

APPENDIX 8

ISSUES TO CONSIDER IN DUE DILIGENCE

CORPORATE STRUCTURE AND GOVERNANCE

(REVIEW DOCUMENTS AND INTERVIEW MANAGEMENT, BOARD, AND ADVISORS)

- ▶ What is the company's corporate structure? C corp., S corp., LLC or LP? Does this model allow for a liquidity event and/or return on investment?
- ▶ Is there an exit strategy?
- ▶ Is the corporate structure overly complicated? If so, why, and might it be simplified?
- ▶ How many existing shareholders? Too numerous, and, if so, why?
- ▶ Does the corporate structure fit with the business model?
- ▶ Does the corporate structure allow for growth?
- ▶ What is the founder share allocation? Do they have a large enough stake to have the incentive to succeed, but not so large as to ignore board and other advisors? Is the founders' stock vested over time?
- ▶ Who is on the board of directors? Do they have the right background for the company? Is there a sufficient number of outside directors? How are board members compensated?
- ▶ Does the company have a board of advisors and, if so, who is on the board? Do the advisors actively participate in the company's development? How are advisors compensated?
- ▶ Has the company been involved in any litigation or been threatened with litigation?
- ▶ Does the company have all required permits and licenses?

FINANCIAL ASSUMPTIONS AND REVENUE SOURCES

(REVIEW ALL FINANCIAL DOCUMENTS)

- ▶ Has the company completed one-, three- and five-year financial projections?
- ▶ Have the financial documents been properly developed according to applicable accounting rules?
- ▶ Has the company used an outside, independent accounting firm to compile, review, or audit financials?

- ▶ How good are the assumptions? (rate of growth, acceptance rate, pricing, multiple revenue streams, costs)
- ▶ Are revenues realistic?
- ▶ When does the company reach cash flow positive, and what cash requirements will it take to get there?
- ▶ Has the company already received funding, and, if so, how much; what are pre-money valuation and terms?
- ▶ What are the follow-on funding requirements and sources? Has the company properly anticipated future needs, and is it already working on those?
- ▶ Have all tax returns been properly filed?
- ▶ What is the company's debt carry? What are the ratios?
- ▶ Is the company's current valuation aligned with its current stage of development and market potential?

MARKET ASSESSMENT

(DO INDEPENDENT MARKET ANALYSIS AND REQUIRE CUSTOMER REFERENCES IF APPLICABLE)

- ▶ Does the company's product or service address a new or existing market?
- ▶ Is the product or service platform-based, with the opportunity for additional products or services? Or is this potentially a one-trick pony?
- ▶ Does the company have a well-thought-out sales and marketing plan?
- ▶ Does the company have key relationships in place, or is it working on the same, with marketing and/or sales partners?
- ▶ Does the company have or need key joint venture relationships?
- ▶ Is the company focused on the appropriate market development, or are they trying to do too much at one time?
- ▶ Have they chosen the right first market?
- ▶ Does their product or service represent a market push or pull?
- ▶ What is the potential market size?

- ▶ Have they conducted thorough market research to support their financial assumptions, revenue model, and valuation?
- ▶ What is their stage of development? Concept, alpha, beta, or shipping?
- ▶ If the company has already introduced its product or service into the market, what is the number of current and potential customers?
- ▶ What is the length of its sales cycle?
- ▶ What are the channels of distribution?
- ▶ Does the company's product or service have a seasonal aspect?
- ▶ Is this a stable market and are COGS stable?

COMPETITIVE ARENA (DO INDEPENDENT COMPETITIVE ANALYSIS)

- ▶ Who are the company's competitors?
- ▶ Has the company realistically assessed its competitors?
- ▶ What is the company's market differentiator? Is this enough to make them superior to competition from the customer's perspective?
- ▶ Is this a market or product consolidation?
- ▶ How entrenched are the competitors?
- ▶ What is the financial stability of competitors?
- ▶ What does the market share look like?
- ▶ How will this company win?
- ▶ Has the company done a detailed feature-by-feature analysis?

MANAGEMENT TEAM

(INTERVIEW ALL TEAM MEMBERS AND KEY EMPLOYEE REFERENCES)

- ▶ What is the caliber/pedigree of the team?
- ▶ What is the team's overall track record?
- ▶ Do they have the combined requisite skills and experience?
- ▶ Do they recognize limitations in management, and are they seeking candidates?
- ▶ Is the management open to discussion and suggestions on improvement to their business model?
- ▶ Has the management team been previously funded?
- ▶ How are management and all other employees being compensated?
- ▶ Does the company have an option plan, and have options been granted to all employees? What percentage do the founders have as compared to other key management?

TECHNOLOGY ASSESSMENT

(MAY NEED EXPERT OR PROFESSIONAL ASSISTANCE IN TECHNOLOGY ASSESSMENT)

- ▶ Do they have market requirements and functional specifications?
- ▶ At what stage is development? Concept, alpha, beta, shipping?
- ▶ Does the company have any usability studies?
- ▶ Does the company have adequate intellectual-property protection? Does it need it?
- ▶ Is the company relying on being first to market, rather than on any IP position, for competitive advantage, and is this realistic?
- ▶ What is product quality assurance like?

- ▶ Is it proprietary architecture or open-source code?
- ▶ Do they have adequate systems in place to identify and protect IP?
- ▶ Who in the company is focused on these issues?
- ▶ Has the company properly set up relationships and documentation to ensure ownership of all intellectual property?
- ▶ Does the company own all necessary intellectual property through internal development or licenses?
- ▶ Do any other companies have potential claims to the IP resulting from previous employment relationships or for any other reason?

OPERATIONS

- ▶ Does the company have an operating plan or outline of the same if early stage?
- ▶ Has the company considered all aspects of operation to successfully launch a product or service?
- ▶ Does the operating plan anticipate growth? Is anticipated growth realistic?
- ▶ Has the company received any citations or notices of violation?
- ▶ For more mature companies, does each division of the company have an operating plan, and are they compatible?
- ▶ Does management meet regularly to ensure compliance with plan or make needed adjustments?
- ▶ Has the company been able to stay on plan?
- ▶ Does the plan take into consideration all cash needs and anticipated cash flow?
- ▶ Does the company have an alternative plan if assumptions do not hold, such as for product rollout, cash needs, and market response?

COMPARABLES:

- ▶ Recent IPOs (10Ks, annual reports)
- ▶ Recent companies funded in this space
- ▶ Third-party (including government) databases, reports, publications, and market analysis
- ▶ Comparable financial models

WHAT TO WATCH OUT FOR:

- ▶ **Unrealistic valuation (or revenue model)**
 - ▶ Affects percentage ownership
 - ▶ Affects possible subsequent rounds
 - ▶ May end up with “down-round” on next financing
- ▶ **Complicated investment terms**
 - ▶ Preferred fine, but be careful of other complicated features such as rights of first refusal; onerous liquidation preferences; registration rights; no lock-ups; co-sale
- ▶ **Heavy debt**
 - ▶ New investment dollars should be used for advancing the company, not for paying old obligations
- ▶ **Missing key assumptions about market or financial model**
- ▶ **One-trick pony (one-product or -service company)**
- ▶ **No board per se**
- ▶ **Inexperienced management**
- ▶ **Poor advisors**