
Due Diligence Checklist

The following due diligence checklist is intended to provide an outline of the topics to be investigated during the due diligence associated with a prospective venture capital investment into a high-technology company. The purpose of the due diligence process is to audit management's business plan in a manner which will permit independent validation of the business' core strategies and assumptions, and will expose the key business risks. Like other audit exercises, due diligence is not intended to repeat every aspect of business planning but will focus on the most important business areas and the ones which may hide the most risk. In no event will all the activities described below be undertaken during the due diligence on any single company. The amount of due diligence on any single investment will be scaled according to the size of the investment, and the magnitude and nature of the investment risk. Although due diligence will generally be shared among the members of the venture syndicate, each individual investor must be satisfied that all of the key items have been adequately addressed.

Management

What to think about:

- Will to win; commitment; dedication
- Listening skills; willingness to accept outside help
- Leadership skills and people management skills
- Communication skills
- Flexibility
- Individual contributor or team player
- Integrity
- Ego and control orientation
- Energy level
- Charisma
- Is the management team complete? What gaps need to be filled, when? The key roles are: leader, seller, sales manager, R&D guru, R&D manager, businessman and scorekeeper.
- How difficult and expensive will recruitment be?
- Skill sets and experience
- How dependent is the organization on any individual?

What to do:

- Interview management both individually and collectively
- Reference checks on management including former employers; former employees; former business peers; industry experts; current business partners; community members; it is important to find references not suggested by the individual in question
- As a matter of general practice, we do not generally hire private investigators or otherwise delve into an individual's private life
- Occasionally, we may seek outside character analysis through such means as psychological profiles and handwriting analysis
- Credit checks



Product/Technology

What to think about:

- Why is the product better, cheaper, faster? What is the benefit of this to the customer?
- Can the product advantages be described in a simple, succinct manner?
- What is the competitive advantage? Is this advantage sustainable?
- Does the product force the customer to make significant changes to accepted practice or to invest in other products or systems?
- What is the process which determines which new products with what specifications will enter the product development cycle?
- What are the barriers to entry? (patents, intellectual property, regulatory, brand name recognition, access to key distribution channels, strategic partnership) Are the barriers real and sustainable?
- Is the technology platform robust enough to extend into a full line of products?
- Will the product benefits scale to different sizes and price points?
- Was the product the result of a singular discovery or a disciplined process which reliably uncovers market needs and develops commercially viable solutions?
- How might technology or market changes cause sudden obsolescence?
- Is the product complete? Is there a defined plan to reach completion?

What to do:

- If the product exists, try it, touch it, see it, get a demo, attend while real users use it. Thoroughly review installation procedures.
- As appropriate, hire technical consultants to perform an audit of the technology and the development process.
- Review quality assurance and quality control procedures.
- Review current and prior development schedules.
- Review product definition specifications, patents and patent applications, patent opinions
- Attend trade shows; user group meetings; industry seminars and conferences
- Talk to customers:
 - Their view of product advantages and disadvantages—what benefit does it provide
 - Their view of the company and its employees and management
 - Their knowledge of competitive product offerings
 - How do they use the product; has it met their expectations
 - Any plans to purchase additional quantities of the product
 - Suggestions for improving the product or extending its function
 - Beyond the product itself what are their views on other “whole product” features such as training, maintenance, packaging, documentation, product support, compatibility with existing systems.
 - Have they quantified the product benefits internally (e.g. payback time)
- Talk to prospective customers who refused to buy the product or returned it after purchase.

Manufacturing

What to think about:

- Can the manufacturing capacity be scaled up or down at a reasonable price in a reasonable time?
- Does the manufacturing process consistently provide for a high quality product?

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- Are there certification or quality standards (ISO 9000; GMP) which create barriers to entry or a competitive advantage?
 - Does the company have control over its gross margins? Which inputs create the most risk?
 - What is the risk that the company will not be able to deliver its product?
 - Are there key components which may increase in price or be in short supply?

What to do:

- Review measures of product quality, e.g. scrap rates; warranty return rates
- Review purchasing and procurement procedures
- Review supply contracts including price escalation clauses, market outs, second sources; review financial stability of key suppliers.
- Review ISO 9000 or other certification status
- Review quality control and quality assurance procedures.

Market Analysis

What to think about:

- Is the market large enough to support the company's projected revenues?
- Is the market growing quickly enough to satisfy the company's growth plans? Any signs of plateauing or market saturation?
- If the company produces a product which is a component of a larger product, evaluate the forces governing rollout of the true end-product.
- Is the market concentrated or fragmented? Is a market consolidation play available?
- What are the barriers to entry?
- At what stage of development is the market (cf. Geoffrey Moore's notions of the hi-tech market chasm and other models of market development); are customers studying, piloting, or broadly implementing
- What is the elasticity of demand?
- Is there one large market or are there many allied niches, each with its own dynamics?
- Is the company projecting a reasonable market share?
- Who are the likely strategic partners for the company?

What to do:

- Validate Company's data supporting market size analysis
- Confirm market data through outside parties such as consultants and market analysis studies
- If possible, review business plans addressing the same general markets to observe different approaches
- Attend trade shows, industry conferences
- Segment market; evaluate competition and anticipated market share in each segment.
- Talk to customers:
 - Would they recommend the product and the company
 - What is their buying cycle
 - How is the purchase decision made and who is the decision maker
 - Customers view of market directions



Sales and Distribution

What to think about:

- What is the selling process; how long is the selling cycle?
- Is this a direct or indirect sell?
- If direct, understand the economics.
- If indirect, understand the economics for the company and the distributor and look for company plans that will create pull through demand.
- Is occupation of the distribution channel by others a barrier to the company's entry to the market?
- Can the distribution channels be effectively leveraged to quickly grow the company?
- Has the company distinguished between sales and sales management?
- Is there adequate geographic coverage?
- Is the sales force technically competent?

What to do:

- Review channels of distribution
- Contact OEMs and distributors to confirm volume purchase orders, cancellation, pricing, payment; restocking and return privileges, exclusivity provisions
- Review the sales compensation plan and/or distribution channel discount structure relative to industry standards
- Review sales quotas and sales productivity data relative to industry standards
- Talk to salespeople in the field and, if permitted, accompany on sales calls as an observer (usually tough to get permission)
- If indirect understand the business case of the distributor.
- Review the sales funnel. Determine quality of the information and historical accuracy.
- Review sales prospecting methodology. Are leveragable techniques such as direct mail and telemarketing viable?

Competitive Analysis

What to think about:

- What are the customer's alternatives to perform this function (competitive products and other methods)?
- What are the competitor products?
- Why is this product better?
- Are the competitors entrenched - if so, how will they be displaced?
- Replacement or new installation?

What to do:

- Get information on all competitive products and companies (annual reports, 10Ks; analysts reports, product literature, press releases)
- Compare sales and marketing strategies
- Compare product offerings - feature/function/price today and project 2-3 years. Create competitive matrix.
- Compare technology strategies and architectures. Create competitive matrix.
- Gather all public information
- Read trade journals and industry newsletters
- Attend trade shows and technical seminars

Financial Analysis

What to think about:

- Our internal projection of the profit and loss statement - particularly the build up of the revenue number and the connection of this to the sales plan.
- Thoroughly understand cashflow projections - cash is king!
- How much working capital is required to run the business; how much capital is required to grow the business?

What to do:

- Analysis of key ratios relative to competitors:
 - Gross Margin
 - EBITDA
 - Aged Accounts Receivable (Days Outstanding)
 - Aged Accounts Payable (Days Outstanding)
 - Quick ratio
 - Return on equity
 - Return on assets
 - Inventory turnover
 - Inventory: Finished Goods as % of Total
 - Working Capital and Total Assets as % of Revenues
 - Revenue per employee
 - Cost per employee
- Review of Accounting Policies:
 - Revenue recognition
 - Inventory valuation (Obsolescence issues)
 - Standard cost valuation methodology
 - Bad debt reserves
 - Warranty reserves
 - Capitalization of soft assets (R&D; licenses; goodwill)
 - Depreciation and amortization policy
 - Off balance sheet obligations
- Review of budgets and forecasts (historical accuracy)
- Review use of proceeds
- Review of budgeting process (top down vs. bottom up)
- Review of internal controls
- Discussion with auditors and audit committee (Auditors' Management Letter; year-end adjustments and writedowns)
- Warranty returns history
- Preparation of our own pro forma financial projections and valuation (First Chicago analysis; Discounted Cashflow analysis)
- Review of company's tax position and any tax planning strategies (SR&ED Tax Credit history and projections)
- Conduct sensitivity analysis on projections (price; margins; sales cycle or salesperson productivity)
- Review banking arrangements and any credit facility. Talk to bankers
- Review auditors' files if company is audited



Pricing and Structure

What to think about:

- Capital required now, how long it will last?
- What will the company look like when the next round of financing is required and what will the likely valuation be?
- What follow-on reserve is required?
- Should pricing and investment be tied to the accomplishment of milestones (ratcheted pricing; investment tranches)?
- Are we in a price competition with other prospective investors?
- Does the deal structure provide for reasonable influence on the company's direction?
- Does the deal structure provide reasonable probability of a timely exit?

What to do:

- Prepare income statement and cashflow projections
- Prepare First Chicago analysis; expected ROI
- Look at valuations of comparable companies
- Investigate realistic liquidity scenarios - Is a big win IPO the only way out? Project exit timing
- Are management, their friends and family investing alongside the venture investors?
- Review of company articles and minutes of directors meetings
- Terms and conditions of prior financings
- Management stock ownership
- Employee Share Option Plan details; review reserves for adequacy
- Representation on Board of Directors
- Consider possible syndication

Legal Issues

What to think about:

- Issues that could impair the company's ability to use its technology, market it freely
- Legal issues that could impair the company's ability to operate freely

What to do:

- Review of material contracts (Employment agreements; Major Leases; Major supply agreements; Strategic Partnerships; Distribution Agreements)
- Review of Company Articles and Minutes of Directors Meetings
- Review of Shareholders' Agreement especially with respect to: amending formula; pre-emptive rights; rights of first refusal and piggyback rights; registration rights
- Any outstanding litigation or history of litigation (formal litigation search)
- Any potential environmental issues
- Review patents, royalty agreements
- Review shareholder lists, share register, options
- Review PPSA and any loan or debt agreements relating thereto