Venture Capital — Due Diligence is No Mystery

What happens behind closed doors when doing due diligence?

By John Occhipinti, Managing Director, Woodside Fund

If you ask ten funded entrepreneurs what happened during the VC due diligence process, you will get ten different answers. Some will say they lost valuable months answering endless questions for VCs that never produced a term sheet. Others may admit they gained valuable insights into their business. I am uncertain when the due diligence process gathered so much mystique, but among entrepreneurs, there is still an 'urban myth' status about what happens behind close doors. At Woodside Fund, we believe it shouldn't be a mystery. Understanding due diligence improves the information flow between venture funds and potential entrepreneurs. Better information leads to better investment decisions and better long-term partnerships. In my opinion...

Due diligence is:

- A process designed to get a 360 degree view of the business.
- An evaluation of an entrepreneurs' ability to ascertain strength AND weakness.
- An opportunity to validate true customer demand.
- The beginning foundation of trust and partnership. Due diligence is NOT:
- Slow torture in the form of a lengthy checklist.
- A stress test for the executive team.
- A chance to prove we are smarter than you are.
- A justification to 'ding' your valuation.
- A delay tactic until another fund takes interest.

At Woodside, our due diligence process focuses on three primary areas: market, technology and team.

Market

A good venture fund can do a lot to help a company, but we can't make customers buy products. Ninety-nine percent of what comes through our doors are "nice-to-have" products presented by entrepreneurs as "must-have."

Customers can't just have a "need" for your product or service. That "need" must be important enough to them personally to cut through the 100 other priorities currently occupying their day. Customers buy for personal reasons not just for the good of the company.

Entrepreneurs must challenge their prospects to get to the real truth. After a customer states they have a need for your product, you might probe further: "I appreciate your enthusiasm but you must have at least 50 other projects right now. How realistic is it that you would even find time to evaluate our product let alone buy?" If your prospect truly "must-have" your product they will defend their pain. If they don't stand up to the plate, then it will not yield a real customer.

Woodside would ask prospective customers the following questions to understand that level of personal pain:

- How long have you been dealing with this problem?
- What have you done to date to address this problem?
- What is the real impact on the organization?

We validate these answers with dozens of customer calls. We'll talk to the entrepreneur's reference list (undoubtedly well prepped), but more importantly, we speak with prospective customers, technical leaders and industry contacts where we have prior relationships. No validated pain, no deal.

While this is the foundation of our market assessment, of course every VC assesses the opportunity in terms of projected market size and potential competition. The presentation with the proverbial bar chart sloping up and to the right, however, does not impress. We are less interested in Gartner and IDC market predictions than realistic bottoms-up, total addressable market (TAM) analysis based on target customers.

We often see the obligatory competition slide with the company logo in the upper right hand corner of a standard two-by-two matrix. This is helpful but not sufficient. You must articulate beyond four quadrants your competitive barriers to entry, your unique differentiators and your future competition. The kiss of death is for us to find unanticipated competition you neglect to mention. Know potential entrants cold.

Technology

Technology differentiation is a critical element to Woodside's decision process. The important point is to not only have technical differentiation, but also to insure it translates to compelling differentiation to customers in the market.

As early stage investors we rarely are investigating a complete product, therefore our technical review is as much about people and processes as it is about the code.

Our technical due diligence typically starts with a full one to two day review with the engineering and product marketing staff. During this session we want detail on the following:

- Market requirements processes
- Feature specification processes
- Roadmap processes
- Architectural review processes
- Engineering schedule process
- Quality assurance processes
- Documentation processes
- Technical recruiting processes

Our goal is to feel 100% confident that the team is capable of building exceptional products - now and in the future. We validate all of our due diligence with outside consultants and industry experts close to our fund. Finally, we round out our technology assessment with a comprehensive intellectual property and patent protection review. We must ensure all technology differentiators are well protected.

Team

Looking back over our 20-year history, Woodside's success has depended on great talent. Our goal is to build world -class teams starting with talented founders and complementing their skills over time. We believe we have a proven methodology for assessing founders and executive teams. While I can't assure you that all venture interviews will be like this, it will prepare you fully for what might come.

Typically we begin with the perfunctory questions that happen in most inter views. After one hour, we will invite you to the whiteboard to diagram the last two to three organizational charts associated with your prior most meaningful jobs. These charts include managers, peers and direct reports by name.

For each individual on that white board, we may ask the following:

- How would you describe this person's management style? (Getting context)
- If we where to talk to this person, (with your permission of course) how might this person describe your strengths?
- How would this person describe your areas for improvement, where would you be considered "less than perfect?"
- Who might your supervisor or board say you had the most difficult time with?
- If we were to talk to the previous CEO, how would they say you were perceived in the organization?
- Among your superiors, peers and subordinates, which group would rank you 1, which one 2 and 3?

This three to four hour process typically has the following outcomes:

- We are obtaining instant reference checks.
- We have built a list of names to call that are off the official reference list.
- When we call these references, we describe the organizational chart process and receive far more candid feedback.
- Most importantly, we begin a relationship based on trust. From here on out, if we invest, the CEO knows they can come to us with problems before they may have solutions.

Woodside believes the time invested up- front pays huge returns. Remember the last time you interviewed an employee?

Most have only an hour to get to know the candidate, with the first 30 minutes allocated to describing the company and the job. If this employee does not work out, you will most likely spend more then an hour getting on a plane to fire the employee than you did interviewing.

Parting Practical Thoughts

As you go through the due diligence process, here are some practical tips to keep in mind:

Continually take temperature

Only 5-10% of entrepreneurs I work with ask closing questions like: "Have I answered all of your key questions? " Or, even better: "How do I compare with the other 100 business plans on your desk and what is the likelihood we'll reach serious due diligence?" Get to the truth early. Waste no time

Course-correct based on feedback

Chances are objections you hear at one fund will be concerns at another. Incorporate the feedback you hear — either by adding it or refuting it. Think of this feedback as sparring practice. It is like training that makes you stronger in fighting real challengers to your success.

Conduct your own due diligence

This process is the foundation for the long-term partnership. Experienced entrepreneurs know that the investor relationship is akin to marriage. Ask to call the fund's prior and existing portfolio CEOs. Simple revealing questions are: "What are they like to work with on the board?" "How do they add value?" "How did they react during a tough time?"

The fund will be your operating partners and you need to assess them like you would your own executive team. Finally, don't sign the deal unless you can comfortably answer the question: "Will they be a good partner when things don't go according to plan?" Because we all know, they never do.

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