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Note on Due Diligence in Venture Capital

Venture Capital firms often receive and evaluate thousands of business plans each year. Therefore, a firm's ability to effectively and efficiently identify winning investment proposals is critical to its success. "Due diligence" is the industry jargon for all activities associated with evaluating an investment proposal. The management of this activity has been commonly cited as a source of competitive advantage. Many venture capitalists have approached due diligence as a distinct process that can be made more efficient. This note examines that process in more detail, providing a description of its basic elements. Most examples are drawn from practitioners in the industry. These practitioners have been at the forefront of the industry in developing processes for due diligence because their success relies on identifying winning investment proposals.

A typical venture capitalist's early career can be referred to as an apprenticeship because learning through experience is a vital component of success. Senior industry practitioners emphasize the value of experience in effectively evaluating investment proposals. For the purpose of this note, the focus will be on business due diligence, not to include legal due diligence. In addition, emphasis is placed on screening due diligence as a stage prior to the in depth business due diligence. The note begins with an overview of due diligence followed by challenges with this process.

The Landscape of Due Diligence

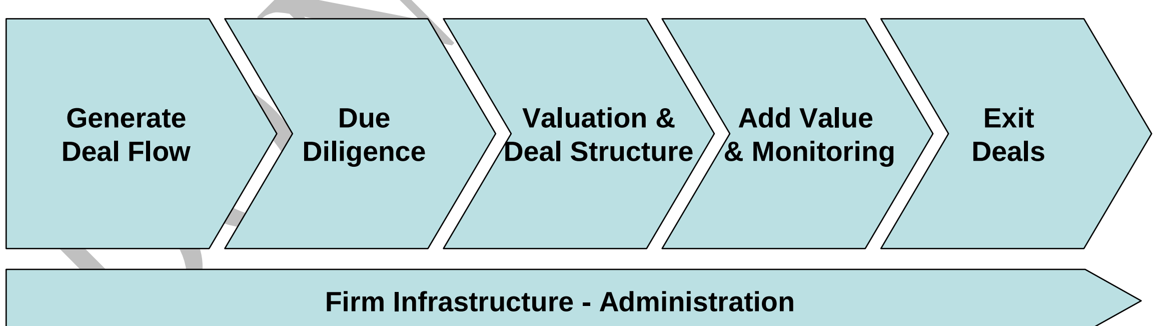
This note was prepared by Hal Nelson T'03 under the supervision of Adjunct Assistant Professor Fred Wainwright and Professor Colin Blaydon of the Tuck School of Business at Dartmouth College. It was written as a basis for class discussion and not to illustrate effective or ineffective management practices.

Underneath the due diligence process resides a simple fact: a significant amount of knowledge resides with the experience of the individual, not the firm. Many practitioners have characterized the assessment of investment proposals to be about "pattern recognition." Therefore those individuals with significant experience tend to have a knack for identifying winning investment proposals. Because this knowledge is hard to extract and codify, many firms struggle with consistently evaluating investment proposals. Either poor efficiency leads to delays in executing a deal or effectiveness fails in identifying potentially successful deals. Clearly there is an opportunity to improve the process. The ability to codify processes and routines become essential in being able to digest the volume of deals being reviewed for acceptance by venture firms. The firms that are able to utilize a formal process should be able to facilitate the evaluation of investment proposals.

The Context of Due Diligence

The venture capital investment process can vary depending on context and vary by the timing, region, and market. However, most activities can be represented by a general value chain for the industry. It is clear when looking at the value chain, that high deal generation will warrant sound mechanisms for effectively and efficiently evaluating potential deals (Due Diligence). An investor's time is valuable and time is money.

Value Chain for Venture Capital Investment



Due Diligence Strategy

The due diligence strategy of a firm establishes the criteria for screening and evaluating potential investment proposals. This strategy outlines the types of investments that are consistent with the firm's investment philosophy. Obviously, a firm has to first define the types of investment that are a fit with the firm. Venture firms typically have a set of investment criteria that define the type of investments that they find attractive. These criteria include the stage of the business, the geographic region, the size of the deal, the industry sector, etc. Once these criteria are defined, a firm will tailor the process to answer specific questions. The fundamental focus of the process is to raise flags with the deal.

As few as 10 to 15 % of business proposals pass the screening phase. The deals that pass the initial screen will be evaluated further with detailed due diligence. For the venture capital investment process, due diligence means a rigorous investigation and evaluation of an investment opportunity before committing funds. The due diligence process is designed to reduce the investors' risk by understanding the issues and challenges embedded in a business proposal. In essence, it involves asking and answering a series of questions, just as the screening process but in much greater depth. This information is used to determine if the deal warrants further consideration in moving to the next phase of the process, valuation and deal structuring.

In addition, each firm must decide how they will execute the due diligence process. There are many alternatives depending on the resources available to the firm. The firm may allow the process to proceed in an ad hoc manner, while other firms may choose to use a defined, rigorous process. The firm may allow individuals to review proposals based on their area of expertise or assign responsibility to associates to conduct a general screening of all proposals.

One approach does not fit the needs of all firms, especially because of industry specialization. In addition, there is no single question that will answer the simple question, "Is this a winning investment proposal?" However, there are opportunities to formalize the process and take a general look at best practices that will facilitate due diligence for a firm.

Due Diligence Process

Due diligence can be broken down to include an initial screening of the deal and a detailed evaluation in determining the suitability of a deal before moving to the next stage in which the valuation and deal structure is conducted. This note will outline the general practices involved in screening due diligence and business due diligence.

Screening Due Diligence. The intent of screening due diligence is to quickly flag the deals that either do not fit with the investment criteria of the firm or the criteria that are deemed necessary for success. Venture firms are often inundated with investment opportunities. These firms typically use processes or mechanisms to quickly screen out the deals that are not of interest. There is no single best approach to screening because each firm has to determine what is critical to its fund and what types of deals will fit. Fit is often characterized by the stage of the business, geographic region, size of the deal, and industry sector. In screening for a high quality deal there are a few additional areas of focus. Therefore most firms screen based on *investment fit* and *investment potential*.

Investment Fit – Determines if the investment proposal is consistent with the investment philosophy of the firm - Venture capitalists may be generalist or specialist depending on their investment strategy. As a generalist, a firm may invest in various industry sectors, or various geographic locations, or various stages of a company's life. As a specialist, a firm may invest in one or two industry sectors, or may seek to invest in only a localized geographic area.

- Stage – Not all Venture firms invest in "start-ups." Many firms will invest at various stages of the business life cycle from seed, to early, or even late stage. A firm may choose to invest in a business when there is only an idea; before a product or company is formed. This is known as seed investing. Early stage investors may provide capital to a company in the first or second stages of the business life cycle. And some firms invest during the late stages of the business development cycle to facilitate the growth of a company towards exit. Finally, buyout investing might assist management or an outside party to acquire control of a firm.

- Geography – Often firms prefer to invest in deals that are in a local geographic area. The reason behind a geographic preference tends to simply be a desire to easily manage the investment. The investors will need to spend time with the management of the company regarding strategic business decisions, in addition to the other investments in the firm's portfolio. If the investment is located within the firm's "region," it saves time in attending meetings, monitoring the investment, and visiting the management team. In addition, location may provide access to resources such as a high caliber labor pool, top law firms, or other needs of a developing business.

- Size – Venture firms will often establish a minimum and / or maximum amount that they like to invest. There are several reasons for defining the range of investment. The lower bound is often related to the need for the investment to be large enough to justify the involvement of the firm. The firm does not want to dilute their time over a lot of small deals. Also the minimum amount could be a result of the size of the fund and the need to put a sufficient amount of capital to work. The maximum amount is often related to the size of the fund as well because the venture firm wants to ensure that the fund remains sufficiently diversified.

- Industry Sector – There are venture firms that will be broadly diversified and will invest in industry sectors as diverse as information technology, life sciences, and consumer goods, and others that may specialize in only one technology. While technology investment makes up most of the investing, venture firms also invest in companies such as retail, manufacturing, business services, etc. It is nearly impossible to maintain the knowledge and skills necessary to understand all industry sectors, thus every investment opportunity. Therefore, discipline is required to ensure that firms focus on sectors that they understand, or solicit consultation, to maximize their potential for success.

Investment Potential – Once the investment proposal is deemed to "fit" with the philosophy of the firm, a screening is conducted to test the viability of the deal. Although screening is unique to a particular firm's needs, there are some common threads that a firm evaluates.

- Management – Generally speaking, one of the most important criteria in the screening process is the quality of management. In real estate it is often said that the three most important words are "location, location, location." In evaluating a business, many venture firms will proclaim the three most important words to be "people, people, people."

- Market – It is no secret that venture firms are looking for large, high growth markets. In fact, it would be surprising to see a business plan that does not suggest a significant market. The ability to clearly articulate why a particular business proposal will experience rapid market growth is essential. Most important is being able to explain the competitive landscape. A deep understanding of the competition is a clear indication that one understands the market.

- Product / Service – The key to evaluating a product or service is to ask, "What customer problem is being solved?" Once an understanding of the solution is clear, the next question is, "Can the problem be solved profitably?" The intent is to get a feel for the types of customers and the value that is added by the product or service.

- Business Model - In evaluating the business model, one wants to determine that the business plan tells a compelling story. Simply put, how is the company going to make money, and how will it operate over time? As noted earlier, there is much discussion in the industry about “pattern recognition.” Does the business model appear similar to other proven models? Identifying analogous business models is not a requirement, there are obviously new models developed every day, but the venture firm will be more comfortable if they can identify with proven success.

Business Due Diligence. Simply put, due diligence is the process by which investors determine that they are getting exactly what they agree to buy. The intent of business due diligence is to verify the potential of the deals that survive the initial screening. Often the criteria which are evaluated are similar to those explored in the initial screening criteria but in greater depth. Therefore, assumptions are often made during the initial screening that need to be further investigated and verified. The business due diligence should test the robustness of the information obtained during the initial screening process.

Due diligence can be described as simply a process of getting answers to questions. The key is in asking the right questions that are open-ended and probing in nature. Continuing to “peel the onion” helps to get below the surface of the initial question. For purposes of brevity, typical questions are highlighted under each category. These questions will help explore management, market, product / service, and the business model in further detail.

Management – Venture firms look for high-energy, driven founders who recognize the value of building a world class organization. One of the reasons that venture capitalist place so much importance on the quality of management is because they know that the environment will change. Management will need to react to competitive threats, changing customer demands, new regulations, and other dynamics. Making the right tactical and strategic decisions will be vital for a company’s success. Venture firms want to be sure that the management team is up for the challenge. Venture firms realize that management teams may often be incomplete. This is not a show stopper. The focus then turns toward understanding the access to key resources and / or the ability to attract the necessary talent.

- Who are the founders and what are their backgrounds?
- Do they have relevant experience?
- How well do the individuals function as a team?
- Do they have a track record of success?

- What critical resources do they have access to?
- How well do they evaluate risk?
- Are they detail oriented?
- Do they exhibit a capacity for a sustained effort?

Market – The business proposal must show how it will serve a large, rapid growth market. The entrepreneurs must be able to clearly identify their target customers and define strategically how they will reach them. In addition it is essential that the competitive landscape is mapped out and action plans developed to minimize competitive threats.

- Who are the users of the product and how many of them are there?
- What are the drivers that are fueling the growth?
- How is the company positioned against competitive threats?
- Describe the competition.
- Is the customer, the supplier, and / or the competition fragmented?
- Are there attractive substitutes?

- What regulations govern this market space?
- What are the barriers to entry?
- What is the distribution channel and who controls it?
- What are the market boundaries?

Product / Service – The companies must describe how their product / service will deliver value to the customer and can not be easily replicated by the competition. A platform that can be easily modified to meet changing market needs and stay ahead of the competition is important. In addition scalability becomes important to the financial success of the venture.

- What customer problem is being solved?
- What unique technology and / or knowledge does the company have?
- How does this technology and / or knowledge create value for the customer?
- Why is this product or service superior to the competition?
- Are there any strategic relationships?
- Does this product exhibit scalability?
- What are the barriers to enter? IP protection?

Business Model – As mentioned in the screening criteria, understanding how a firm is going to make money is necessary to defining the key financial drivers. It is more important to see if the company understands the key components that drive profitability than to spend time trying to forecast each line item over the next five years. Although forecasts represent a predication of the future, they are simply that, a predication. The focus is rather on potential for high gross margins and potential for recurring revenue streams. Companies with these two components will be well suited for rapid growth and fierce competition.

- How will the company sell its product or services?
- How will the customer perceive value?
- Are there comparable companies to benchmark?
- Who are the key market influencers that the company needs to target?
- What are the financial requirements, ie capital investment, cash, etc.?
- Is the business model scalable?
- What is the potential for recurring revenue?
- What are the anticipated margins?
- What is the exit strategy? Is it feasible?

Origin of the deal - Venture firms place significant weight on the origin of the deal. This is because firms often know more about the source of the deal than the quality of the deal itself. In fact several firms noted that they would not support a deal that arrived without recommendation.

Due Diligence Infrastructure

To execute the above process, venture capital firms need an appropriate infrastructure. This includes defining the roles and responsibilities and organizational expertise to ensure that the process is effectively managed.

Roles and responsibilities. Several different functions exist within a venture capital firm, often depending on the size and context of the firm. The positions can range from an entry level analysts to a managing partner. Deal screening and the due diligence process tends to be some portion of each person’s responsibility. The extent of the involvement tends to be related to the size of the firm. As firm’s become larger they have additional resources, such as associates, to conduct more of the initial screening and reduce the time burden on partners. However, the partners will ultimately be involved in evaluated the potential deal and making the final investment decision.

Organizational expertise. At venture capital firms, there tends to exist subject matter experts. These areas of expertise may be organized around industry sectors, functional knowledge, or selected activities. These individuals have the responsibility for analyzing and understanding the area relevant to their assignment, developing strategies to attract deals, and setting investment strategies and priorities.

Organizational process. Each organization is unique in the manner in which the investment proposals are reviewed. However, each firm will typically hold formal investment meetings on some frequency; often Monday of each week. The dynamics of these meetings are another driver of the success of the firm. These meetings serve as a platform for critiquing potential deals. Often an individual will support a particular plan and present the opportunity while other members of the organization will challenge assumptions. This act of constructive dialogue serves to promote a deeper review of the opportunity.

Challenges

Despite the progress that has been made in the industry in developing processes and organizational routines to manage due diligence, a number of key challenges still remain.

Consistent application of criteria. This challenge is particularly prevalent in the larger firms. As many of the firms have grown they have added employees and have even expanded to new locations. Various firms indicate that their process is outlined and documented but tends to be more institutional. Formal documentation is not fully utilized. When asked about consistency in the process, since little formal documentation is used, one firm proclaimed that the process was "self-correcting" and the consistency comes out of the system. In contrast, the ability to articulate and codify the fundamental elements of the screening and due diligence process should create valuable time to explore the details of a potential investment opportunity.

Capturing knowledge and experience. As mentioned earlier, success in this industry is often characterized by "pattern recognition." Clearly experience is an advantage in this industry. Therefore, efforts to enhance one's learning curve become critical in facilitating the capture of knowledge. Often it becomes necessary to have knowledge that is "narrow and deep" to intimately understand a particular market / technology space. This intimacy with a particular space leads to improved handling of the due diligence process.

Proactive Research. Often firms are focused on their core expertise and are not able to devote sufficient time and resources to exploring new market spaces. Firms often comment that, if time allowed, they would like to devote resources to understanding new market space opportunities through extending their knowledge and core competencies. The ability to not only identify new market space, but to also identify the specific companies, could create a significant potential advantage for firms. Therefore, improving the process of due diligence should create time to devote to other endeavors.

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