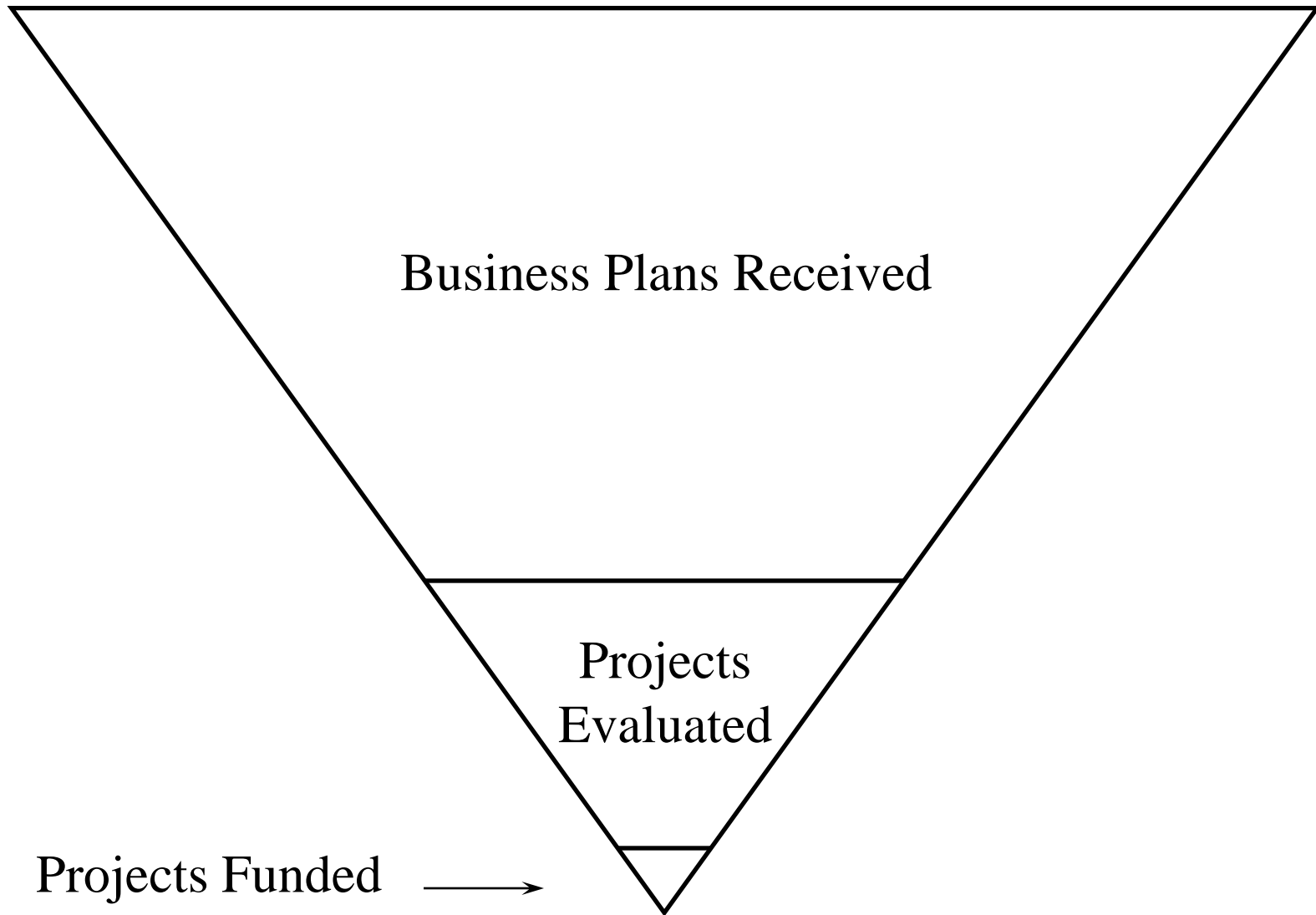
↘ The Management

↘ The Method

↘ The Money

↘ The Metrics

Venture Capital Deal Flow



Key Triage Factors

- **Management Pedigree**
- **Deal Source**
- **Process Management**
- **Customer Validation**
- **Adherence to Plan**

Key Focus Areas

- **Major Risk Factors**
- **Obvious Show Stoppers**
- **Better, Faster, Cheaper, or Brave New World**

Major Risk Factors

- **Technological**
- **Market**
- **Regulatory**
- **Operational**
- **Financing**

Market

■ Macro

- **Size**
- **Growth Rate**
- **Concentration**
- **Barriers to Enter**

■ Micro

- **Economics (Pricing, Operating Margins)**
- **Customers**
- **Segmentation**

Methodology

- **Business Model**
- **Value Proposition**
- **Distribution Strategy**
- **Competitive Differentiation**
- **Growth Strategy**
- **Technology**

Management

- **Vision**
- **Experience (Quality, Quantity, Relevancy)**
- **Education**
- **Track Record**
- **Capability**

Money

- **Financial Strategy**
- **Capital Requirements**
- **Structure**
- **Valuation**
- **Liquidity Path**
- **Use of Proceeds**

Numbers

■ Income Statement

- Revenue Projections (\$, Units, Average Sale Price)
- Expense Projections (Head Count, Salary Level, Corporate Overhead)
- Margins (Gross, Operating)

■ Balance Sheet

- Cash
- Accounts Receivable
- Inventory
- Goodwill/Intangibles
- Debt
- Liabilities

- **Cash Flow**

- **Operating**

- **Financing**

- **Budget**

- **Capitalization Table**

- **Investors**

- **Management**

- **Option Pool**

The Process

- **Business Plan Review**
- **Management Presentation**
- **Site Visit(s)**
- **References**
- **Competitive Analysis**
- **Financial Analysis**
- **Corporate Review**
- **The Deal**

Business Plan Review

- **Form**
- **Substance**
- **Vision**
- **Business Model**
- **Marketing Plan**
- **Technology Plan**
- **Financial Plan**

Venture Capital Glossary

<u>What We/They say...</u>	<u>and What We/They Really Mean...</u>
Acquisition Strategy	the current products have no market
Basically on plan	revenue shortfall of 25 percent
Dotcom business model	potentially bigger fools have been identified
Considerably ahead of plan	hit plan in one of the last three months
Currently revisiting the budget	financial plan is in total chaos
Cyclical industry	posted a huge loss last year
Entrepreneurial CEO	totally uncontrollable, bordering on maniacal
Ingredients are there	given two years we might find a workable strategy
Investing heavily in R&D	trying desperately to catch the competition
Limited downside	it can't get much worse

Venture Capital Glossary...

What We/They say...

Long selling cycle

On a manufacturing learning curve

Possibility of a slight shortfall

Repositioning the business

Somewhat below the plan

Too early to tell

Turnaround opportunity

Unique

Upgrading the management team

Window of opportunity

Work closely with the management

and What We/They Really Mean...

yet to find a customer who likes the product

can't make the product with positive margins

a revenue shortfall of 50 percent

multimillion-dollar investment recently written off

revenue shortfall of 75 percent

results to date have been grim

lost cause

no more than six competitors

the organization is in complete disarray

without more money, the company is dead

talk to them on the phone once a month

Pipeline Qualification

- ***Suspect:*** A potential Prospect
- ***Prospect:*** A Suspect with whom contact has been made
- ***Qualified Prospect:*** A potential Customer with budget actively seeking a solution
- ***Customer:*** A contractually committed financially viable client

Technology Review

■ Technology

- **Architecture (web-enabled or web-centric) thick versus thin client**
- **Operating System**
- **Relational Database**
- **Application Code**
- **Development Environment**

Technology Review *(continued)*

■ Resources

➤ Budget

- » Cap Ex
- » Development
- » Operating
- » Maintenance

➤ Staff

- » External
- » Internal

Technology Review *(continued)*

■ Track Record

➤ Finance

➤ Development

➤ Experience

Technology Review *(continued)*

■ Function

➤ Publish

➤ Interact

➤ Transact

➤ Transform

Technology Review *(continued)*

■ Development Semantics

➤ Pre-alpha

- » A concept in someone's mind

➤ Alpha

- » Works only in development laboratory

➤ Beta

- » Installed in production environment, partial feature/function complete

➤ First Customer Release

- » Debugged, defined feature/function shipping to paying customers

Management Presentation

- **Articulation**
- **Cogent Strategy**

Site Visit

- **Headquarters**
- **Outlets**
- **First Impression**
- **Organizational Culture**

References

- **Management:** **Former employer(s), bosses, peers, direct reports, board members, advisors, competitors, analysts**

- **Customers:** **Current, former, prospective**

- **Company:** **Auditor, legal, bank, investors**

Competitive Analysis

- **Market Share**
- **Mind Share**
- **Momentum**
- **Differentiation**
- **Buyer Motivation - Painkiller or Vitamin?**
- **Sales Cycle**
- **Pricing**

Financial Analysis

- **Actual vs. Plan**
- **Sales Pipeline**
- **Leverage (Operating, Financial)**
- **Competition (Margin, R&D, Distribution, ASP, Corporate)**
- **Valuation**
- **Return (\$, IRR)**

Corporate Review

- **Audit and Management Letter**
- **Legal (Lawsuits, Licensing, Agreements, Distribution Agreements, Employee Agreements, Employee Benefits, Shareholder Agreements, Stock Options, Financing Agreements, Stock Ledger, Customer Contracts, etc.)**
- **Regulatory (Licenses, FDA, Environmental)**
- **Intellectual Property (Patents, Copyrights, Trademarks)**
- **Insurance (Liability, Key Man, D&O, E&O)**
- **Leases (Real Estate, Capital Equipment)**

The Deal

- **Term Sheet**
- **Legal Representation**
- **Document Preparation**
- **Closing**
- **Post-Closing Review**

Tips

■ Dos:

- **Conduct site visits of corporate and regional offices' arrive early**
- **Tour with junior (non-management) staff**
- **Meet with worker bees**
- **See production environment**
- **Ask lots of questions**
- **Obtain prior round business plan (if applicable)**

Tips

■ Don'ts:

- **Mistake development for production**
- **Visit only corporate site and staff**
- **Discuss anything in elevators or bathrooms**
- **Leave your files unattended**
- **Sign the visitor log**
- **Lead the witness**
- **Volunteer competitive information**
- **Breach moral/written obligation of confidentiality**
- **Assume you can structure your way to a good investment**
- **Invest in haste or you can repent at leisure**

Human Capital Assessment Venture Techniques

- **Art Critic**
- **Sponge**
- **Prosecutor**
- **Airline Captain**

Management Orientation

- **Missionary**
- **Mercenary**

Cognitive Traps

- Availability Bias
- Contamination Effect
- Hindsight Bias
- Heuristic Affect
- Induction Problem
- Scope Neglect
- Conjunction Fallacy
- Calibration Overconfidence
- Confirmation Bias
- Bystander Apathy

Source: *The Ascent of Money*, Niall Ferguson