

A guide to help evaluate Early Stage investments

This booklet is based on the investment guidelines followed by Sophia Business Angels (SBA), an international club of business angels based in Sophia Antipolis, France. SBA has invested 15m euros in over 30 companies since 2005.

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I. Investment Principles & Guidelines

1. Investment Background

It is important to consider the background of the investors and what their investment objectives are. Private equity investments are considerably more risky than quoted shares and are only suitable as part of a balanced portfolio, including some less risky investments. Businesses funded by private equity tend to be early stage and may not yet have established sales traction in their market place. Worst case, the entire investment could be lost, so no money should be invested in private equity unless a total loss can be contemplated without serious consequences for the investor.

Also important is whether the investor is willing to offer his experience, his contacts and some of his time to help the company in which he is investing. Many experienced private equity investors will only invest in businesses where they are involved.

Beware of investing simply to benefit from tax breaks. Whilst these can be appealing and can improve the final return on investment, they should never replace a careful investment analysis. A good or bad investment decision is unlikely to change its outcome as a result of a tax benefit.

2. Investment principles

The general principle of private equity is of investing for long term capital of growth and accepting a medium level of risk in order to achieve higher returns. One should not be afraid of some smaller investments failing but one should try and focus on post-revenue businesses which have the potential to grow rapidly and exit at high valuations. For example an investment target could be to deliver an Internal Rate of Return of at least 20% which would return 3 x the original investment after 6 years.

It is highly unlikely that any dividends or return of capital will be paid for several years so the investor must be prepared for his money to be tied up long term. Often no return is achieved until the business is sold, so it is important that the majority of shareholders are aligned in their exit objectives. Moreover many early stage businesses require additional funding rounds before they reach cash break-even. An early investor must be prepared to provide additional funding to protect their percentage holding, or to accept dilution from subsequent rounds.

Bank debt is scarce these days, so private equity is often required to fund working capital once sales growth is established. So there is a risk of further dilution even in successful growing companies.

The stage of development of the company will have an important effect on the risk: reward profile. First round funding is typically provided by friends and family and is used to develop the product or service to the point of commercial exploitation. The chances of a successful business emerging are lower at this early stage, but the potential rewards are much higher as the valuation will be lower.

As a company achieves sales and establishes its market, takes on staff and refines its product and pricing, the risk diminishes. However the entry price for an established business with repeat sales from multiple clients will be considerably higher. This second or third round funding is often undertaken by business angels, either individually or through co-investment as part of a club or syndicate of investors.

Thereafter investment could come from private equity firms, VCTs or trading partners.

3. Portfolio structure

A portfolio of several different private equity investments is less risky than one single investment. However the larger the portfolio, the less easy it is to remain in touch with each company to follow how your money is being utilised.

For later stage investments one should focus on companies seeking funding rounds of 1m € or more, which is not traditional business angel investing. At this level, companies should be post revenues with a proven business model, reducing the risk of failure, but with a higher entry price and a lower prospective return on investment.

In addition one could invest into a portfolio of earlier stage companies (including pre-revenue, but not start-ups or incubator deals). This would increase the chances of finding a big winner, with relatively little additional risk. For these younger companies the investment decision would depend heavily on the investor's personal conviction regarding their prospects and ability to deliver.

There should be no limitations on industry sectors but one should try and invest in sectors where one has some experience.

4. Investment guidelines and process.

4.1. Information to be supplied

To be considered for investment, companies must be able supply the following information:

- Full business plan and investment case (Information memorandum if available).
- Historic Profit & Loss accounts and current or recent balance sheet.
- Future projections for at least 3 years (profit and cash flow).
- Executive Summary sheet.

4.2. Investment criteria

To qualify for investment, established companies should comply with the following criteria and will be judged against them when advisors decide:

- Ideally be in a sector where the investor or his contacts have expertise.
- Have existing sales revenue or strong evidence of customer demand.
- Have a prototype, website, patent or other evidence of product/service in development.
- Be capable of scaling up their operations efficiently to facilitate profitable growth over a relatively short timescale.
- After the planned investment, to be able to achieve their business plan without further investment for at least 12 months (without jeopardising their long term objectives).
- Have an identifiable exit route after 5 years.
- Have the potential to deliver 10 times the original investment within 6 years if earlier stage and higher risk; 5 times the original investment if more mature and lower risk.

Earlier stage companies should be judged against the following criteria:

They would be investible if:

- There is access to expertise about the area of activity.
- Full time CEO with relevant mix of talent in the management team to scale the company and drive the business plan for success.
- Clear market differentiation (value proposition).
- Clear and realistic 'go to market' /sales strategy.
- Risk mitigation plan well-articulated / available.
- Potential for growth and profit well identified.

They would be rejected if

- Capital intensive area without lead investor at the time of any other investor (i.e. the first or only confirmed investor).
- Lack of Leadership and vision from CEO and/or Management team.
- Outside of scope of Investment (strategic vertical segments).
- No clear competition analysis or understanding.
- Lack of scalability of the existing team.

4.4. Score card

One idea for evaluating potential investments is to develop a score card. All potential investments can be scored on relevant aspects and a total score derived. Only those investments in the 'green' range (e.g. above 75%) will generally be progressed. Exceptionally, those at the high end of 'amber' (e.g. 50-75%) may be progressed if their weaknesses can be addressed and the opportunity is very appealing.

An example of such a score sheet is shown in Section II.

4.5. Sponsor principle

As a business angel club, SBA insists that potential investments must be 'sponsored' by a member of club. The sponsor will typically have experience in the sector and will challenge the management team in order to test the assumptions and ensure the business plan is robust. Most sponsors will already know the company and the management team and will have worked with them for some time to prepare them for investment.

The sponsor must agree to invest in the project. The sponsor will represent the company to the advisory board and assist with the provision of Due Diligence documentation. Due Diligence itself will be carried out by someone other than the sponsor to ensure an objective, independent review.

After investment, the sponsor will continue to work with the company as a director or advisor to review strategy, monitor performance and mentor the management team. This will be on terms to be negotiated with the company, subject to the minimum fees/terms specified in the Investment Agreement.

4.6. Percentage shareholding

It is important to consider what percentage of a company's equity your investment will represent. A large investment in an early stage company may result in a high percentage of the equity, giving you rights to call general meetings, block certain actions by management, even force a sale. If these rights are important to you, then remember that they may disappear if you are unable to maintain your percentage holding after subsequent funding rounds.

4.7. Co-investment

Co-investment should be actively encouraged from other investors and corporate partners to further increase the chances of success.

4.8. Negotiation of terms

Depending on the size of the investment, the investment agreement should include the following terms:

- The right to appoint (and subsequently change) a director to the board (or alternatively an advisor/consultant) to represent your investment, including minimum fees to be paid by the company and minimum input expected from the sponsor.
- A requirement to hold at least 4 board meetings per year.
- A mechanism to match the price of any subsequent funds raised below the price paid by the investor within 12 months of our subscription date. (down round protection)
- An obligation to report every six months in a format prescribed (including financial statements) and to provide an annual budget. This to include the right to impose external resources on the company (at their expense) if they are unable to achieve the necessary standard of reporting with internal resources.
- Formal commitment from the founder(s) and majority shareholders to create an exit after 5 years if not before (best endeavours).
- Drag-along clause to ensure a clean exit with a majority vote.
- Tag-along clause to enable minority shareholders to exit if a majority of shareholders so decide.
- Equal voting rights to all other investors.

- the requirement to pay a fee on the capital raised (for example, to cover external due diligence costs) or for the company to fund such costs directly.
- Warranties from the company that the information they have provided is accurate, complete in all material areas and not misleading.

In the event of disagreements over valuations, one can utilise a ratchet mechanism to issue further shares at nominal value if performance does not achieve pre-set targets. The same mechanism can be used as a penalty in the event of default on post-completion conditions or breaches of warranties.

It is also worth asking for some form of priority on exit, such that you receive back your investment before the founders receive any proceeds. This covers the negative scenario where the company fails or has to be sold for less than you paid at the time of investment.

For particularly risky investments such as rescue finance, an exit priority of a multiple of your investment may be appropriate, e.g. you get 2x your investment back before the founders receive any return.

Such mechanisms can be implemented through different classes of preference shares or through convertible (discounted) loan notes. These will have important tax implications so it is important to take professional advice.

Finally, if you feel strongly about how your investment should be spent, you can add the necessary clause about 'use of funds' to ensure the company uses your money how you wish.

4.9. Due Diligence

You will have to decide what level of due diligence is appropriate for each company, taking into account its stage of development, your connection with the company and its management and other relevant factors.

The individual carrying out the due diligence should follow the due diligence guidelines later in this leaflet. These documents should be submitted to the company in advance to enable documentation to be collated and their responses prepared.

Due diligence should be carried out by someone other than the investor, to provide an independent assessment of the company's prospects.

When necessary, independent verification may be sought from outside parties at the company's expense.

4.10. Final investment decision

The final decision to invest rests with you. Don't feel obliged to continue if you are uncomfortable with the information you have received. It is common for early stage companies to become reliant on one or more potential investors and to pressurise them to conclude a deal, citing dire consequences if investment is not received.

Keep cool and detached and make a rational decision, ideally with your head rather than your heart. Be cautious about investing in businesses run by close friends – it will be much more difficult to walk away if you decide not to proceed.

II. Score sheet

Company Information	Name of the company	
	Name of the contact ("key-man" of the project)	
	Location (City, Country)	

		Risk	How to mitigate the risk
Key Risks	<ul style="list-style-type: none"> ▪ Technical – system integration issues, engineering requirements, etc; ▪ Resources – lack of resource availability, lack of required skills, location of work, etc; ▪ Commercial – pricing issues, profitability, milestone / payment issues, withholding tax, etc; ▪ Legal – contractual terms and conditions (e.g. liability, warranty), partners, NDAs, etc; ▪ Partners – who primes, division of work, conflict of interests, etc" 		

Additional Opportunities	Advice on weak parts of the BP...	

Opportunity Qualification Scorecard

		Enter X in relevant box						Please answer to ALL the questions: if you do not have the information, choose the negative answer (NO/WEAK/SMALL ...) and enter your comment here:
TECHNOLOGY / PRODUCT	SCORE	1	2	3	4	5		No information:
1. Intellectual property based or entry barriers	WEAK						STRONG	
2. Stage of development	IDEA						PRODUCT	
3. Does it respond to a need? Is it user driven?	NO						YES	
4. Proven technology	NO						YES	
		0						
MARKET	SCORE	1	2	3	4	5		
5. Size of market / Relevance to a niche market	SMALL						BIG	
6. Competition	STRONG						WEAK	
7. Marketing and sales plan	POOR						GOOD	
8. Is there a first sale?	NO						YES	
9. Time to market	BAD						GOOD	
		0						
TEAM	SCORE	1	2	3	4	5		
10. Is the team effective / in place?	NO						YES	
11. Quality, experience of the team	POOR						EXCELLENT	
12. Is the team well balanced?	NO						YES	
13. Is the team adapted to the project in term of size?	NO						YES	
		0						
FINANCIAL PROJECTIONS	SCORE	1	2	3	4	5		
14. Clear business model?	NO						YES	
15. Is the financial	NO						YES	

content complete?								
16. Are the figures realistic?	NO						YES	
17. Are the needs justified?	NO						YES	

0

OVERALL QUALITY OF THE BUSINESS PLAN	SCORE	1	2	3	4	5		
18. Are all elements in the BP? Is it complete?	NO						YES	
19. Good balance between all the elements?	NO						YES	
20. General feeling?	POOR						EXCELLENT	

0

OVERALL SCORE	0
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GREEN = 75+

AMBER = 50 – 75

RED = 50 and below

III. Due Diligence Guidelines

Introduction

Due Diligence is an important stage in the investment decision process. It is realistically the last chance to spot that a potential investment has major problems and that you should not proceed. Alternatively the due diligence might identify serious weaknesses in the business, leading to conditions on the investment to deal with these.

Due Diligence in the Investment Process

Due diligence will be carried out on target investee companies where an agreement to invest exists in principle. The degree of due diligence required should reflect work that may already have been carried out:

Full A full investigation into all aspects of the company operation

Update For companies where other trusted parties have already carried out due diligence, or are already working with the company, the due diligence will be limited to issues around the business plan for the new funding round.

Nominate an individual to lead the due diligence (hereafter referred to as the "Investigator"). This person should be somebody different from the sponsor/introducer, the idea being that the due diligence is an independent review.

The output of the due diligence will be a report to the investor(s) with recommendations, together with the copies of the complete set of documents from the Investee Company. It is possible further expert analysis will be requested by the person leading the due diligence.

A template for the report is provided in Section V, describing the areas to cover.

Due Diligence Objectives

The due diligence exercise is intended to

- Ensure that the information provided is actually true.
- Find out any additional information the investors should have been told, but were not.
- Probe into the assumptions in the business plan, to check they are valid and realistic.
- Identify the principal risks to the business and if there is a plan to address them.
- Conduct a more detailed analysis of the current state of the company – e.g. maturity of technology, strength of the sales pipeline, detail of agreements etc.
- Further analyse the competitive environment and the place of the investee company within it.

In addition to these points, the aim is also to get a subjective "feel" of the company – is there a good impression when you walk in the door, do people seem to be working hard and focussed, or is it a mess.

Due Diligence Conduct

Due diligence is normally expected to involve ~1 day's visit to the company's principle site, questioning the CEO/Founder and other senior managers on various aspects of their business, and examining records and documentation. The time required may be more or less depending on the complexity of the business and the length of its trading history.

Prior to the visit, the evaluator must make sure they are familiar with the company, its business plan and the material provided to the investors when they made their decision.

In addition to the visit, the evaluator may also need to research the company's competitors and customers.

The evaluator must question the management hard, always seeking as much hard fact and detail as possible. To give some examples:-

If technology is being patented

- What is being patented
- What stage are they at
- What evidence do they have that the patent is applicable
- Who are they using to do lodge the patent
- Can we talk to them, contact details?

If they have for example, a "global agreement with Orange"

- What does the agreement cover
- Is it exclusive, or if not how many other companies have similar agreements?
- Can it be cancelled, and if so under what terms
- What money changes hands and when
- What activity has happened under this agreement to date?

IV. Project Evaluation Checklist for Investments

Company Name:

Evaluator Name:

Task	Date done	By whom	Output
Make contact with introducer.			
Make contact with company (via introducer) and explain role evaluating for Advisors (A). (Talk through the items in this list to explain role).			Contact point established between company & Advisors (A)
Initial assessment to confirm suitability and conformance with investment. See Appendix for checklist.			OK to proceed with full evaluation
Confirm documentation complete. To include Exec Summary, full Business Plan, financial results + 3 years future projections, Info Memorandum or investment proposal. Confirm with Introducer that all documentation is the latest version.			
Complete score card evaluation.			If <75% consider rejecting. Proceed to next step only if scorecard indicates potential to invest.
Carry out commercial assessment (speak to introducer, company, assess product/technology, 'go to market' strategy, management team, research competition, ask others who know sector, test assumptions, valuation, co-investors, etc. Sensitise business plan to realistic numbers).			One or two page report recommending whether to invest or not (subject to Due Diligence & negotiation). Assessment of proposed valuation. Scorecard to be finalised and circulated If recommending NOT to invest, share feedback with Introducer to get their response before circulating report + their response to A members.
DECISION POINT 1		A	Proceed or not to next stage. Valuation guidance.
Ensure Company has planned AGM to approve capital increase, if required. Request 5-year financial projections for valuation.			Send recommended email to company.

Prepare short briefing note on valuation & proposed conditions.			
Arrange meeting or conference call with colleagues to discuss valuation and conditions.			Recommended valuation to be negotiated with company. Conditions to be included in investment agreement.
Complete draft Term Sheet and send to company. Explain terms required.			
Contact any co-investors to coordinate negotiations, Due Diligence (DD) and timing.			
Negotiate valuation and terms as required. Update Term sheet accordingly.			
DECISION POINT 2		Value	Agreed potential deal subject to contract, fund raising & DD
Assign due diligence (rely on co-investors, appoint someone else, or do personally?).			
Send DD template to company to pre-complete in advance (in practice this can be sent earlier to save time).			File of hard copies of all documentation to be provided by company to evaluator.
Complete financial analysis table to calculate projected investment returns.			Estimated return on investment.
Arrange visit to company.			Answers to questions DD Template to be completed. DD file handed over with all requested documents.
Carry out DD visit & write report.			Written report & recommendation to A, highlighting any points of concern.
DECISION POINT 3		A	Review Due Diligence. Proceed to contract or not? Amount & valuation confirmed.
Send Term Sheet to the lawyer to draw up Investment Agreement.			
Confirm who will be nominated to board to represent the investor.		A	
Obtain bank account for funds transfer.			
Schedule and attend closing meeting.			Deal signed!

Appendix: Example Checklist for Initial Assessment

Investment Criteria	Check OK	Comments
Has a sponsor in place or referred by a partner company.		
Sponsor intends to invest or is already an investor in Company.		
Operates in a sector where we have expertise.		
Has existing sales revenue or strong evidence of customer demand.		
Has a prototype, web site, patent or other evidence of product/service in advanced development.		
After investment can achieve their business plan (as sensitised by Investigator) without further investment for at least 12 months.		
Has an identifiable exit route after 5 years.		
Has the potential to deliver 10 times the original investment within 6 years if earlier stage (5 times if more mature and lower risk).		
Practical issues		
Are seeking to raise at least [insert minimum criteria] €.		
After investment we would own what % of enlarged equity?		
Capital increase is planned in ordinary shares on terms at least as favourable as existing shares.		
All existing shareholders are in agreement to raise funds.		
The company is judged capable of completing an investment within the required timescale.		

V. Due Diligence Template

1 Management Summary

Key findings of Due Diligence Exercise

The aim of this document is to provide a template for a due diligence report, and some ideas for questions to ask and lines of enquiry to make. The list of questions is not intended to be comprehensive, and many may be inapplicable to certain companies. Clearly with a wide range of business models, stages of development and trading history, this will never be a "checklist" exercise. The template is therefore intended as a guide as to the principal areas to cover and a starting point of questions to ask. Depending on the answers, some areas will certainly need more thorough investigation. A further aim is that we have some consistency in the due diligence exercise, to allow an advisor to compare different investments.

2 Corporate Structure and Ownership

Objectives: Identify if there are any issues with the ownership structure that may cause us difficulties/conflicts of interest in the future, or be prejudicial to our shareholder interest.

What Corporate Structure is used?

Who are the shareholders?

List by shareholding.

Identify who are:

Full time active in the company?

Non full-time but active investors?

Passive Shareholders?

Corporate Shareholders?

Identify shareholder objectives for all major shareholders.

If corporate shareholders exist, what is objective of shareholding?

Depending on split may be necessary to speak with all principal shareholders.

Identify any possible conflicts or difficulties with different shareholder interests.

Are there any subsidiaries?

If these exist, how are they managed?

Documents to be provided:

1. Articles of Association and Memorandum, together with a copy of the company's latest annual return to Company's House. Copies of all shareholder agreements still in force.
2. Current share register and details of different classes and rights, if applicable.
3. Copies of all shareholder agreements still in force.
4. List of proposed new investors with likely amounts to be invested and any conditions applicable.
5. Details of all outstanding share options, warrants, conversion rights or other agreements that may result in further shares being issued.
6. List of any subsidiaries with percentage owned, purpose of company, name of director(s), and latest sales turnover, net profit and balance sheet.

3 Financial

Objective: Ensure we have a true and accurate picture of the financial state of the company, and realistic projections going forward.

Examine the accounts that exist. Are there any previously documented business plans with which to compare them? If not, why not?

What are the key revenue items for the business? How reliable are they going forward?

What are the key costs of the business? How are these likely to evolve over the next 3 years? How might they be reduced if circumstances required it?

What are the assets on the balance sheet? If there are any unusual items, how is the value arrived at?

Look at the debtors register. Is this company having difficulty getting paid? If so, why?

Has the company filed all necessary tax returns (TVA/VAT, Profit related Tax etc.)?

Is the company benefiting from any government grants/loans etc. and if so on what terms?

Documents to be provided:

7. Copies of the last three audited (or provisional) annual accounts.
8. Sales and estimated net profits during the current financial year to date and an estimated balance sheet at the latest available date. Details of any material changes since such balance sheet.
9. Details of any loans, overdrafts or other indebtedness currently outstanding.
10. Documentation relating to any government grant/aid or loans.
11. Projections for the current full financial year and four further years, including sales turnover, gross margin, overhead costs, EBITDA, net cash flow and year end cash balance.
12. Contact details of the company's accountants and authority for us to speak to them about the company's financial affairs.
13. Name and contact details of the company's principle bank and authority for us to contact them to obtain a standard bank reference.
14. Details of any current or anticipated legal action or tax enquiries affecting the company. Name of legal adviser and permission to speak to them if any legal action pending
15. List of premises occupied, leased or owned by the company with rents payable and dates of lease expiry or break clauses.
16. Summary of principle insurance policies.

4 Business Plan

Objective: To ensure that the business plan is realistic, based on reasonable assumptions and that the ideas behind it have been tested.

What are the key assumptions behind the business plan?

What evidence exists to support these assumptions?

What will be the key challenges in achieving the business plan?

What are the USPs of the business. What is the evidence that they are genuinely unique?

How sensitive is the business plan to changes in the price and volume of sales?

How sensitive is the business plan to sales developing more slowly than planned?

What is the planned use of funds? Is there a detailed and realistic budget for this?

Are the costings complete – e.g. are there allowances for extra overheads etc. as the business grows? Are there any other “holes” in the budget?

What is the competitive position of the business? How are the claims with respect to the competitive position justified?

Who are the main competitors? What are their strengths and weaknesses?

If this is a novel product or service, what evidence exists that there is a demand for it?

Has any trial, market research etc. been carried out?

What are the main dependencies on third parties? Do they look reasonable?

What are the barriers to entry for competitors if the idea is a success?

5 Sales and Marketing

Objective: To be confident the company has a plan and the skills to get their product or service into the market and sell it profitably.

What is the go-to-market strategy for the business? What makes them think it will work?

If there is a significant marketing activity (and spend) planned for this business, what evidence is there that it is well focused?

What is the evolution of sales in the last three years?

Who were the top ten customers in the last three years? Have they changed?

Have any major customers stopped doing business with the company. If so why?

Have there been any significant customer disputes in the last three years, whether taken to court/tribunal or not?

Has the company had to issue any refunds/credit notes etc. for any reason?

What is the sales projection for the next three years? What is this based on?

What is the forward order book?

What is the current sales pipeline? How are win % arrived at?

What significant customer contracts currently exist?

If the sales strategy involves third party channels, what arrangements are in place?

What contracts/partnerships' exist?

What evidence is there that the pricing model is correct?

Can they supply a high profile customer reference that would be happy to speak to us?

Documents to be provided:

17. Copies of any material contracts on which the companies' future projections are largely dependent, e.g. dominant customer, exclusive supply agreement, etc.

6 Assets

Objective: to ensure the assets owned by the company have the value assumed in the business plan, and that such value will be protected.

What technology or other important assets are owned by the business?
Is it reliant on any technology provided by third parties to provide its product or service?
If so what agreements are these covered under? Can they be cancelled?
Is the technology patented, or in the process of being patented?
If the business has developed a product or technology, what documentation exists concerning the product/technology e.g. product plans and roadmaps, specifications, design documentation etc.?
How easy is it to develop the technology further?
What is the current state of the development?
What Quality Assurance measures have been put in place to ensure the reliability of the product or service?
How dependent is future development on key individuals?
If funds are to develop a product, how have the development costs been estimated?
What is our confidence level in these?
Do employment contracts explicitly assign copyright to the company?
Have any of the company's products been developed outside the company i.e. by a third party organization, or by non-employed independent contractors (even if working on the company's premises). If so what measures are in place to ensure Copyright, Intellectual Property Rights, Patent Rights vest entirely with the company?
Are any Open Source items used in the company's products?

Documents to be provided:

18. Details of any contractual obligations requiring payments to be made, e.g. royalties, license fees.
19. List of all intellectual property patents owned or applied for and details of scope and protection and dates of expiry.
20. Copy of all contracts relating to 3rd Party development of products, including engagement of individual contractors, outsourced development and/or production.
21. Copy of any License agreements assigning rights to customers.

7 Management and Staff

Objective: Ensure that the company has the right people and is able to recruit and keep the necessary staff to execute its plan.

Who are the key people in the management team?

Identify skills and background, summarize career history.

Identify which are shareholders.

How will key non-shareholder management be retained/incentivised?

Are there any significant gaps in the expertise of the management team, looking forward as the company grows?

What recruitment is needed over the next few years? Are there any problems anticipated with finding and keeping the necessary staff?

Have there ever been any significant disputes with staff, whether taken to formal proceedings or not?

How many staff has left over the last 3 years?

Estimate staff turnover.

Is there any profit-share or other performance related schemes in place, and what are the potential costs?

Documents to be provided:

22. List of all employees with job title, salary, and details of any unusual contractual terms.
23. Details of any union agreements if any.
24. Copy of standard employment agreement(s) used for the different staff categories

8 Operations

Objective: Understand how the business is run and controlled, and whether this is “fit for purpose” both now, and under the growth planned for the next few years.

How is the company run? What responsibilities have been defined?

Are the powers of the Managing Director formally defined?

Are the power and authority of other Directors or senior managers defined (e.g. spending powers, authority to sign contracts etc.)?

Is there a staff handbook or similar document?

What other documents exist defining company processes?

What records exist of what decisions have been taken and why?

What management/board meetings take place, and on what frequency? What records exist of these?

If the company plans to grow significantly, is there a plan to cope with all the implications of this e.g. premises, Infrastructure, new roles in the company etc.

To what extent does the company rely on suppliers to be able to offer its product or service? What are the contractual arrangements in place? What is the supplier management approach?

How sensitive is the business to changes in the price of supply?

Documents to be provided:

25. Copies of Management/Board Meeting minutes.
26. Copies of key supplier contracts not already covered elsewhere.

9 Legal

Objective: To understand if there are any unusual legal obligations entered into by the business that may affect our view of its value.

Has the company signed any non-competition agreements (or agreements with such clauses in them) with any other party?

Has the company signed any exclusivity agreements (i.e. to not work with competitors of any of its customers) or agreements with such clauses in them?

What NDA's are currently in force?

Has the company ever been subject to legal proceedings, or the threat of them? If so provide details?

Are there any other non-standard legal agreements the company has entered into, which may affect the value of the company?

Documents to be provided:

27. Copies of any relevant legal agreements not already covered elsewhere.

10 Risks

Objective: Identify the key risks that might prevent the business achieving the planned success, and any plans to mitigate them.

What are the key risks to the business in the view of the Entrepreneurs? What plans exist to mitigate these risks?

Are there any further key risks identified by the Evaluator?

11 Other Observations

Anything else of note uncovered.

12 Recommendations

Could be

Further specific investigations required, (maybe by specialist in finance/technology/law etc.).

Further references/research required to resolve concerns.

OK proceed subject to certain conditions (e.g. business employs specific skills)

Or...

Run like hell – whose idea was this?

VI. Calculating return on investment

The financial projections for a business are only one indicator of likely success, to be evaluated alongside other important factors. Nonetheless it is important to ensure that the return for investors will reflect the risk they are taking, so some evaluation of the financial projections is required.

There are many ways of approaching this task. Venture Capital companies often use the 'Internal Rate of Return' or 'IRR' which is very sensitive to the length of time between investing and an eventual exit. Most private investors find it easier to think in terms of what multiple of their original investment they will receive. The time value of money and the level of risk can be taken into account by 'discounting' the future returns. The higher the perceived risk of failure, the higher return expected for success and the higher discount factor should be applied to reflect the uncertainty of future returns. Most investments ultimately come down to a judgement about risk vs return.

The following table shows a relatively simple model, based on evaluating the likely multiple of the investment that would be received on exit five years later.

The company should be able to provide five year projections of both their Income Statement and Cash Flow. However these will be based more on hope than expectation and may need to be adjusted to reflect more prudent assumptions. Certainly the further out the projections, the less reliable they become. Most entrepreneurs running early stage companies are naturally optimistic about their prospects – this confidence is essential in order to succeed. However their ambitious targets are rarely achieved in practice.

It is said that a good business is one that achieves its year 1 targets in year 2. So one way of 'aiming off' for over-ambitious projections might be simply to assume that the sales and profit targets are achieved one year later than forecast. Alternatively one can apply a percentage reduction to the revenue numbers. Note that this will not be the same percentage reduction to the profit/loss line as the costs will probably remain the same.

Once you are comfortable with the business plan assumptions you need to consider the additional investment required by the business to reach cash breakeven (or the dilution from further funding rounds if you do not participate).

The eventual return is likely to be from a sale of the business, based usually on a multiple of profits or turnover. The amount attributable to each shareholder will depend on the surplus cash or borrowings remaining in the business at the time of sale. A variable discount factor can be applied to facilitate comparison between lower risk and higher risk investments. Different scenarios can be compared to provide forecast returns for varying sales revenue growth assumptions.

Ultimately the results are another indicator of the attractiveness of the investment, but beware of putting too much reliance on the financial evaluation. A good idea in an attractive market with strong barriers to entry and a competent and focussed management team are ultimately more important indicators of likely success.

Company:

FINANCIAL PROJECTIONS



= Entry fields (do not change other fields)

All in '000 €	2010	2011	2012	2013	2014	2015	
Sales Turnover	113	735	2 785	5 458	9 825	17 685	
% growth		550%	279%	96%	80%	80%	
Gross Profit		625	2 367	4 640	8 351	15 032	
GPM %		85%	85%	85%	85%	85%	
Selling & Admin costs		815	2 073	3 886	6 877	11 849	
EBITDA	-111	-190	294	754	1 474	3 183	A
Net margin %	-98%	-26%	11%	14%	15%	18%	
Net cash balance	-180	192	108	453	-	-	C

VALUATION MODEL

000 €

Entry valuation pre-money

400

Investment planned

100

Other share issues planned
At estimated pre-money valuation of:

150	500			-	-
400	1 200			-	-

Existing or planned share options
At entry valuation of:

102
400

Dilution % from further shares issued
% of enlarged equity

	29%	0%	0%	0%	20%
15,4%	10,9%	10,9%	10,9%	10,9%	8,7%

D

Estimated exit P/E (x EBITDA). Range 5 - 15 depending on sector, net margins, growth rate and future potential.

15

B

NB: Cross check with turnover multiple below:

Estimated exit valuation
Add 2013 closing cash balance
Forecast proceeds to shareholders

2,7 x turnover

47 745
-
47 745

A x B

C

Discount factor (<i>high risk = 20%, medium risk = 15%, low risk = 10%</i>)	20%	
Forecast exit valuation at present values, risk adjusted	19 188	E
Forecast net proceeds to investor at present values, risk adjusted:	1 660	E x D
Multiple of original investment - Gross	41,3	x
Multiple of original investment - NPV - risk adjusted	16,6	x