Alumni Ventures

Network-Powered Venture Capital

eGUIDE

What's Involved in Performing Diligence?

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What’s Involved in Performing Diligence

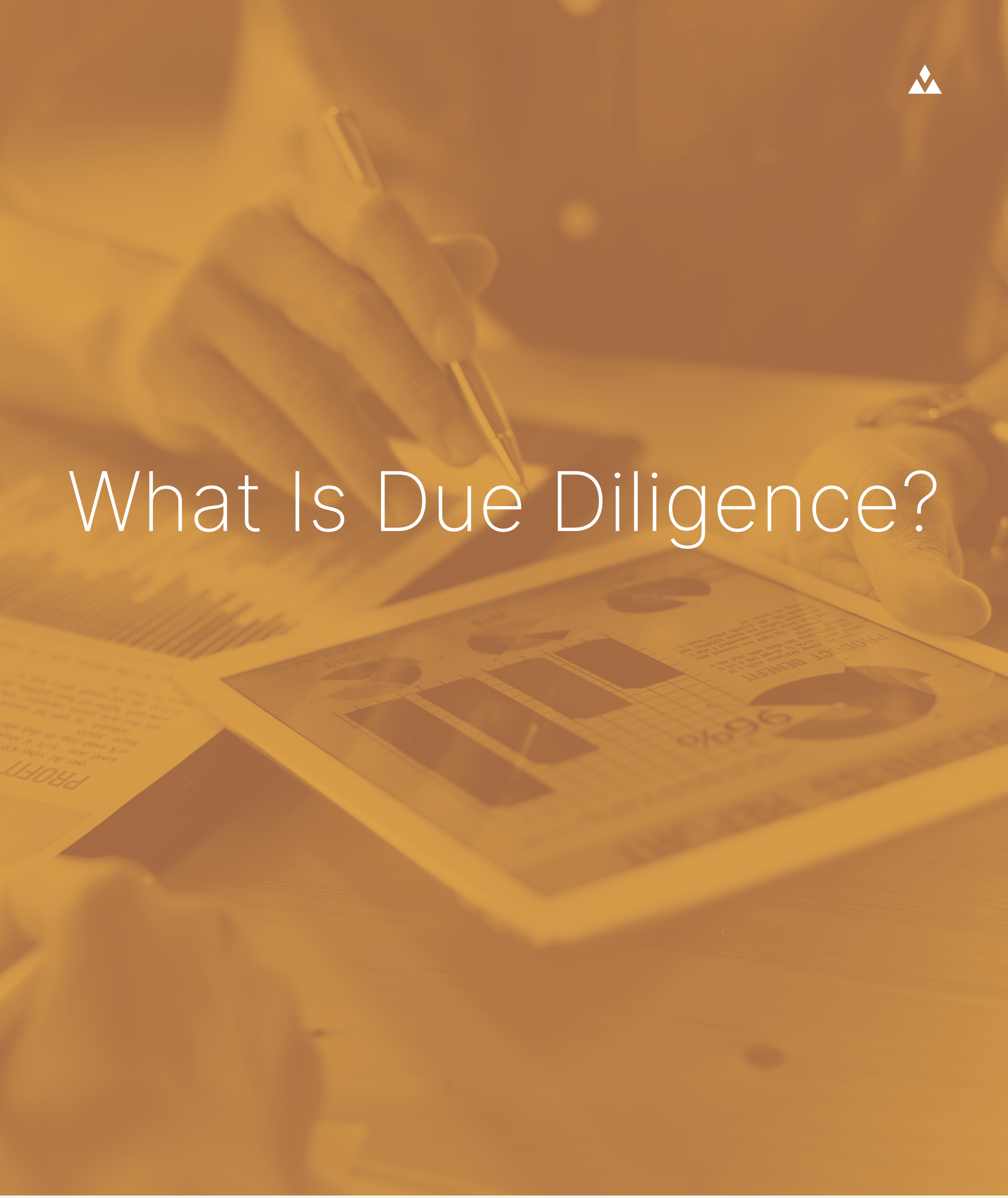
> “Due diligence is a critical part of venture investing.”

Venture firms invested approximately $150 billion across 15,500 deals in 2021.[1] With so many private companies raising capital, how do VCs sift out red flags and potential winners?

Due diligence is a critical part of venture investing, as it helps VCs decipher the quality and potential of different opportunities. VC firms of all sizes perform due diligence on a company before adding it to their portfolio.

In this Venture 101 piece, we will explore the due diligence process: how it is performed, the benefits, and what VCs look for in choosing an investment, followed by a quick summary of Alumni Ventures’ own diligence process.

1 “Value of venture capital investment in the United States from 2006 to 2021,” Statista.com.



What Is Due Diligence?

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The due diligence process involves deeply investigating a company's fundamentals to help unveil the most promising opportunities — often done with the help of a scorecard that touches on different aspects of each company. While diligence techniques may differ between VCs, most reports focus on these key areas:

1. **Market Value**
2. **Product Potential**
3. **Management Team**
4. **Business Model & Investment Opportunity**

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Evaluating Market Value

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Evaluating the market value — also commonly referred to as TAM (Total Addressable Market) — helps determine potential demand for the company's product or service and frames the company's opportunity for growth. While targeting a large, growing TAM is typically a good start, there are also other areas to be addressed, such as:

- **Competitors in the space:** A large market isn't always beneficial if it is already populated with well-established, thriving companies. For example, the online retail market is heavily saturated with top businesses like Amazon, Walmart, etc., making it difficult to compete in that sector.[2]

- **Market need:** A critical question VCs ask when performing diligence on market value is whether the product/service is breaking into a new or old market. If new, is there an unmet customer need? Is the technology easily digestible? If old, what sets the company apart from current competitors (see above)? Evaluating the need is crucial to depicting whether there is space in the market for the business.[3]

- **Early traction and ability for evolution:** Depending on a company's stage, it's helpful to see signs of early success in customer demand and revenue, as well as plans to evolve into different markets and income streams.

Since the market size and sales relate directly to a VC's Return on Investment (ROI), addressing these points is vital in determining company potential.

2 "A Complete Guide to Venture Capital Due Diligence." Going VCResearch, 2020

3 Ibid

Determining Product Potential

Another critical part of the due diligence process is understanding just how revolutionary a company's product or service may be. VCs often decipher product potential by determining if it is easy to understand, solves a real problem, and is a new innovation or offers an original take on an existing product.[4] Even if the market and team are stellar, odds of success are very low without a product or service that checks some of those boxes.

An excellent example of this would be the e-commerce company Alibaba. In 2000, Japanese telecom giant SoftBank invested $20 million for 34% of the company.[5] Alibaba was in a pre-revenue and pre-business model stage when SoftBank's founder Masayoshi Son chose to invest strictly based on the product idea.

Alibaba founder and CEO Jack Ma spoke of his partnership with Son some years later, "We didn't talk about revenue, we didn't even talk about a business model. We just talked about a shared vision."

Son recognized not only the market potential of Alibaba (the Internet was beginning to take off during this time), but also the power of and demand for the product. In 2014, Alibaba sold $22 billion of stock — still the largest IPO on record.

4 Quake Capital, "What VCs Look For In A Great Product." Medium, June 1, 2018

5 "From Alibaba To Zynga: 45 Of The Best VC Bets Of All Time And What We Can Learn From Them." CB Insights, June 9, 2021

The Conviction of the Management Team

> A strong team in the eyes of a VC has an entrepreneurial track record, complementary skill set, and relevant expertise and experience.

The quality of a company's executive team plays a significant role in their success or failure. The main areas VCs consider when analyzing the credibility of a company's team include:

- **Track record:** Building a venture-backed business has its unique challenges, so a CEO with previous exits and entrepreneurial successes is a critical value-add.

- **Credentials and experience:** Many VCs look for teams that have strong credentials, such as a degree or multiple degrees from a well-known college or university, as well as relevant industry experience. Specifically, experience in similar roles at startups and venture-backed companies is highly beneficial.[6]

- **Founder/market fit:** In addition to credentials and experience, company founders must be a good match for the specific problem they're tackling. For example, if the company is looking to sell a SaaS product into enterprises, it would make sense to look for a team experienced in developing and monetizing SaaS products and with a network of potential enterprise customers.[7]

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6 Vandegrift, David. "A Guide to Venture Capital Due Diligence." 4 Degrees, March 28, 2021

7 Ibid

Analyzing the Business Model & Opportunity

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Finding a great company is one level of difficulty; finding a great investment opportunity is a still higher challenge. Even well-established VCs invest in companies that fail, so it is important to identify possible holes in its business model before buying in. This typically involves digging into not only the company's momentum, model, and runway, but the dynamics of the current round such as valuation, terms, co-investors, and cap table. Questions that VCs consider during this part of the diligence process include:

- **What level of traction has the company achieved with its target customers?** Established revenue and existing customers will decrease the risk of the investment.

- **What is the capital going to be used for?** Determining runway is important in knowing how long it will take a company to achieve its goals before raising its next round.

- **Is the price right?** Evaluating terms and valuation vs. market is imperative to ensure a VC is not buying into a company at too high a price and that incentives between management and investors are aligned.

- **Is the company's business model attractive?** VCs look for strong margins and a model that can be scaled relatively easily.

Alumni Ventures' Due Diligence

Alumni Ventures evaluates companies on many of the same metrics. However, as a co-investor, we add an additional layer of diligence. We scrutinize the lead investor in every round we join and work to decipher what makes this firm and specific partner ideal for this stage of this company's growth. Essentially we are interviewing the Board Member who will speak for our shares in the cap table. Additionally, we strongly leverage our network of ~600,000 individuals, seeking experts with relevant backgrounds to further analyze an investment's potential.

Our process is rigorous and disciplined. While we do refine our score-card from time to time, these are the characteristics we evaluate and the relative weight we assign to each:

Category	Metric	Specific Data
Deal (30 points)	Round Composition	New investor leading, past participating
	Valuation	Price vs. market value vs. performance to date
	Investor Rights	Pro rata and informaton rights for Alumni Ventures
	Runaway	How long can company operate given fundraise, existing cash, and projected burn
Lead Investor (30 points)	Firm Quality	Firm expertise at that stage and within that sector
	Conviction	Size and terms of lead investor's check relative to past average
	Lead Partner's Expertise	Partner's relevant investments in sector and stage
Company (40 points)	Customer Demand	Customer adoption or willingness to pay
	Business Model	Unit economics and scalability
	Momentum	Revenue growth and/or profress on industry-specific hurdles
	Capital Efficiency	Progress given amount of capital raised
	Competitive Moats	How defensible (technical, IP, regulatory, network, etc.)
Team (20 points)	CEO	Record of success in similar scenarios, comparable roles
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Bonus (5 points)	Board Composition	Third-party top-performing VC on the Board

A deal must receive a score of 80+ to be added to the Alumni Ventures portfolio.

In addition, we use the wisdom of small crowds to validate our assess-ment. Professionals on our investing teams collaborate with immediate teammates, our Office of Investing, and multiple investment committees to confirm our assessments. This check-and-balance system means that every AV deal goes through the intellectual rigor of multiple experienced eyes scoring the deal. Yet because we are a co-investor, we move quickly and with minimum friction on the entrepreneur.

Final Thoughts

Venture is a Power Law asset, requiring a VC to take multiple swings at bats before hitting a home run with an investment. But practice and good form help too. This is why performing diligence on a company's market value, product potential, management team, business model, and investment opportunity can significantly impact the success of a venture capitalist's portfolio.

Our standards are high — Alumni Ventures reviews over 500 deals a month and only does detailed diligence on about 50. But given our large team of investing professionals, disciplined process, and vast network to source and vet deals, we have been able to to keep to those standards while delivering one of the largest venture portfolios in the world.[7]

7 "The most active investors of 2020." Pitchbook, February 22, 2021

Important Disclosure Information

The manager of the AV Funds is Alumni Ventures, LLC (AV), a venture capital firm. AV and the funds are not affiliated with or endorsed by any college or university. These materials are provided for informational purposes only. Offers of securities are made only to accredited investors pursuant to each fund's offering documents, which describe among other things the risks and fees associated with the Fund that should be considered before investing. The funds are long-term investments that involve a substantial risk of loss, including the loss of all capital invested. Past performance is not indicative of future results. Opportunities to invest in any security (of a Fund, of AV or in a Syndication offering) is not a guarantee that you will be able to invest and are subject to all terms of the specific offering. Diversification cannot ensure a profit or protect against loss in a declining market. It is a strategy used to help mitigate risk.

AV offers smart, simple venture investing to accredited investors. Specifically, AV provides a path for individuals to own an actively managed diversified venture portfolio with a single investment co-investing alongside experienced VC firms. Traditionally, with limited investment capital and contacts, individual investors have had limited access to desirable deals alongside experienced VC firms, and even if they could access one or more such deals, it would take an inordinate amount of time, money and negotiation to build a diversified portfolio. With AV Funds, investors can choose from a number of funds to make a single investment to gain exposure to a diversified portfolio of investments selected by an experienced manager. AV Funds' simple fee mechanism permits investors to avoid constant capital calls throughout the life of the fund as found in other private investment vehicles. Contact info@av.vc for additional information. To see additional risk factors and investment considerations, visit av-funds.com/disclosures.

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