Stones Unturned: An Investor's Guide to Due Diligence in Early Stage Companies

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This article is the first in an ongoing series on Due Diligence. To learn more about performing due diligence quickly and effectively, download this free eBook today Stones Unturned: An Investor's Guide to Due Diligence in Early Stage Companies or purchase our books at Amazon.com.

Some investors will tell you after spending 60 minutes with an entrepreneur they know in their gut whether to make an investment. They rely on their instincts and sometimes their ability to “pattern match” with successful opportunities and entrepreneurs they worked with in their past.

At the other end of the spectrum, there are investors who will spend countless hours digging into every aspect of a startup company. They want to feel 100% confident in their investment decision before they sign the check. Comprehensive due diligence efforts like this usually drag on for months and may do relatively little to actually de-risk the deal.

What is challenging to explain is that both types of investors meet with some success, and both types meet with some failure. Because so much judgment is involved in investing, it can be very hard to know what the right amount of diligence is, and how to go about it. It turns out that picking the right level of diligence is achievable: due diligence is really nothing more than the gathering of additional facts which you can consider before making a decision. If you need to make a decision, it will generally be easier if you have some data. There is no specific amount necessary, and not all data will be directly helpful with the decision. The amount will vary by stage of company. But good data, timely and efficiently gathered, will never hurt.

Our Approach to Due Diligence

Accordingly, in our roles as Managing Directors at Launchpad Venture Group, we believe in a balanced approach to due diligence. As my partner, Christopher likes to say: “We major on the majors.” Over the years and after making investments in nearly 100 companies, we designed a process that is intended to be quick, efficient and focused on the key issues which underpin the key risks. Executed properly our process can be completed in under 40 aggregate person hours of effort. Split this effort across a team of investors and you have a very fast and manageable project.

Before we dig into how our process is structured, it’s important to describe the stage of company we are typically examining. We invest very early in a company’s lifespan. Usually, the company is pre-revenue, though in some cases they might have up to $1M in annual revenue. So to be clear, we aren’t talking about businesses with substantial operating histories, multiple divisions, multiple geographies, large teams or complex product portfolios. In the parlance of early stage investors, we are looking at companies during their Series Seed or Series A rounds of investment.

3 Guiding Principles of Due Diligence

Our process is driven by three guiding principles:

1. Identify Key Risks
2. Develop the Investment Thesis
3. Acknowledge “What Needs to Be Believed” to Invest

Let's dig a bit deeper into each of these guiding principles so we can demonstrate how we focus our efforts and come to an investment decision in such a short period of time.

Identify Key Risks

After listening to the entrepreneur's presentation, we caucus to discuss first impressions and immediate top of mind questions and concerns. From that we are able to distill it down and pull together a list of 3 or 4 critical areas that need further examination. These areas are usually covered to one degree or another in the investor pitch deck (e.g. customer problem, market opportunity, management team, competition, financials, etc.). Each topic area is naturally going to have a few important questions that we need to further research.

For the sake of completeness, we cross-check against our due diligence checklist when forming these questions. But, to keep the process efficient and focused, our diligence team members work together to distill the list of key questions we are really trying to answer and disregard questions which will not add value in a given situation. The answers to the key questions help us identify the areas of solid ground as well as the key risks that will need to be addressed for the company to achieve a successful exit for the investors.

Develop the Investment Thesis

Ultimately when you are forming an investment thesis, you are building a model or likely scenario in your head. An important filter that can help when assessing potential investment opportunities is sometimes defined as the Three P's: Potential, Probability and Period. Formulating the Three P's into questions, we have the following:

- Total Potential of this Company's Success: Is this a billion dollar IPO opportunity or is it more likely to be acquired for under $50M? Or something in between?

- Overall Probability of Success: Are there a limited number of risks that can be mitigated or are we buying a lottery ticket for Powerball?

- Likely Period Until Pay-out: Will it take 10 years to complete the product and get FDA approval, or could this company be acquired in the first couple years by a big competitor?

Acknowledge What Needs to Be Believed

Once we have a handle on the key risks, and we have built an investment thesis, we need to synthesize them into a workable company hypothesis. The best way to keep yourself honest when doing this is to take the trouble to acknowledge and actually list "what needs to be believed" for the investment to make sense. Thus, when we get to the final stage of our due diligence effort, and we write up our very brief report, we make sure we know and prominently document right at the beginning "What Needs to Be Believed" or WNTBB. If an investor just cannot get comfortable that something on the WNTTB will come true, then maybe this deal is not for them.

The core of the WNTBB exercise is really a test to make sure we are not fooling ourselves. It forces us to ask:

- Have we identified the key risks?

- Do we understand the premise of the deal (i.e. the investment thesis)?

- Is there a balanced logic to the deal?

14 Key Factors of Due Diligence

Now you have a very high level conceptual overview of our Due Diligence Process. To make it fully understandable, and more importantly, something you can actually practice, we need to delve into more detail. With this series of articles our goal is for you to better understand the types of questions we ask, major risks that concern us, and how we structure our deals to work well for founders and investors. Over a series of articles, we will take an in depth look at the following:

- Key Risks: With early stage companies, what are the key areas of risk every investor needs to accept?
- Management Team: Beyond simple reference checks, how do you assess the leadership team?
- Technology: What must you understand to determine if a company has breakthrough technology?
- Product/Solution: How do you evaluate whether customers really need the company's product?
- Intellectual Property: How do you evaluate the importance and strength of the company's Intellectual Property? Have they built any significant barriers to entry with IP or any other means?
- Go-to-Market Strategy: Does the company have the right initial strategy for selling to the customer and a plan for doing it at scale?
- Competition: What is the competitive environment including but not limited to the set of competitors that the company identifies? What will it be in 5 years?
- Market Opportunity: What is the long term potential for the company based on the addressable market opportunity today and in the near future?
- Financials: After digging into the financial model do you understand key assumptions and near term milestones for this current round of financing?

- Funding Strategy: What is the model for the long term funding strategy of the company and how will different strategies impact the early investors?

- Legal: What legal issues are critical with an early stage company in areas such as regulation, contracts, IP and employment?

- Exits: What are the exit opportunities for the company? Who will buy this company and why?

- Deal Terms: How do the deal terms, funding strategy and exit opportunities combine to produce a reward that justifies the risk of an early stage investment?

- Alignment: And finally, how do you make sure that the goals of the investors and the company founders are in alignment?

This is a lot of material to discuss... and to master. I am sure many of you are wondering how it's possible to cover all these questions in a short, concise due diligence effort. Trust us… we've executed this process dozens of times over the past few years and it works!

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