Due Diligence: The Secret To Improving Returns By 5X?

Originally published on Forbes.com 2/18/16
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Fact: A study found that angels who spent more than 20 hours on due diligence experienced 5 times higher returns than those who spent less time. Equally important, they also reduced their losses by about one-third.

Most angels understand why due diligence is important. Beyond potentially improving your returns, as your angel deal flow increases, due diligence helps you screen deals to help determine the deals and companies you're most comfortable with. It also reduces risks by shining a light on potential weaknesses and future problems, which helps angels prepare for the issues and help the company as it grows.

Although understanding why due diligence is important, learning how to do it well is the real opportunity, as is removing the intimidation newer angels feel when they hear the two words "due diligence."

For that, I consulted with two seasoned angels, Barbara Clarke, founding member of Astia Angels and Wendee Wolfson, of New Dominion Angels. Both are lead investors in the Rising Tide Fund, which is developing a set of great educational tools for new angels along with the Angel Capital Association and Go Beyond Network.

Clarke and Wolfson offer some great practical tips, including how to reduce the intimidation factor. For example, they emphasize that due diligence is a process that every angel can add value to because of past work skills and experience. On top of that technologies and social media like LinkedIn make it much easier to do research. "Technology has dramatically made due diligence easier," Clarke explained. "There are easy platforms to share documents."

They are sharing many more hard earned insights in a February 23 ACA webinar, titled Perform Due Diligence Like the Pros. Here are a few of their tips:

- **Work with other angels as a group.** Due diligence is easier and better when you team up with other angels. Create a team that includes a leader who oversees deadlines and makes assignments for each angel to investigate on their own. The team comes back together in a meeting or call to compare notes on potential opportunities and problems and discuss if the group is still willing to take the risk on a deal. Typically, members of a due diligence team are interested in the deal, but including a skeptical investor is also valuable, because they ask great questions.

- **Use Your Unique Skills.** Everyone on a due diligence team has their own unique expertise and experience. For example, angels with journalist backgrounds are good at research and interviewing. Clarke's background is management consulting, and she's found that she is comfortable with competitor and market analysis, even in industries and fields she is unfamiliar with. I encourage new angles to get involved in a due diligence team so they can learn from the other team members. You may be surprised by how much you add to the team.

- **Focus On the Top Concerns and Risks.** Clarke and Wolfson point to six main categories of comprehensive due diligence, but recommend that teams start by asking the BIG questions. For most deals that means honing in on the three most important questions and concerns for that particular company.

- **Research the Management Team.** It turns out that the management team is almost always among the top three areas to validate. Start with their references, but look beyond them to get a true picture. LinkedIn can help you find other people connected to the team to talk with who are in different niches and can offer different perspectives. Be respectful of the entrepreneur and team, but ask the questions that need to be asked of references and connections. When you talk with references and customers or potential customers, listen to what's being said and what's not being said. Follow your instincts. If something seems suspect, keep asking questions and/or check into it more.

- **Deal Details.** As the team gets together, ask everyone key questions that help determine if you should keep digging or if it's time to stop. Is the deal structure in the term sheet acceptable? Are you ok with exit plans and timing? Can your group of investors get involved if more funding rounds are required?

- **Customer Fit and Sales Cycle.** Talk with customers and potential customers to understand if the company's product is really something they will buy. If the product doesn't solve a pain point, they aren't going to buy the product, and you are likely done with your due diligence process. Assuming there is a good fit, understand the length of the sales cycle – how many hoops will the company have to jump through to get to a sale? Sales is tricky; and it's especially hard for startups when there isn't a lot of data yet. Realize that the sales cycle is usually much longer and more complicated than an optimistic entrepreneur suggests. Also understand the pricing: what would really get customers to buy the product or service?

With all of these data points to check you may wonder, how much due diligence is enough? Wolfson said it's important to keep going until you're comfortable and ready to take that leap of faith. If you're not, then don't do the deal.

If red flags surface, it's time to stop the process and say no, or not now. Oftentimes red flags are confirmations of your top concerns, but other things can come up like the integrity of the management team; or perhaps the CEO isn't coachable, the investors and CEO don't get along, or the market for the product isn't big enough. "Be careful about how you report the due diligence findings back to the entrepreneur," Wolfson added. "Make sure all of the angels understand that the due diligence materials are confidential."

In the end, due diligence is a great tool for angels to pick better deals and have confidence in moving forward. Equally important, it can improve your returns and reduce your losses. If you haven't been part of a due diligence team before, go past your fears and give it a try – it can actually be a fun experience and one that helps your returns.