How to Screen Startup Investments: Eight Principles

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Getting Started with Startup Investing Screening

When deciding to invest in a startup, what do you look for?

I'm going to help answer that question.

The purpose of this guide is to help early-stage investors effectively screen and evaluate startup companies seeking funding.

These insights are derived from my past four years at E8 Angels in Seattle Washington. At E8, I co-manage deal screening and due diligence of some of the most innovative cleantech startups in North America.

Whether you are an investor evaluating startups, or an entrepreneur seeking funding, I hope that this guide will be a helpful resource to you and point you in the right direction.

What is Screening?

To begin, it is helpful to understand the investment process.

Investment evaluation takes place in four basic stages: Screening, Pitching, Due Diligence and Funding Decision

Screening is the first gate that a startup must pass through when seeking funding. It is important to remember that the threshold to be accepted into screening or to pitch to investors is lower than that to actually invest money in a company. Much like inviting a job applicant to an interview, a company does not have to be perfect to pitch to investors, but to generate enough "Curiosity and Credibility" to warrant further attention. There will still be big questions to be addressed prior to investment, but this will come later, during due diligence.

While this is not intended as a stand-alone investment guide, the guidelines here will help you ask the right questions about whether a startup warrants further interest.

Due diligence will be an opportunity to dig deeper and ask some of those hard questions of whether to invest.

To make things simple to understand, I have distilled my experience of screening and due diligence into Eight Principles which add value to a startup.

I have also included a template checklist. Please feel free to download or copy this resource.

What To Look For: Eight Principles

From my experience, investors have different rules for investing in a given deal. These rules or criteria are often specific to the risk tolerance of the investor, the stage and the industry of the company.

That being said, while different investors have specific rules of what they look for in a startup, the underlying principles that inform their decisions are very similar. I call these the “Eight Principles of Startup Investing and Screening.” These all add value to a startup, and investors are looking for them.

1. **Traction**
2. **Exit Potential**
3. **Company is Scalable**
4. **Winning Team**
5. **Competitive Advantage**
6. **Stage, Valuation and Terms Are Appropriate**
7. **Large Market, But Focused**
8. **Deal Fits Investor Culture and Risk Tolerance**

The purpose of this is to familiarize you with these basic principles of startup deal screening. Under each principle, I have listed a few specific rules that I use to decide whether or not to proceed with a deal.

I think that these specific rules work well and are a good place to start with deal screening. Feel free to make your own rules as you see fit. Depending on your risk tolerance, the sectors you invest in and at what stage you like to engage with the companies, you might change or add to these rules to fit your specific context. The Eight Principles, however, will generally stay the same.

The Eight Principles

One: Traction

A company's value goes up when customers are buying or testing what they are selling. This is called "traction". I consider traction any kind of direct validation from customers, even those that don't involve revenue.

My experience suggests that companies in a given market are often not unique, as there are usually several companies doing similar things. Having customers is a way to show that people want what the company in question is selling, and often differentiates it from similar players in a crowded marketplace.

For a startup that is fundraising, traction can take many different forms. Here is a simple, non-exhaustive list (better is near the top).

- Recurring revenue
- One-time revenue
- Users or downloads (applicable for media, social media or apps)
- Contracts
- Letters of Intent (LOIs)
- Paying Pilots
- Pilots
- Kickstarter campaigns (If pre-orders, which validate customer demand)
- Minimally Viable Products(MVPs), prototypes with customer feedback
- Customer Development or interviews with customer segment

Traction is one of the most important things to look for, because it shows that people actually want what the company is selling. This sounds obvious, and it is. This also addresses a huge risk, that of failure of market fit.

Depending on the stage of the company, amount of appropriate traction will vary to be considered for investment. Venture capitalists, angels and accelerators will have different criteria or rules of what level of traction is required to invest. Nonetheless, the principle is the same. Traction adds value.

Two: Exit Potential

Angel investors and venture capitalists generally only make money when their investment company is acquired by another company or goes public (has an IPO). The acquisition of a company by another entity or IPO is called an “Exit”. Likelihood of an investment to Exit is called “Exit Potential”.

Exits are described as multiples of returns. A 5X return will yield an investor five times more than what they invested. 10X is a ten-times yield. 1X is break-even (if you ignore lost value due to inflation).

Startup investments are highly illiquid (you can’t get your money out after you invest), and investors can expect to wait several years before they see any return on their money. About 90% of an investor’s returns will come from 10% of their companies, which means that most companies will have disappointing exits, if they exit at all.

One exception to the exit requirement is revenue-based financing, where investors are paid back a percentage of the startup’s revenues, until they have returned 1.5-3X of the initial investment. This is an emerging financing model that can be very good fit for startups and investors. Typically, the companies that receive revenue-based finance have consistent revenue of +$200k per year and +50% margins. Most often, software companies fit this best. Additionally, some impact investors are using revenue-based finance to avoid the exit requirement.

Regardless of the investment vehicle, the likelihood and potential magnitude of an exit is of great interest when deciding to invest.

Smart startups will have a slide in their pitch deck (i.e. fundraising PowerPoint presentation) that shows Exit Strategy or Exit Potential in variety of ways. Here are the three most common examples.

A. Comparable Exits

- A list of comparable companies in their industry that have been acquired in the last 1-3 years
- The amount that was paid for them, or the 5X, 10X or 20X return to the Series A (early) investors, and the names of the acquisition partners (buyers)
- Trends in the acquisition space, awareness of consolidation

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B. Relationship with an Acquisition Partner

- Outline of conversations with a Strategic Investor or Buyer
- Investment in the company made by a Potential Acquisition Partner, or specific milestones that would warrant investment or acquisition
- Sales to an potential acquisition partner

C. Some Intellectual Property (patents, copyrights, trade secrets), user base or customer pipeline which is of measurable and proven market value to an acquisition partner.

The key thing to look for: the startup understands who has been acquired, who the players are in the acquisition space, that they understand what the acquirers need, can identify acquisition trends in the space and have some relationship with those acquirers.

Three: Company is Scalable

Scalability refers to a company's ability to grow quickly, and not be curtailed by its structure or resources.

Generally, investors look for companies that do not require massive capital expenditures (such as investment in factories, warehouses or expensive equipment) in order to be successful. Or, if they do require capital to scale, their initial business model does not require large initial investment in order to be shown commercially viable.

Technology, particularly software startups are often scalable because their growth requires very little warehousing, inventory or added infrastructure to grow quickly.

When evaluating hardware companies, we identify companies that can initially go-to-market without large initial capital investment. They show this by leveraging partners or outsourcing production using contract manufacturing. Usually hardware companies that get funded also have a software component.

A few things worth considering regarding scalability.

- Does their core technology work, or will it require much more testing and significant investment before it is marketable?

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- Does the startup have a credible plan, team and resources to scale their technology?

- If they are a hardware company, must they build a factory initially. Or, can they scale using contract manufacturing, or third-party partners?

- Are there potential supply, labor or distribution constraints to growing their business, and do they have a credible plan for surmounting these challenges?

- Do they have a credible go-to-market strategy?

This scalability issue is an important component of whether or not to fund a company. However at the screening stage, it is not always clear from the startup's slide deck and application materials whether they have a credible scaling plan. Scalability concerns are worth paying attention to at the screening stage, but more granular questions about scalability should not be deal breakers during this early evaluation phase.

Four: Winning Team

A common refrain of startup investors is that they "...invest in the team…" but what does that really mean? Here are a few team characteristics you should look for, as they generally add value to a startup.

- Founders that have had previous exits or are serial entrepreneurs. Or that have been on teams that have gone through acquisitions.

- Prior experience in the field, as this also contributes to their ability to understand customers and the industry, as well as hire and recruit the best for their startup.

- Teams that have complementary skill sets and that have worked together before. Most startup teams are unpaid or underpaid. To the extent that teammates are willing to join at this early stage, particularly if they have prior experience together, indicates a high level of trust and commitment.

- Coachability, the demonstrated ability to be persistent towards a goal, yet also willingness to listen to feedback and adjust their course when necessary. This may not be evident early on in deal screening process, but is worth watching throughout due diligence or during follow-on rounds.

Investors may have their own rules that they want to add to this. For example, they choose to only invest in companies that have at least one woman founder. They may require that two co-founders be technical. You should feel free to make your own rules as you see more deals. Teams are difficult to evaluate, but they are the most critical component to success.

Five: Competitive Advantage

The ability to compete against other players in a given market is called competitive advantage. The two general ways that a company can demonstrate competitive advantage are by being:

1) Cheaper than their competitors.

or

2) Better Product or Service.

While price is important to some buyers, startups usually don't have economies of scale that can justify a lower price during their early days. Higher margins help the startup get to positive cash flow more quickly, and give them more time to experiment (and make mistakes) and hone their business model. Therefore, a better product or service that can charge a premium is desirable.

Here are a few things that show competitive advantage.

- Company has a service, patented technology or product that can't easily be copied or bought by competitors.

- Company has a privileged or unique relationship with a major buyer or suppliers that could contribute to their long-term success (for example, an energy efficiency company that has strong relationships with a utility would have a competitive advantage over companies that don't.)

- Company has an exceptional team that demonstrates deep expertise and relationships in the industry.

- Company is not competing with large incumbent and well-financed competitors. The company has a reasonable understanding of the other competitors in the space and requisite understanding of overall landscape.

Determining whether a company has true competitive advantage can be tricky. It is helpful to have investors with market or domain experience involved in the screening process. They will be familiar with the market to help validate, refute or contextualize the startup's claims.

Six: Stage, Valuation and Terms Are Appropriate

If you're buying a car, a key thing to consider is, "What is my price range?". This is similar to startup investing, the price or value of the startup is known as the valuation. If the startup is raising a convertible note, this is called a cap.

The higher the valuation or cap is, the less the investor gets for their money, and the entrepreneur will keep more ownership. The lower the valuation, the more ownership is retained by the entrepreneur, and the investor receives less for their investment.

At the angel investment stage, startups will either come with their own valuation, or wait for the lead investor to negotiate a valuation. Typically it is the former. Valuation at the startup stage is more an art than a science. The easiest way to approach it is to find the valuation of comparable companies and begin there. It's a bit like buying a house. If you look at enough houses, and take into account location, size and condition, you will have a good idea of what you should pay for a given property. Same with startups.

At E8, most of the companies we fund tend to have a valuation or cap of $2-8MM. If a company is more than this, it is not a deal-breaker, but it's worth asking what things justify this higher rate. If its valuation is much higher, like $40MM, it's usually more appropriate for a venture capitalist, and we most often decline to invest.

As with other factors, accelerators, angels or venture capitalists will have different thoughts on valuation and what their appropriate range is. The key thing is to look at lots of companies which are stage that you want to fund. Use this to determine a general valuation range, then try to find companies that are within that range. Evaluate risk versus value, and proceed from there.

Terms and “Use of Funds” are another thing that are worth addressing, though they tend to more relevant to the later stages of due diligence. Terms can get tricky, but a general rule that I hear from experienced investors is “Simpler Is Better”.

For equity rounds, there will be a valuation and a raise amount or size of round.

For a convertible notes, expect interest rates around 5% and a discount of 15-20% and a cap. A cap for a convertible note is analogous to a valuation in an equity round. The convertible note should be a bridge to an equity round, preferably within 18-24 months. If a company is an LLC, it should have plans to convert to a C-corp.

For equity rounds as well as convertible note rounds, a company should have a clear use of funds, and concrete milestones that will result from proceeds of raise.

Seven: Large Market, But Focused

Because of the high risk and illiquidity of angel and venture investments, companies need to have the potential to return at least 10x to their investors. This means that the market must be large enough to support such exponential growth potential.

What this means is the total addressable market for a given startup should probably be at least $500MM-1B for the foreseeable future, which will ensure follow-on funding, and exit options.

A startup can’t capture all of this market, so it’s important to initially be very focused. The general rule of thumb is that a startup should segment the market enough to realistically capture at least 20% of their specific market in five years.

For an investment group, it is important to have some members with deep domain expertise in a given segment, who can credibly evaluate the size of potential market within the exit horizon of the deal.

Eight: Deal Fits Investor Risk Tolerance, And Specific Deal Culture

Most accelerators, angel groups or VCs have certain kinds of deals or sectors that they generally fund.

For example, our group, E8 Angels funds promising companies that will contribute to the sustainability of our planet. Therefore, companies we see will be mostly from the following sectors.

- Solar and Wind
- Renewable Energy Finance
- Energy Storage
- Energy Efficiency
- Precision and Green Agriculture
- Green Building, Materials and Chemicals

For example, at E8, we will often receive applications from software or technology startups that are promising, but not cleantech. Because we have a very clear mission of only funding cleantech companies, we will decline them or refer them to other angel groups that would be a better cultural fit.

Risk tolerance of investors is another important consideration when screening startups. Some accelerators or angels are satisfied with a great idea and a smart team. Others require significant market validation or technology maturity prior to funding. If a startup is too early, but otherwise promising, an investor will provide clear milestones for future application, and invite them to return after they have made appropriate progress. This is a great way to give entrepreneurs actionable feedback. Execution of aforementioned milestones will give investors valuable insight about the caliber of the company and team.

Conclusion

Good luck with your deals and investing, and thank you for reading this. This guide is a living document, and has been strengthened by countless conversations with entrepreneurs, students, angels and venture capitalists such as yourselves. With this in mind, your feedback, comments and questions are always welcome, please feel free to email me, Johnnychiles@gmail.com.

About the Author:

John Chiles is passionate about helping people and businesses succeed.

He is Co-chair of Screening and Due Diligence at E8 Angels in Seattle WA, a group that has invested more than $30MM in 70+ innovative cleantech and renewable energy startups since its founding in 2006.

In addition to co-managing the deal pipeline and driving due diligence for E8, he coaches entrepreneurs on how to make credible pitches to angel investors.

John has also served as a teaching fellow at Bainbridge Graduate Institute Sustainable MBA program (now Presidio) where he coached student entrepreneur and finance teams on how to use business to address climate change and other challenges.

Prior to that, he worked in green construction, founded a college sustainability organization and ran an off-the-grid hydroelectric plant in the Cascades of Washington.

In his spare time, he builds wooden lamps, plays guitar and enjoys epic hikes with friends.

A native of the Missouri Ozarks, he lives in Seattle.