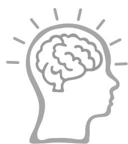
9 Key Questions for Evaluating Venture Stage Investments



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Assessing the risks associated with a venture-stage equity investment is very challenging, particularly if it's not your day job. "Venture" in this case means a business that is not consistently generating positive operating cashflow. "Stage" is a relative assessment (start-up, early, mid, late or pre-IPO) that is in the eye of the beholder - one entrepreneur's later-stage financing might still be viewed as an early-stage investment by an experienced venture investor.

The following provides equity investors with a framework for evaluating different venture investments by:

- Identifying the important risks (the "Leaps of Faith") associated with a venture-stage investment;
- Helping you determine whether you are comfortable taking on the risks inherent to the investment.

Venture investing can generate very attractive returns for investors, as well as the ultimate risk - losing 100% of the investment. Too often, non-professionals commit funds based only on "feelings" or "impressions," when they could be much better informed. Knowing the right questions to ask will help better understand the venture stage you are considering to then decide whether you are comfortable with the associated risks.

After 20+ years of evaluating thousands of venture-stage companies, Carofin has identified what we feel are among the most fundamental considerations for gaining a relative measure of such enterprises. The questions below get to the heart of the venture analysis process and help break it into digestible pieces for further due diligence.

We call this framework the "Nine Leaps of Faith."

1. Has the entrepreneur personally launched a start-up before (successful or otherwise...) – or is this his or her "first rodeo?"
2. Is the product or service an improvement to the current way of doing things, or is it a "disruptive technology?" [1]
3. Do they have a product?
4. What are customer's motivations for buying the product?
5. Do they have customers?
6. Are distribution channels and a sales pipeline in place?
7. Has a management team been assembled?
8. Is the business ready to scale?
9. What is the competition?

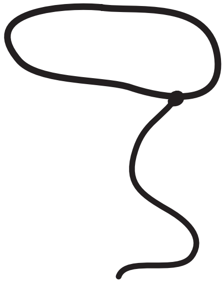
No venture stage investment is riskless; it's about gaining a relative measure of the situation as some risks (no product, no customers) are arguably more challenging than others (e.g., assembling a management team). If you aren't comfortable with the unknowns or unproven aspects, we suggest you consider directing your investment dollars elsewhere or simply "sit on the sidelines" until a better opportunity presents itself. There are a lot of fish in this sea. You don't have to participate in every opportunity, and, in most cases, you will be gratified, in hindsight, by the investments that you didn't make.

As with any type of investment, we also recommend you conduct extensive due diligence *(see "Due Diligence and Investments: What do I really need to know?")* before making any investment.

But if you are ready to consider equity investments in businesses with some (perhaps many) of the risk listed below...leap on!

1 Credit to Clayton Christensen's The Innovator's Dilemma

1 Has the entrepreneur personally launched a start-up before (successful or otherwise…), or is this his or her “first rodeo?”



Entrepreneurship is tough, and successful entrepreneurs are incredibly persistent, creative and flexible - personal traits which can’t be learned in a classroom. Prior corporate success doesn’t necessarily translate, given the relative lack of support for an independent, early stage business.

Not all of us possess these personal traits…in fact, relatively few of us do. Entrepreneurship is appealing when looked at from the outside, and the media tends to cover the more spectacularly successful start-ups and their founders. In reality, entrepreneurship is a constantly challenging, soul-searching, often humbling journey that relatively few people are cut out for.

Prior corporate success doesn’t necessarily translate. Successful corporate managers may have climbed the ladder, reached a high level, and now want to start their own business. However, gone are their assistants, their HR staff, their legal, accounting, and advertising colleagues. It’s now them, in a room they often share with silence.

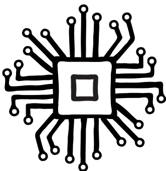
This is also not to suggest that serial entrepreneurs with prior, big-return “exits” are guaranteed to succeed in their next venture. However, like horse racing, picking a winner is more difficult if there isn’t a track record to look at.

RELATED QUESTIONS INCLUDE…

- Have they worked at other venture-stage businesses before?
- How much money have they invested personally in the enterprise?
- Do they have the personal financial wherewithal to last 3-5 years or more without a paycheck?

- Where have they failed before, and what have they learned from past failure(s)?
- Do they look to others for advice? Are they "teachable?"
- If they have come from the more established corporate world, have they been trained in ways that will help them translate their experience into starting a business venture (e.g., academic training, a corporate role focused on initiatives, etc.)

2 Is this product or service a "sustaining technology" (an improvement to the current way of doing things), or is it truly a "disruptive technology?"



"New new things" -- borrowing a term coined by Michael Lewis in his book "The New New Thing" -- are tough to introduce and take much longer than is normally expected to gain a customer foothold, no matter how beneficial they might appear. Human beings generally like their existing "happy place"; it gives them a sense of security - their most dominant instinct. Also, existing infrastructure (supply chain, out-sourced fulfilment, etc.) supporting the status-quo can be highly resistant to change.

If what you are investing in "rocks the world," be prepared for the company to face unexpected challenges convincing customers. Double any timeframe presented as well as the cost of success. When it pertains to customers, this means a longer timeframe to achieve a significant level of sales (see *"Crossing the Chasm"* by Geoffrey Moore) and a higher cost of acquisition per early customer.

Affecting the choices people make isn't easy. Human beings are naturally resistant to change. We all have our "happy place" – a particular make of blue

jeans, the brand of paper towels we use, the toothpaste your mom said was the best – familiarity engenders a sense of security.

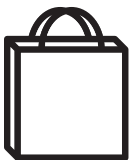
Furthermore, existing infrastructure (supply chain, out-sourced fulfilment, etc.) supporting the status-quo also can be highly resistant to change. A supplier takes a risk adapting (or creating) equipment to produce and process a product for which a consistent demand has not yet been proven.

Products or services which are not disruptive, if well branded, may still lead to a successful venture. Think of all the sneaker companies or soft-drink companies which don't offer a game-changing product. What many do is engage experienced branding partners to set them apart from the competition, creating an identity that ignites brand ambassadors.

RELATED QUESTIONS INCLUDE...

- How great are the benefits delivered to the customer by the product or service?
- Are patents and other intellectual property in place?
- Do customers have a significant investment already committed to their current way of doing things?
- What are the supply chain issues for delivering the product?

3 Do they have a product?



Is there a product ready for sale? If so, is it still at a developmental stage ("alfa"), testing customer use ("beta"), or is it commercially viable and now being regularly used by customers? Are they happy with it?

Many entrepreneurs are really proposing investments in concepts - they haven't yet created something they can actually sell to a customer! Look out for "smoke and mirrors."

Where in the development process does the product/service stand? Is it still in the developmental stage (e.g., still a prototype) or has it been tested

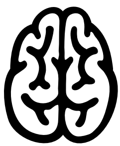
with real customers (but is still evolving) to determine appetite, pricing optimization, design, etc.? A company offering an investment at the developmental stage may be of interest to you, but it should be offering a higher potential return on investment because the risks are so much greater - it is more likely to fail because it is in an earlier stage.

If beyond beta, is it commercially viable and now being regularly used by customers? What percent of customers are repeat purchasers/users? How happy are they with it?

RELATED QUESTIONS INCLUDE...

- What is the per-unit cost to produce, market and sell? Has the company tested pricing points to ensure a viable profit margin that supports growth and time to gain market share?
- Can the business compete successfully against larger, household-name competitors who can undercut their prices on one line of business for an extended period?
- Has the company established a supply chain of third-party vendors, and in what stage are negotiations to ensure deliveries and other support?

What are customers' motivations for buying the product?



Customers' motivations are complicated and evolve over time - they may not be the same as in the past. A management team must be laser-focused upon what's driving the buying decisions within their primary (and secondary) target markets.

Psychology plays a massive role in a customer's purchasing behavior, and consumer products companies take advantage of this. Obviously, this is not news, but any company in which you invest must have a clear understanding of what motivates potential customers to buy their products.

While there are many theories surrounding consumer behavior, and what motivates a potential customer to make a purchase (see consumer decision-making model, behavioral influence model, experiential model, among others), often is a combination of several. To make matters even more complex, the motivation will vary across the customer base, as not everyone buys the same product for the same reasons.

One example:

Teenagers might buy an iPhone because all their friends have one, and he might feel embarrassed to have something different.

Business professionals might buy the same iPhone model because all their work-issued devices are Apple products; the functionality that comes with integrating their personal phone into that same ecosystem is too important to risk purchasing an Android or other non-Apple product.

There are also other customers, as you can imagine, with separate and different motivations and concerns as well. Was the product sustainably produced? Is it more efficient? Is my current product wearing out or obsolete? Each example represents a pool of potential customers that a good marketer targets differently to capture different motivations.

Bottom line…it's critical that a company thoroughly understand what motivates their customers' buying decisions. Otherwise, they are just seeing whether the "spaghetti sticks to the refrigerator" when projecting customer demand.

RELATED QUESTIONS INCLUDE…

- Who is the ultimate customer (the end-user, a consultant, a distributor)?
- How is the buying decision made (unilaterally, the next level of management, by committee)?
- How vulnerable is the customer to making a wrong decision?
- Is this a one-time purchase, or does one sale lead to ongoing sales (such as in the case of consumables)?
- Are existing product purchases being cannibalized, or is this a new purchasing category?

5 Do they have customers?

A venture that has paying customers is at a very different stage than one that doesn't...

A wise man once said, "If you don't have customers, you don't have a company." As noted by Carofin in our other articles and white papers - customers for a new product or service are typically very difficult to generate. Making sales is often the most difficult hurdle for young companies.

Does the company have satisfied customers who "embrace" the product? Have they generated "raving fans," as Kenneth Blanchard noted in his book of the same name, who are loyal to the brand? And is the business attracting a growing audience? Are there repeat customers?

Borrowing from Khalid Saleh in invespcro.com, it costs "five times as much to attract a new customer than to keep an existing one." Building loyalty is critical to a product's (and company's) success, and, yet, most companies allocate a preponderance of their marketing dollars to customer acquisition, rather than measuring and extending the "Customer Lifetime Value."[2] Does this company focus on customer retention?

RELATED QUESTIONS INCLUDE...

- What is the cost of acquisition, or, stated differently, how much did it cost to make those sales?
- How do they reach their customers – are sales made directly by the company or through a channel strategy, where a third party makes the sale (e.g., retailers, system integrators, other service providers)?
- What is the customer concentration?

2. Customer Acquisition vs. Retention Costs, Khalid Saleh, invespcro.com

6 Are there active distribution channels and a sales pipeline in place?

How advanced is the sales pipeline, and how well understood is the customer acquisition process? FYI… corporate customers are "employees," extremely risk averse and resistant to change (they prioritize keeping their jobs).

Actively managing a sales pipeline is critical to any business, particularly at earlier stages when products are "sold" to customers, not "bought" by them. Most successful entrepreneurs aren't just visionaries or strong managers, they are also effective salesmen who are myopically focused on "closure."

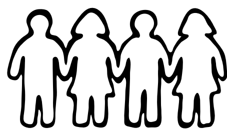
A sales pipeline should not only specify potential customers and/or sales channels (like retailers for a consumer product), but it should specify the sales potential while "risk weighting" the likelihood of realizing those sales. As a rule of thumb, if the visible pipeline of risk-weighted sales isn't at least 2 times the projected sales (more is better!), sales projections will probably fall short. Entrepreneurs are inherently optimistic – most customers aren't.

How deep is their sales pipeline by channel? Can they see sales beyond six months? How long does it take to close a sale, what is the customer acquisition cost, and how long before they capture revenues?

RELATED QUESTIONS INCLUDE…

- Does the entrepreneur have any experience managing a sales pipeline process?
- What are the economics underlying a channel partner's motivation to sell the product – are they sufficiently motivated?
- What is the balance of a company's direct sales versus channel partner sales?
- Are sales conducted online (see Carofin's white paper on Demand Generation Marketing), or are other, more effective, traditional distribution channels — brick and mortar, events and conventions, distribution agents, etc.?

7 Has a management team been assembled?



One person can't do it all. Has a capable team been assembled (Sales, Marketing, Operations, Finance, HR, etc.), and is the entrepreneur a good leader and manager? Are people loyal to her/him?

History is replete with famous—even eccentric—successful entrepreneurs (e.g., Steve Jobs). However, the great ones also have the capacity to motivate others to do their best, to make great personal sacrifices for the company and to stay the course during tough times (again, Steve Jobs).

Ultimately, a full management team is needed, and they must "salute the flag" and pull in the same direction. The entrepreneur must have the personal qualities needed to make this happen at least until the company has reached a level of financial stability when a move to professional management in the CEO position may be required.

Very few entrepreneurs possess the ability to take a company from start-up to a multi-$billion enterprise (e.g., Bill Gates). Candid conversations regarding succession should be a part of the investment analysis process.

RELATED QUESTIONS INCLUDE...

- Does the entrepreneur's ego allow for contribution and contradiction by others?
- Based upon experience, where is the entrepreneur most qualified to contribute (technology development, sales, financial management, etc.)?
- What is the entrepreneur's most challenged skill set (it's often financial management)? If self-aware, he or she should be cognizant of weaknesses and be willing to hire qualified staff to answer those demands.
- What's missing in management's capabilities? (Don't forget to look for adequate financial management that has a strong voice in planning and budget management!)

- Are others in the company adequately compensated or otherwise motivated for the career risk they are taking? Has enough equity in the business been allocated for senior management and other key employees?
- Does the business have a "cash culture" (compensation is primarily salary and cash bonus-based), or, as suggested in the above question, is it an "equity culture" (stock options broadly allocated)?

8 Is the business ready to scale?

Anyone can create an Excel spreadsheet projecting growth. What are the practical realities of growing 10x, 100x, 1000x?

All too often, the relatively mundane is ignored during the analysis process—the unexpected "snakes in the grass" often seriously derail business growth.

In general, businesses which are manufacturing a physical product are much more challenging to scale. This is, in part, because they are often more dependent on third-party vendors, supply-chain reliability and logistics (i.e., transportation). You probably won't be able to uncover everything that will challenge the company over time, but by asking the right questions, you will at least begin to see how much planning the company has put behind delivering its product in higher volumes—and its contingency planning.

In service businesses, it often hinges on finding enough people with adequate skills. With the current low level of unemployment in the U.S. and the aging of societies worldwide, staffing is increasingly a challenge, particularly for lower-wage positions. Look for potential technology applications by the company, such as artificial intelligence, which reduce the need for a linear growth in headcount.

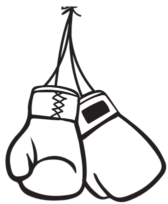
Beyond having an adequate sales pipeline, good suppliers, sufficient customers, good management, strong financial controls and a well established logistics process, the question of how fast to scale is an

important consideration. Growing beyond available resources, both internal and with partners, can frustrate buyers and lower customer satisfaction ratings, lose distribution channels and, ultimately, induce failure.

RELATED QUESTIONS INCLUDE...

- Has the entrepreneur scaled a business in the same industry before?
- Has anyone on the management team scaled a business in a related industry before?
- What is the critical path in product delivery, and how vulnerable are points along that path to disruption?

9 What is the competition?



Are there other businesses vying for the same sale and/or aggressively protecting their turf? Competition can be other businesses or the status quo - currently familiar processes (again, a person's "happy place" or what they feel good doing now).

The good news about competition (yes...there is good news) is that you have more businesses educating customers on the buying opportunity. The bad news is that the company must convince customers that their product or service is better than the others.

You should be a bit paranoid if the company can't readily identify competitors...it's a big world, and there's almost always someone else seeing the same business opportunity and trying to realize on it.

If direct competitors are not identified, be prepared for a long customer education process – in other words, a high customer acquisition cost. As noted above, most target customers tend to cling to familiar purchasing patterns, whether as a part of their lifestyle or in business. With a "new, new thing," familiarity may be your toughest "competitor."

RELATED QUESTIONS INCLUDE…

- Has the entrepreneur ever competed in business?
- Is "coopetition" a consideration (collaboration between business competitors, in the hope of mutually beneficial results).
- Again, what drives the customer's purchase decision (price, value-add, relationship, etc.) and how does this company's product compare to others?
- How is the company going to play in the ecosystem? Will its product complement other related, but not identical, companies' services, or will it supplant and fight for a slice of the same pie?

Conclusion

The above may seem a bit overwhelming – it should... Venture investment is, arguably, the type of investment with the highest risk, and a total loss on some investment is commonplace, if not inevitable.

While this white paper addresses investment analysis in individual businesses, venture investment should be done on a portfolio basis wherein numerous (6+) smaller investments are made – none of which individually or in the aggregate represents “betting the farm” by the investor. An appropriate venture capital investment allocation should be expected to deliver to the investor a compelling blended return where the winners balance out the losers.

Defining where you want to play is important. Some investors crave the heart-pounding excitement of a company in the early developmental stage. Other investors look to make bets in companies already producing products and with revenues poised to grow much further. Both represent risks, but not all risks are equal. A company that has product(s) and customers is usually a safer bet than one that doesn’t.

There's much more to the corporate analysis than the above. For other guidelines to help you in this progress, please look at Carofin's Knowledge Base:

WHITE PAPERS ON BASIC COMPANY ANALYSIS:

Primary Investment Considerations (or First Principles)

Seven Key Questions for Evaluating a Private Company

FOR DUE DILIGENCE SUPPORT, SEE THE FOLLOWING ARTICLES:

Due Diligence for Private Business Investment Opportunities

"Due Diligence" and Investments: What do I Really Need to Know

We hope the above helps investors weigh the relative merits of each venture-stage investment they consider and allows them to make more informed choices.

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Nine Leaps Worksheet

(FOR USE FOR EVALUATION)

Leap of Faith

	Yes/No/ "Kind-of"
1. Is this the entrepreneur's "first rodeo"?	
Entrepreneurship is tough, and successful entrepreneurs are incredibly persistent, creative and flexible - personal traits which can't be learned in a classroom. Prior corporate success doesn't necessarily translate, given the relative lack of support for an independent, early stage business.	
2. Is the product/service a "disruptive technology?"	
"New new things" are tough to introduce and take much longer than is normally expected to gain a foothold, no matter how beneficial they might appear. Human beings generally like their existing "happy place"; it gives them a sense of security - their most dominant desire. Also, existing infrastructure (supply chain, out-sourced fulfilment, etc.) supporting the status-quo technology can be highly resistant to change.	
3. Do they have a product?	
Is there a product? If so, is it still at a developmental stage, testing customer use ("beta"), or is it commercially viable and now being regularly used by customers (are they happy with it?).	
4. Do they understand customers' motivations?	
Understanding customers' motivations is complex. What drives customers' buying choices today may not be the same as it was in the past. If consistently focused upon what need their product or service meets, that management team is more likely to succeed.	
5. Do they have customers?	
If there are happy customers, the business is on its way to becoming a company; if there aren't any, it's still a concept...	

6. Are there active distribution channels and a sales pipeline in place?	
How advanced is the sales pipeline, and how well understood is the customer acquisition process? FYI...corporate customers are "employees," extremely risk-averse and resistant to change (they want to keep their jobs).	
7. Has a management team been assembled?	
One person can't do it all. Is a capable team assembled (Sales, Marketing, Operations, Finance, HR, etc.), and is the entrepreneur a good leader and manager? Are people loyal to her/him?	
8. Is the business ready to scale?	
Anyone can create an Excel spreadsheet projecting growth. What are the practical realities of growing 10x, 100x, 1000x?	
9. What is the competition?	
Are there other businesses vying for the same sale and/or aggressively protecting their turf? Competition can be other businesses or the status quo - currently familiar processes (again, a person's "happy place," what they feel good doing now).	

Notes