

DUE DILIGENCE CHECKLIST - BUSINESS ISSUES

1. CORPORATE STRUCTURE AND GOVERNANCE

- 1.1 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?
- 1.2 Is there an exit strategy?
- 1.3 Is the corporate structure overly complicated? If so, why, and might it be simplified?
- 1.4 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? Does the founders' stock vest over time?
- 1.5 Who is on the board of directors? Do they have the right background for the Company? Are there a sufficient number of outside directors? How are board members compensated?

2. FINANCIAL ASSUMPTIONS AND REVENUE SOURCES

- 2.1 Has the Company completed one-, three- and five-year financial projections? How good are the assumptions? (rate of growth, acceptance rate, pricing, multiple revenue streams, costs).
- 2.2 Have the financial statements been properly prepared according to applicable accounting rules?
- 2.3 Has the Company used an outside, independent accounting firm to compile, review, or audit financials?
- 2.4 Are revenues realistic?
- 2.5 When does the Company reach cash flow positive, and what cash requirements will it take to get there?
- 2.7 Has the Company already received funding, and, if so, how much; what were the pre-money valuation and terms for each round of funding?
- 2.8 What are the follow-on funding requirements and sources? Has the Company properly anticipated future needs, and is it already working on those?
- 2.9 Have all tax returns been properly filed?

- 2.10 What is the Company's debt service? What are the ratios?
- 2.11 Is the Company's current valuation aligned with its current stage of development and market potential?
- 2.12 Gross profit margins for the Company's product vs. competitive norms.
- 2.13 Cash on hand and burn rate.
- 2.14 Detail for current liabilities.
- 2.15 Future funding needs:
 - a. Critical milestones
 - b. Likely sources and timing for next funding
- 2.16 Financial statement projections:
 - a. Best case
 - b. Worst case
 - c. Time to break even
- 2.17 Staffing plan
- 2.18. Exit plan: what is it? Is it realistic?

3. **MARKET ASSESSMENT**

- 3.1 Does the Company's product or service address a new or existing market?
- 3.2 Is the company selling a "vitamin" (nice to have) or a "drug" (must have) product?
- 3.3 Is the product or service platform-based, with the opportunity for additional products or services? Or is this potentially a one-trick pony?
- 3.4 Does the Company have a well-thought-out sales and marketing plan?
- 3.5 Does the Company have key relationships in place, or is it working on developing those relationships?
- 3.6 Does the Company have or need key joint venture relationships?
- 3.7 Has the Company chosen the right first market, or are they trying to do too much at one time?

- 3.8 Does their product or service represent a market push or pull? Does this resonate with their Go To Market Strategy?
- 3.9 What is the potential market size?
- 3.10 Have they conducted thorough market research to support their financial assumptions, revenue model, and valuation?
- 3.11 What is their stage of development? Concept, alpha, beta, or shipping?
- 3.12 If the Company has already introduced its product or service into the market, what is the number of current and potential customers?
- 3.13 What is the length of its sales cycle?
- 3.14 What are the channels of distribution?
- 3.15 Does the Company's product or service have a seasonal aspect?
- 3.16 Is this a stable market and are COGS stable?
- 3.17 Regarding the product:
 - a. Does it sell itself?
 - b. Will your grandmother understand the concept?
 - c. Is it easy to use?
 - d. Does it require a change in behavior (or does it fit within the customer's daily routine)
 - e. Does it work?
 - f. Is it significantly differentiated from competitors' products?
 - g. Do customers actually buy it (as opposed to positive comments in focus groups)?
- 3.18 What is the customer's (or end users) pain, and does the product relieve that pain?
- 3.19 Define target customers:
 - a. What strategic partners and/or marketing partners exist?
 - b. What is the company's branding strategy vs. its competition?
 - c. How affordable are marketing and promotional programs?
 - d. What is the cost to acquire a customer?
- 3.20 How will the product or service be priced? How does this price point compare with competing products?
- 3.21 How much does it cost to support a customer?

3.22 How easy is it to retain a customer?

4. **COMPETITIVE ARENA**

4.1 Who are the Company's competitors (both actual and potential competitors)?

4.2 Has the Company realistically assessed its competitors?

4.3 How entrenched are the competitors?

4.4 What is the financial stability of competitors?

4.5 What does the market share look like?

4.6 What is the Company's market differentiator? Is this enough to make them superior to competition from the customer's perspective?

4.7 Has the Company done a detailed feature-by-feature analysis?

4.8 Barriers to entry - do they exist, are they adequate, what protection do they provide?

5. **MANAGEMENT TEAM**

5.1 What is the caliber/pedigree of the team?

5.2 What is the team's overall track record? What were their failures? How did they react to those failures?

5.3 Do they have the combined requisite skills and experience? What are the holes in the management team, and how will they be filled?

- a. Functional expertise
- b. Prior direct selling experience
- c. Domain expertise
- d. Prior P&L experience

5.4 Do they recognize limitations in management, and are they seeking candidates?

5.5 Is the management open to suggestions for improvement to their business model?

5.6 Has the management team been previously funded?

5.7 How are management and all other employees being compensated?

- 5.8 How much of their money is in the deal?
- 5.9 Is the management team coachable? Do they listen?
- 5.10 Will team members step aside, if necessary, at the “right” stage of growth?
- 5.11 Have background checks been performed on the management team?
- 5.12 CEO:
 - a. Experience managing people
 - b. Willingness to share equity
 - c. Integrity, trust and leadership qualities
 - d. Outside activities and distractions
 - e. Ability to attract/recruit advisors and experts
- 5.13 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?

6. **OPERATIONS**

- 6.1 Does the Company have an operating plan or outline of the same if early stage?
- 6.2 Has the Company considered all aspects of operation to successfully launch a product or service?
- 6.3 Does the operating plan anticipate growth? Is anticipated growth realistic?
- 6.4 For more mature companies, does each division of the Company have an operating plan, and are they compatible?
- 6.5 Does management meet regularly to ensure compliance with plan or make needed adjustments?
- 6.6 Has the Company been able to stay on plan?
- 6.7 Does the plan take into consideration all cash needs and anticipated cash flow?
- 6.8 Does the Company have an alternative plan if assumptions do not hold, such as for product rollout, cash needs, and market response?
- 6.9 Does the Company own all necessary intellectual property through internal development or licenses?

7. COMPARABLES

- 7.1 Recent IPOs (10Ks, annual reports).
- 7.2 Recent companies funded in this space.
- 7.3 Third-party (including governmental) databases, reports, publications, and market analysis.
- 7.4 Comparable financial models.

8. WHAT TO WATCH OUT FOR

- 8.1 Unrealistic valuation (or revenue model).
 - a. Affects percentage ownership.
 - b. Affects possible subsequent rounds.
 - c. May end up with “down-round” on next financing.
- 8.2 Complicated investment terms.
 - a. 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.
- 8.3 Heavy debt.
 - a. New investment dollars should be used for advancing the Company, not for paying old obligations.
- 8.4 Missing key assumptions about market or financial model.
- 8.5 One-trick pony (one-product or -service Company).
- 8.6 No active, independent board.
- 8.7 Inexperienced management.
- 8.8 Poor advisors.