

# Winning in the Due Diligence Process

## Tips for Companies Seeking Investment from VCs

by Robbie Kellman Baxter



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### **W**hat is Due Diligence?

When a VC tells you they want to do some Due Diligence on your company, generally, it is a good sign. It means that they like your business model, and want to make sure that you are telling them the full truth. VC's expect that the company presenting the business plan is going to present the competitive market, sales pipeline, financials and product quality in the best possible light—as they should. Now it's up to the VCs to validate the facts given, make sure they're correct, and also get some objective industry experts to give them some facts.

### *What Might a Due Diligence Exercise Include?*

#### Customer Interviews

- Ensure that the customers have purchased what the company says they've purchased (i.e. are all customers actually “beta testers” or “friends and family”)
- Ascertain how the product is being used
- Find out if the customer is happy with the product
- Understand if the customer is planning to buy more and/or make referrals to others

#### Prospect Interviews

- Validate the pipeline—how serious each prospect is
- Understand what other options are being considered (competition)
- Determine how strategic the product is and how much the customer is expecting to pay

#### Detailed Scrutiny of Financials

- Review financials and capital structure with CFO
- Talk to investment bankers to understand possibilities for exit (how long, what way, how much)
- Talk to existing investors to verify additional planned investments and how strong they would be if the company stumbles

#### Calls with Industry Experts

- Talk with pundits, analysts and other objective people familiar with the space
- Determine if the company is perceived of as being a player with a chance at success

#### Reference Calls About Management Team and Board Just like reference checking for a job—with both past employers and current colleagues

- VC wants to know what it's like to work with these people
- Wants to understand how the team gets along with each other
- Assess commitment and integrity of each key player
- Talk with Board members and major investors
- Ensure that the attitudes of all constituencies are
- aligned and consistent with those of the prospective investor

### *What Do Companies Do Wrong?*

#### Forget to Prepare

Too often, companies aren't prepared for the requests of the VCs relating to Due Diligence. They haven't identified which customers they want to make available, or haven't spent time with the customers to un-

derstand the risks. Especially in early stages, start-ups may appear disorganized and unprofessional when they aren't able to quickly respond to the VC.

#### Withhold the Truth

Companies sometimes fudge the truth. While every savvy VC understands that the company will portray itself in the best possible light, VCs also are evaluating companies for honesty and ethics. The Due Diligence process is likely to bring out all the warts, and any "dirty laundry" that only comes out after the VC digs in is likely to be perceived as particularly damning.

#### Put all Eggs in One Basket

Some VCs deliberately take their time in the Due Diligence process, often encouraging the company to put off other interested suitors. In the moment, it might seem like a show of good faith to work with the leading VC and not mislead the other VC firms, but

it is always in the company's best interest to work with 2-3 other firms throughout the Due Diligence phase. Otherwise they run the risk of being stuck accepting an unappealing term sheet just before they are due to burn through the last of their cash.

#### ***Putting Your Best Foot Forward***

Companies should put as much effort into preparing for Due Diligence as they do in crafting the Investor Presentation. Think like the investor and try to anticipate what their greatest concerns will be, and what "objective" evidence you can make available to them that will allay these worries. Due Diligence is actually an opportunity to strengthen the relationship with the Venture Capitalist, to increase their perception of value in the company, and ultimately to justify a higher valuation.

**This article initially appeared in American Venture Magazine.**