What do investors look for?

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Video transcript

Tyler Cassack (00:05): Generally speaking, early-stage startup investors are going to be super focused on a select few things when it comes to diligence in your company. Those are: who owns what in terms of equity in the company, who owns the intellectual property, and what do your financials really look like? I'm Tyler Cassack, and I'm here with Max Schwartz-Labell to talk about what investors look for when diligencing in a company.

Max Schwartz-Labell (00:25): Thanks, Tyler. So firstly, there is the cap table. Investors will want to know exactly who has a stake in your company and how much that stake is worth. The cap table should list all of the people or entities that hold equity in your company. And so, any type of equity stake a person has should make its way onto it.

Equity takes different forms. People may own shares, stock options, SAFEs, convertible notes, warrants, and other instruments. The cap table will present all of these security holders in an organized way according to the type of security they hold and what it represents in terms of ownership in the company. The governance, voting and economic rights that your startup will operate under are going to be highly intertwined with and influenced by the breakdown of your cap table.

So it is really important that founders spend time with their lawyer to drill down and make sure the cap table has no gaps and is well-understood. Next up is intellectual property or "IP". Investors are going to want to review your intellectual property strategy and protection. The kind of IP strategy you will need is highly dependent on the type of startup you have.

A biotech company, for example, will have to have a clear licensing and patent strategy, whereas a B2B SaaS company may not need to have addressed the full gambit related to its IP strategy at the early stage. At the most basic level, however, you will need to make sure that all founders have properly assigned their IP to the company and that all of your employees, advisors, and independent contractors and consultants have done the same.

And then you'll get into things like trademarks, patents and trade secrets. You will need to show that you have adopted the correct protective tools for the kind of IP you have. Investors may be okay with some gaps in the early stage, but you should still be prepared to provide convincing answers on the plan to address these gaps and issues.

Tyler Cassack (02:12): So, another important area that investors are going to drill down on are your financials. This may entail reviewing financial models, projections, budgets, historical financial statements and etcetera. There's sometimes some tension between founders and investors as to the importance of these financial materials. Founders sometimes don't find them relevant at the early stage, where business models may still be in flux and investors aren't necessarily investing for cash flow.

There may be validity to those points, but having financial items put together shows investors that you can think critically through important financial matters. And at some point in the business's life cycle, that will become very important to manage and message. So, you might as well start with a good practice early on. Naturally, outstanding debt obligations will also be highly scrutinized. You should be prepared to clearly show potential investors a breakdown of the balance sheet in terms of all lines of credit loans, including shareholder loans, grants, non-dilutive funding, and any other items that your startup may have received. At the end of the day, diligence is company and deal-specific, but you should expect each of the items we discussed to be a priority and should be cleaned up and ready to share in the data room.

The risk of not having these offers clean ahead of diligence are significant. First, it sets off alarm bells to an investor. They think if these crucial matters have gaps, what else does? And they begin to scrutinize more and more. Second, you may have to react by rectifying issues. This can add serious time delays to a deal, especially where rectifying those issues means dealing with a third party.

Plus, there's also the added costs to cleaning those issues up. Third, if the issues take time to resolve, you may find yourself in a worsened financial position with less leverage, and investors may use this to negotiate last-minute terms in their favour. Moreover, it's also possible that the overall market dynamics shift during this time, which can also impact the deal terms.

Max Schwartz-Labell (03:58): Understanding your cap table, IP protection strategy and financials, especially including your liabilities, will definitely be top of your investor's due diligence priority list. And speaking of lists, you can also expect that your investor will deliver a due diligence request list, setting forth all the diligence items they'd like to review in deciding whether to invest in your startup. This is especially true in the case of preferred share financings.

These lists typically set forth the scope of requested disclosures relating to a variety of matters, including employment, company capitalization, tax, litigation, intellectual property, financials, and more. And will require that you set up a secure data room where you can respond to these questions and upload the requested materials for your investor to review. Responding to these lists can be quite time consuming, and often it catches founders off guard.

The good news is that founders can be preemptive by keeping their records organized and by setting up a data room in advance that is responsive to these customary “cookie cutter” type requests. And as the company scales, the data rooms should be updated regularly so that you are prepared for a diligence process whenever one arises. This will make for a quick and easy diligence process, instill confidence in your investors, and save yourself and your investor time, money and energy, best reserved for the fun stuff.

Raising capital: a vital part of your startup’s journey, and one that often comes with challenges and significant effort from your growing company’s team. It’s also a step that requires startups to prepare for diligence reviews from investors.

In this video, Tyler Cassack and Max Schwartz-Labell share the key areas investors generally focus on when reviewing early-stage startups.

They discuss:

- what investors want to see on your cap table
- expectations around your intellectual property
- considerations for your financials

To discuss these issues, please contact the author(s).

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