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The Due Diligence Process

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How venture capital firms choose their investments

What can you expect venture capital firms to examine as they reach a determination regarding funding your enterprise?

Before making any investment, our goal as venture capitalists is to understand virtually every aspect of the target company: the experience and capabilities of the management team, the business plan, the nature of its operations, its products and/or services, the methods by which sales are made, the market for the products and/or services, the competitive landscape, and other factors that may affect the outcome of the investment. While due diligence investigations are viewed by many as mundane and irritating tasks, the process enables venture capitalists to address areas of concern, is an important tool in determining a fair pre-investment valuation, and may help to avoid significant and otherwise unexpected liability following the investment.

For example, at First Capital Group, we view the due diligence process as a means of identifying and becoming comfortable with the risks to which our capital will be exposed. Our due diligence process involves an assessment of both the microeconomic and macroeconomic factors that can affect the earnings growth of the target company. The due diligence process also includes a review of the corporate and legal records, including the documentation supporting any previous issuances of the company's securities.

Microeconomic analysis

These are the factors within management's control and include a careful assessment of the management team, the business model, the value proposition, the distribution strategy, the intellectual property, the financial strategy and capital requirements, and the legal structure and records of the company.

Macroeconomic analysis

These factors are generally outside of management's direct control and include a review of such areas as market size and expected growth potential, the perception of the company and its products by its suppliers and customers, the competitive situation and product differentiation, and government and regulatory influences.

Over the years, we have developed and fine-tuned an extensive due diligence questionnaire which we supply to prospective companies at the inception of the due diligence process.

Due diligence, itself, is both a quantitative and qualitative process. The due diligence process commences only after the venture capitalist has spent sufficient time with a prospective company to become convinced that spending the additional time and energy required will be a worthwhile endeavor.

Perhaps the most critical aspect of the entire process is the close interaction between the venture capitalist and the management team throughout the due diligence process. In the process of getting better acquainted with the management team, we are able to discern whether the management team is appropriately experienced and committed to the business, as measured through the team's behavior as well as their response to queries.

While some of the findings of the due diligence process do little other than to confirm the initial "gut feelings" of the venture capitalists, there are some areas that are best described as "show stoppers." Show stoppers include determining that the target company has a flawed business plan, is managed by a group of convicted felons, has technology that does not work, or products that cannot be sold. However, there are other, less obvious issues that may arise in the due diligence process to cause a venture capitalist to break off discussions with a company.

One such problem is the inadvertent violation of provisions of the Securities and Exchange Act that occurred when the company was raising prior rounds of capital. Unfortunately, this is a frequent faux pax committed by many early-stage companies that raised their initial capital from family, friends, and casual acquaintances without proper documentation. In this instance, the company and an unsuspecting investor could find a significant portion of the proceeds of new financing being used to fund the repurchase of securities from disgruntled existing investors who have successfully sued for rescission of an earlier and improperly documented securities offering.

In one instance, we had agreed on a preliminary term sheet, subject to the satisfactory completion of due diligence, which established a pre-investment valuation of the company significantly lower than the two previous investment rounds. Both of those financings were funded by individual investors, many of whom were not accredited investors. Additionally, we determined in our legal due diligence that there were numerous failures to fully comply with provision of Regulation D of the Securities and Exchange Act.

Because our proposed financing would have been extremely dilutive to the existing common stockholders, there was considerable consternation among the investors in the prior rounds. Ultimately, we concluded that the only cure for the securities violations would be for the company to initiate a rescission offer to repurchase any securities that the earlier investors wanted to sell back to the company; the price of the rescission offer would have been at the price those investors paid for the stock they had purchased.

We felt that most, if not all, of those investors would tender their shares and recover their original investment. The cost of completing the rescission offer would have consumed a significant portion of our proposed investment and increasing the proposed investment would have adversely affected the economics of an investment in the company. Ultimately, we chose not to proceed with an investment in the company.

Pending litigation can be another issue that can bring the investment discussions to an abrupt halt. Not being able to determine how a court or a jury may rule in a patent infringement suit is generally not a risk that a venture capitalist is willing to assume. Both of these risks can be avoided by proper legal due diligence review of the company's books and corporate records.

To summarize, if the due diligence process confirms an investors' initial instincts, nothing

untoward arises during the review process, and the additional time spent between the venture capitalist and the management team results in a positive working relationship, the result is likely to be the successful closure of an investment in the company. Additionally, a detailed due diligence process usually results in a more informed investor who can help management in the value-creation process from inception rather than spending time following the initial investment trying to understand the business and the challenges faced by the management team.

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