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The pre-seed diligence framework – TechCrunch

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By now it's clear that seed is the new Series A. Seed rounds have tripled in size and companies have been around for 2.4 years before they raise a seed round. A new stage called pre-seed has emerged to fill the gap.

But many in the ecosystem equate investing at pre-seed to buying a lottery ticket. We disagree.

We believe that with the right amount and type of diligence, an investor can build the same amount of conviction pre-traction that you need to make a Series A investment.

Below are three core ways in which conducting diligence is entirely different at this stage (and how founders raising pre-seed should position their company).

Focus on short term versus long term

Conventional wisdom in venture is to invest in companies that are going after large markets and can be worth billions of dollars one day. While we agree that venture returns are based on the power law, we think it's pretty much impossible for founders and investors to truly predict at the pre-seed stage how large a potential outcome the company is capable of.

In its first pitch deck, Airbnb (called AirBed&Breakfast back then) projected that their entire addressable market was 10.6 million trips/year, a meager 0.6 percent of the larger hotel market. No wonder they struggled to raise their first million dollars! Even the founders couldn't have imagined that within a few years they'd pose an existential threat to the entire hotel industry. Airbnb now hosts more than 2 million people each night!

Uber's "pre-seed" pitch deck stated that the entire market for Uber was $4.2 billion. Amazingly, the company is on track to do over $10 billion in net revenue 10 years later (and more than $40 billion in bookings).

So, instead of overly analyzing the market size and how this company can gain large market share, we focus on what the team can achieve in the short term: the next 6-12 months. Typically, the initial market tends to look pretty small, but there is a path to a larger adjacent market. If the company successfully captures the initial market, they can raise more money to go after the larger opportunity.

The question we ask ourselves is simple — can this team get to "first base" and, if so, is this the kind of team that can then figure out how to get to the next base? Once they wedge themselves in the door, do they have what it takes to pry the door open? In our experience, the best investments were in companies that went after seemingly small markets that upon years of incredible execution, eventually ended up owning markets no one could have predicted when they got started.

Product is more important than distribution

While most founders and investors will agree that distribution is just as important as product, we believe that at the pre-traction stage, a thoughtful product strategy trumps an elaborate distribution plan. In fact, we'd go as far as saying that the best pre-seed companies treat distribution as another feature of the product.

For B2B companies, it's important that the "sales cycle" be on the order of days and weeks, not months. Precious time spent getting the product in the hands of the end consumer is time wasted; you are not learning how to make the product better and how to beat your competition.

> The best founders scale and mature as the company takes off.

For B2C companies, it's OK if you acquire your first cohort of users in an unscalable/unrepeatable fashion. Again, the key is how you leverage the initial version of the product to get feedback and have users share it with their friends.

It's important to demonstrate that even though the product is very raw, the need in the market is so huge that end users are willing to jump through hoops to use the product.

It's not clear whether these founders can run a large company one day

Most founders we back are "non-celebrity," i.e. first-time founders or folks that have been acqui-hired before. They can't raise millions of dollars on their resume.

Here are a few traits across most of our founding teams:

- They have never managed a large team
- They have never owned P&L
- This is their first time starting a company
- They don't necessarily have the "larger than life" personality we associate with big company CEOs

You can see why founders that raise "pre-seed" are not an obvious bet for most investors.

Instead of trying to figure out if this team can run a large company, we analyze whether this company can build a super successful "small company" in the short term. And then it's our job to help put executives and advisors around the founders to help scale it to the next phase.

Here's what we look for in our potential founders:

- They understand the market opportunity and use case better than people that have spent years in it
- But at the same time, they have a strong point of view that is contrarian to what incumbents believe
- They have a bias toward small, lean and fast moving teams
- They have already identified the first five hires from their own networks
- They have an insatiable hunger to deliver a product that wows the customer and have a "hacker" mentality to get to early signs of product-market fit
- Growth keeps them up at night, not scale. They know scaling the business only matters if they achieve product-market fit

In our experience, the best founders scale and mature as the company takes off. They are self-aware of the skill gaps on the founding/management team and actively seek talent to backfill. Watching the "Social Network" again reminded me how raw Mark Zuckerberg was when he got started. It'd be hard to imagine just 10 years ago him running a company worth almost $500 billion. But he understood his target audience really well and what it would take to grow the user base as fast as possible.

We think there are great opportunities to invest at every stage — pre-traction or post-traction — but it's important to figure out where you will specialize and then orient the fund around that stage.