

Due Diligence

What defines a good venture?

In innovation and entrepreneurship, “due diligence” refers to the process of researching the claims and potential value of a new venture. The term “due diligence” refers to the appropriate amount of research and analysis necessary to make an informed decision (e.g., whether to invest in a company, buy stock, hire an employee, etc...). Within entrepreneurship, due diligence describes the process a professional investor would follow in deciding whether to make a investment in a new venture. The larger the investment, the more extensive the due diligence process. All venture capital investors will conduct some version of due diligence before they invest.

For an entrepreneur, the ability to conduct a thorough and objective due diligence process is critical for two reasons. First because you are investing your own time and money in the new venture and it is your responsibility to exercise due diligence that this venture is indeed viable. And you should pursue due diligence on your idea early and often (keep checking to make sure the original assumptions still hold). Second, by performing your own due diligence, you can recognize and correct any shortcomings that potential investors would see in your business.

The challenge of due diligence is to be neither too optimistic nor too pessimistic. The objective is to find a process that enables you to avoid investing in bad ideas that appear good at first glance, without accidentally not investing in a good idea just because it first appears bad.

In this way, due diligence is the art and practice of trying to identify the flaws of a particular business concept and then evaluate the possibility and probability of being able to fix those flaws. It precedes the decision to invest more time and

money in their venture and involves attempting to identify and resolve the most critical uncertainties (unknowns) surrounding the new venture. This handout helps guide the determination of those uncertainties in new ventures.

We have developed a structured worksheet that provides an initial set of general questions that you should ask about an early-stage venture. This provides both an evaluation of the status and prospects of a new venture as it is currently designed and--more importantly--an identification of how the prospects for a new venture can be improved.

This due diligence report is organized in the following way:

- 1. Overview and summary** (a good test of whether you can communicate the essentials of the company clearly and easily)
- 2. The Market**
- 3. The Business**
- 4. The Technology**
- 5. The Business Model** (overall strategy for aligning the market, business, and technology choices)

Try to answer all of the questions, when applicable, and use this process as a means for creating an objective sense of how others would see the strengths and weaknesses of your company. The process is intended to raise more questions than answers--and should point you in the direction of what more you need to learn to feel comfortable investing your own time and money in your venture.

The Technology

Key Questions:

Characteristics: What is the product or service? Is the technology disruptive to the current state-of-the-art? How well is it understood by the company? Is the product and/or service immediately viable? What is its stage of development? Is there a working prototype? Is product and/or service readily scalable? Are there government regulations that govern its use? How is it deployed or implemented?

Supply Chain: Are there elements of the technology that depend on critical suppliers? Are any elements scarce or subject to variability in supply or quality? Will the technology (product and/or process) survive the distribution environment?

Differentiation: Does the company possess defensible IP? Are there substantive technical or legal barriers to entry? What is the company's IP strategy? Does the product offer significant advantages in either cost or cycle time to alternative products or methods?

The Market

Key Questions:

Market: Is the nature and importance of the business need this company addresses clearly articulated? Is the overall market clearly defined in terms of size, structure, and geography? Is the market large and/or rapidly growing? If not, can the company reasonably create such markets? What is the current product or service approach and what market needs are not being met?

Competitive Landscape: Is the overall structure of the competitive landscape defined? Are the most relevant competitors identified, their business models and true capabilities clearly understood? Are there any competing technologies on the

Market Penetration Strategy: Has the company clearly identified the target market(s)? Is there a credible, prioritized plan for acquiring customers in each of the target segments? Are key customers identified? Is the marketing approach viable? Is the sales process understood? Are the economic buyers identified and is the value proposition clear and irrefutable? What is the average deal size? What is the pricing strategy and is it consistent with the value proposition?

Market Validation: Is the company working with initial customers? Has the company secured letters of intent for product and/or services? Is there strong evidence the target customers are willing to pay for this product? Has the company secured key partners to facilitate its growth?

The Business

Key Questions:

Management: does the management team have a strong demonstrated track record in executing business plans, soundly managing cash, raising capital, adjusting plans to meet changing business conditions, and leading organizations within this industry? Are the leaders driven and charismatic? Is the management team complete – does it have the necessary skill sets on board to execute the business plan?

Board of Directors: Does the board possess strong and independent members with relevant governance background and experience within the industry and/or stage of the company? Does the board have good contacts for initial customers and/or raising funds? Does the board have sufficient influence and authority over the management team?

Financial Projections: Does the plan show realistic gross margins, unit/sales volume, and return on capital invested? Is there a clear relationship between the market definition, penetration strategy, and revenue/expense ramp projections?

Required Funds: Does the use of proceeds look sound? Is the asked amount adequate to fund a successful ramp, or will follow-on investment be required?

The Business Model

Key Questions:

Characteristics: What is the business model – how does the company plan to produce, market and sell their product or technology? What is the company structure? What is the company's proximity to it's market?

Differentiation: How is this model clearly differentiated in the target market? Are their barriers to entry at the model level (e.g. Southwest Airlines)? Does the company have first mover status, world class technologists, proprietary processes, and/or key customers under contract?

Risks: What are the risks associated with the model and how are they to be mitigated? Is there sufficient supply of essential materials, components, and third-party services? Are key partners capable of becoming competitors?