

THE DUE DILIGENCE PROCESS

- A TWO-WAY STREET -

INTRODUCTION

In their search for private capital, many entrepreneurs are unprepared for the due diligence process that "angel" investors will undertake when exploring an investment opportunity in a venture. Moreover, in their eagerness to obtain private venture capital, entrepreneurs often fail to conduct their own due diligence of the investor(s), to be sure that a potential relationship will be right for their company. This brief article outlines the questions that entrepreneurs should be prepared to answer from potential investors, as well as the inquiries they should make of those investors as any funding proposal is evaluated. In fact, the due diligence conducted by experienced private investors is even more extensive than that outlined here.

However, before turning to due diligence, angel investors considering a venture opportunity are sure to ask the question "Is the valuation reasonable?"

THE VALUATION ISSUE

An early decision to be made by the entrepreneur seeking funding concerns the type of capital to be sought (e.g., equity, debt, combinations thereof, in kind services, etc.)? If equity capital is being raised, before discussions with private investors are begun, the company's management must decide what percentage ownership in the company should reasonably be given up for the targeted amount of investment capital. This means that the entrepreneur must have a "realistic" valuation of the company as a starting point. The most common problem that private investors encounter in venture deals are unrealistically high valuations.

While it is not possible to explore the art and science of valuing developmental stage ventures in this article a few indicators are worth noting. If the venture is basically a start-up, investors will expect a at least 50-60%/yr return on their investment for the level of risk. If it's an expansion stage deal, 35%-50% return will be sought. If you assume that investors hope to achieve liquidity after five years, their total return for a start-up will need to be a minimum of 7-10 times the original investment and for an expansion stage venture, 4-7 times. The entrepreneurial

management team must make an objective appraisal of whether the returns they forecast are likely to meet a private investor's requirements--before they begin to seek that investment. If the rate of return on outside investment is too low, the management team must determine whether (a) giving up additional equity in the business to raise the investor's ROI is feasible and prudent, or (b) other forms of financing should be sought in order to bring the venture to a later, less risky stage, where lower returns are acceptable, or (c) the venture should be restructured or closed because it cannot generate high enough returns.

DUE DILIGENCE BY THE PRIVATE INVESTOR

In evaluating a potential business relationship with a venture, investors will be asking the following questions:

1. Is this management team able to grow their venture rapidly and successfully?
 - Have they done it before?
 - Do they have industry knowledge and experience?
 - Do they have the necessary key positions filled?
 - Are the principals trustworthy (credit and criminal background checks)?
 - Have they begun to build solid advisory and legal teams?
2. Is the product or service unique and fully developed? Does it create compelling benefits for The target customers? If it is not fully developed, does management understand the time and dollars required to complete development? What intellectual property protection exists?
3. How large is the market? Are there existing customers with whom the investor can talk? Is the market large enough to support rapid growth and attractive margins? Is the market for the product/service growing? Has the management team conducted credible and systematic market research?
4. Does management's marketing plan make sense? Are there strategic partnership agreements with other players that are beneficial to the venture?

5. What are the barriers to entry by competitors? Who are the competitors and what strengths do they possess? How will the venture gain and defend its target market position?
6. Are the venture's operations logical and scalable? Who are the vendors and what are the risks associated with key supplies? Have/can they be mitigated? Can the vendors be contacted?
7. How much investment capital is needed? In how many rounds? How will it be employed? Does the cash flow analysis demonstrate this need? Has management carried out a sensitivity analysis of their capital requirements? In other words, so they demonstrate an understanding of how much their key business assumptions would have to change for the capital sought to be insufficient to meet their objectives?
8. Is the potential return on this investment sufficiently attractive in relation to the risk? Does the management team clearly understand the key business elements that must be managed for the venture to be successful?

Once the entrepreneur gets beyond the due diligence process with an investor, h/she must be prepared to negotiate the basic issues:

- Equity % given up (stock price).
- Type of equity and/or debt as well as restrictions.
- Restrictions on salary, commitment to the venture, management and employee stock options.
- Dilution protection.
- Board of Directors composition.
- Performance milestones and consequences of not meeting them.
- Exit/liquidity plan.

DUE DILIGENCE BY THE ENTREPRENEUR

If investors are interested in a venture, entrepreneurs must be prepared to do their own due diligence to protect their interests. Some of the issues/questions are:

1. Accredited or not?

2. Background checks (credit and criminal).
3. Industries in which the investor has previously invested? Any complementary or competing investments?
4. Size and venture stage of existing and past investments by the investor?
5. Does investor typically play a lead or follower role in investments?
6. What role does the investor indicate he wishes to play in this venture?
7. What value added or other benefits does he bring to the venture (industry contacts, financial expertise, name recognition, assistance in recruiting key staff, etc.)?
8. Are the personalities of the investor and entrepreneur(s) compatible?

CONCLUSION

Due diligence is truly a two-way street. Both entrepreneurs and investors have too much at stake to be anything less than prepared and thorough in their due diligence process. When they are, a mutually beneficial investment agreement can be concluded and the venture's chances for success will be significantly enhanced.