Startup investment memo.

The purpose of this article.
The two-fold purpose of this article is to:
1) Provide an investment memo template for a startup investor, investment fund, or angel group.
2) Enable early stage startups to understand how they will be assessed.

This article is linked to “Due diligence questions for an early stage startup”[1]

There are three phases to an early stage startup.
Startup
1) A startup is a temporary organization designed to search out a repeatable and scalable business model. Lots of learning experiments are carried out. The focus is on getting some delighted cash paying customers.
2) A business model describes how a company creates value for itself while delivering products or services to customers. What are you building and for whom? What urgent problems and needs are you solving?

Preparing to scale
The startup believes it has a business model which can meet the needs of a large number of cash paying customers. The focus shifts to putting in place cost-efficient and easily scalable technology, processes, and talent.

Scaling
The focus shifts to growing the:
1) Geographies.
2) marketing, sales, delivery resources and activities.
3) channels and distribution partners.
4) Customer segments.

The purpose of the Investment Memo .
Recommend whether or not the investment is appropriate to proceed to the term sheet stage. The Investment Memo is based on:
1) The answers from the early stage company to the due diligence questions.
2) Additional facts gathered from third party questions.
3) Analysis of the collected facts.
4) Investor judgement, based on a variety of criteria.

In an early stage fund, the investment memo is presented to the partners to explain why the investment should be made, or not made.

The investor will have used simple criteria to quickly filter out early stage companies before devoting time in due diligence E.g.
1) After spending less than 5 minutes reading an emailed application.
2) After a 15-minute phone call or meeting.
3) After listening to a pitch at an event.

A deal-killer recommendation.
Each investment fund will have some deal-killer criteria. If the startup-meets any one of these criteria, there is no deal. The deal-killer criteria vary by fund. E.g. market size is too small, founders are not trust-worthy, no potential customer interviews or surveys, etc. Deal-killer criteria could include not answering, or unable to answer, critical due diligence questions.
In this situation, the investment memo only one-page long.

Investment Memo with no deal killers – the process.

The detailed structure of the Investment Memo follows the structure of the due diligence questions for the startup.

For each question, indicate whether the questions were answered, whether or not there are any issues, and what validation was done. Validation can include: talking with 3rd party experts, doing independent primary and secondary research, preparing analysis separate from that summited by the startup. I’ll indicate below some possible approaches to validation in each section of the investment memo.

There is a one-summary, which includes the recommendation. Each section in the summary has 1-2 lines.

Recommendation: either proceed to a term sheet OR recommend not to proceed with the reasons why.

Each of the six sections in the one-page summary also contains: recommendation: yes or no and why, plus any critical read flags

1) How does the company create value for customers and itself?
2) What are the plans?
3) Investor specific
4) What is being asked of the investor?
5) Legal documents
6) Historical results.

Detailed report

Each section of the detailed report starts with the summary information from the one-page summary.
Each section/subsection of the report contains:
1) Indication of whether or not the due diligence question was answered
2) Indication of whether the answer was a "pass" or "fail".
3) Any red flags.
4) Any input from third party experts.
5) Any input from the investors primary and secondary research.
6) Any results from the actions noted below.

#1 How does the company create value for customers and itself
Target Customers
1) Interview potential and current customers.
2) Assess market size determination (TAM, SAM, and SOM) and review sources cited.
Value proposition
1) Review some or all interview notes from potential or current customers.
2) Review some or all survey responses from potential or current customers.
3) Review analysis of interview notes and survey responses.
4) Interview potential and current customers
Channels
1) Review some or all interview notes from potential or current customers.
2) Review some or all survey responses from potential or current customers.
3) Review analysis of interview notes and survey responses.
4) Interview potential and current customers regarding their expectations.
5) Review detailed financial information to validate appropriate allocation of costs & revenue to: CAC (Customer Acquisition Costs) and calculation of LTV (Life Time Value)
6) Review calculation of the churn rate.
Key Partners
1) Interview current and potential partners.
Key resources
1) If patents, check with patent offices
2) If trademarks, run a trade mark check
3) If contracts, call third parties to validate
4) Have all required resources been identified?
Key Activities
1) Have all required activities been identified?
Cost structure
1) Assess whether the cost-drivers are in fact cost-drivers.
Charging customers
7) Review some or all interview notes from potential or current customers regarding value and pricing.
8) Review some or all survey responses from potential or current customers regarding value and pricing.
9) Review analysis of interview notes and survey responses regarding value and pricing.
10) Interview potential and current customers regarding their expectations regarding value and pricing.

11) What are competitors or similar companies charging?

Talent

1) Assess team bios for relevant skills and experience
2) Run a background check on the team.
3) Are the founders emotional or irrational under pressure?
4) Do the founders have empathy?
5) Are the founders unable to clearly and easily communicate their pitch.
6) Are the founders arrogant or overconfident?
7) Are the founders transparent and honest?
8) Are the founders fully committed or is this a part time effort?

#2 What are the plans?

1) Does the 24-month Gantt chart reflect the key milestones?
2) Is the 24-month Gantt chart plausible?
3) Review the detailed allocation of costs and revenues to validate the calculation of LTV and CAC.
4) How does the LTV to CAC ratio change in the cash flow forecast? How does it vary by customer segment, channel, and partner?

#3 Investor specific

1) Are the presentation decks (oral and standalone) consistent with the rest of the due diligence material.
2) What are the issues with the current and forecast cap table? Do the founders have enough equity.
3) What are the options for an investor exit?
4) How long has the fundraising round been open, what's been committed, by whom?
5) Who is the lead investor and what is their reputation?
6) Are previous investors following on? If not, why not?

#4 What is being asked of the investor?

1) What are the issues regarding terms and valuation?

#5 Legal documents

1) Who has the legal right to make what kinds of decisions under what conditions? Review loan agreements, voting trust agreements, shareholder agreements, board of directors and committee mandate, delegation of authority to CEO, etc.

#6 Historical results

By target segment, by channel, by partner, by cohort.

1) Monthly growth rate in number of cash paying customers, and revenue.
2) New customer value achievement leading indicator (e.g. for Slack it was 2,000 team messages sent within 60 days).
3) New customer success metric (e.g. % of new customers achieving new customer value achievement indicator within 60-90 days).
4) NPS (Net Promoter Score)
5) How many similar competitors have failed in the past? Why? How is this startup different?

Next steps

Regardless of what type of investor you are:

1) Prepare your list of deal-killer criteria and deal-killer unanswered questions.
2) Prepare a one-page investment memo.
3) Customize the due diligence questions and due diligence report to reflect the specific nature of investor and the nature of the investment. The due diligence questions, due diligence report, due diligence cost and time invested will be very different for an angle investor contemplating a $25,000 investment in a pre-revenue company vs an investment funding contemplating a $10 million investment in a company that is scaling.

Footnotes:

[1] Due diligence questions for an early stage startup: http://koorandassociates.org/selling-a-company-or-raising-capital/due-diligence-questions-for-an-early-stage-startup/

Further Reading

Definition of startup terminology and metrics: http://koorandassociates.org/selling-a-company-or-raising-capital/startup-terminology-and-metrics/

Red flags for any investor to consider: https://medium.com/swlh/red-flag-list-for-vc-deals-9beea446270d