

# LESSONS FOR BUSINESS FROM A DUE DILIGENCE EXPERT

By Richard Genzer

Securing funding takes significant effort beyond potential investor interest based on a strong business plan. In fact, the interest merely kicks off a detailed and sometime grueling due diligence process that will cover topics beyond the written plan. And while this process has a focus on established plan components such as the opportunity, market, team, financials, product and legal, some critical lessons can be derived from some softer issues as well. Competent and well-organized businesses have furthered their fundraising goals by following a few simple themes that include:

- **Appearance** is often an easy and obvious indicator of underlying practices
- Once the **truth** bond is broken, it is difficult to repair
- Being **crisp** is an reliable indicator of focus that creates an efficiency in the process
- Clearly articulated **goals** distinguish well run organizations
- Follow the **format** that has been dictated by the investor

## Appearance

The external appearance of an organization often represents important indicators on other areas of an organization. Appearance can be derived through a range of sources from internal and external office space to employee dress to employee work areas to printed documents. To a due diligence reviewer, these outward signs are noticeable indications on how the company is run and are likely to conjure up questions or create bias quickly.

As an example, shabby or opulent appearances in one area of the company may lead to particularly distressing topics about how people are treated or an investigation of the compensation chasm between employee levels. To the contrary, a generally pleasing and consistent outward appearance may avoid such topics given the assumption that they are unlikely to reveal underlying issues.

Corporate materials convey similar signs. Marketing collateral, presentations, business correspondence and physical document handling can all be positive or negative indications of how a company is managed. A high quality business plan in terms of writing, formatting and printing may peak an investor's interest but the due diligence process will reveal whether that quality is indicative or an aberration.

Regardless of how management feels emotionally on this subject, an organization's appearance should reflect the messages conveyed by management. A disconnect between what is seen and what is intended can lead the process astray.

## Truth

Trust, once broken, is difficult to reestablish in a personal setting. The same holds true in a business setting where reestablishment is difficult but not impossible. However, the due diligence process is a business setting with a firm deadline in time, people and budget. As a result, once trust is broken it redemption is highly unlikely.

Many business folks feel that truth is inefficient because telling the truth requires much more explanation than a well placed fabrication. During the previous stock market run up as an example, some businesses felt that it was better to overstate company financials

instead of explaining why they would fail to meet investor expectations. Perhaps the truth was seen as time consuming or impossible and likely to result in market ruin.

In a due diligence setting, once this bond of trust is broken, the due diligence review is likely to wonder “if they are willing to lie about *this* what else are they willing to lie about?” As a result, the first lie will likely bring into focus a wide range of statements or presumed facts which were previously accepted as fact. This is likely to elongate the process or depending on the severity of the propaganda, stop the process – and the investment – dead in its tracks.

The good news is that the due diligence process is a platform for the target company to explain themselves clearly. Management is given the opportunity to talk about what they do well and what challenges they face. There is no significant shortcut to understanding, so assuming that the reviewers are savvy enough to fact check, it is always best to provide all the requested information; warts and all.

Another element of truth is how honest management is with themselves. Often management becomes so enamored with what they have come to believe, they lose sight of reality. In this case, management is not lying, rather they have become convinced to the point of shortsighted bias. Good due diligence reviewers will notice exaggerations through fact checking and are likely to notice inconsistencies. It is therefore best to have objective third parties review material on an ongoing basis to ensure the proper amount of enthusiasm balanced by a healthy reality.

## **Crispness**

Many organizations are led by individuals who are articulate and well regarded for what they know, feel or have experienced. As a result, these individuals can make simple answers long and drive conversations into unwanted territory. Beyond the personality of individuals, organizations can also be verbose in their written communications. This lack of crispness can lead to inefficiencies in the due diligence process and open the possibility for unintended topics.

Beyond simply taking too long, verbose organizations are inherently less clear than those that take the time to be crisp. Being concise and cogent is always the most effective way to communicate an idea. The more effective the communication, the more the due diligence review is going to understand and the more likely the transaction will be to proceed with a positive outcome.

As a rule, answer only the question that was posed. Generally, if a reviewer wants more information or is confused, they will ask for follow up. If they are satisfied they will move along. This creates efficiencies. Rapidly running through a list of questions should be interpreted positively not negatively. Do not attempt to derail the process.

## **Goals**

A key test for management is how well they articulate goals. Clearly stated goals that include details on metrics, achievement, success probabilities and challenges are excellent predictors of long term market success. Conversely, meandering responses void of details, measurements or reality often indicate a lack of focus. This lack of focus may then become an important area for investigation but is certainly a sign of trouble.

Most investors place the burden on the due diligence reviewer to provide indications on how well positioned a company is in achieving its professed goals. Without clearly articulated goals, the reviewer must surmise and then assess how the company might progress. These reviewer-created goals become the property of the potential investor and are unlikely to be communicated unless funding takes place. So not only does a lack of goals hurt the company, it elongates the due diligence process and provides a breeding ground of assumptions left in the hands of the reviewers/investors.

The motivation of the senior management also comes into play under goals. Invariably, every senior manager will be asked how their personal goals align with the overall corporate mission. This is an excellent test to see how well senior management understands the mission and whether they are committed to seeing it through to the end. Since this is often a topic of conversation that is revisited during numerous interactions, it is difficult to hide questionable short term gains.

Another manifestation of lack of goals is the gambler mentality. Often leaders who lack goals believe that luck might come their way and somehow bring a windfall without hard work. If we learned anything from the recent technology bubble, we know that luck rarely takes the place of high quality execution.

## **Format**

Due diligence processes often follow a pre-defined format. Unfortunately, the format is likely to be unique to each potential investor. As a result, the target company typically bears the burden in customizing their company materials for each potential investor. Given that this is sometimes difficult or costly, many companies prefer instead to regurgitate *everything* with the hope that something will resonate rather than taking the time to follow the format.

The problem with this approach is that it always increases the time it takes to perform a quality review because there is so much extra material to absorb. Beyond simply creating inefficiencies, many organizations will reject applicants simply because of their disregard for the rules. Organizations often complain that these processes are too burdensome. If this is truly the case, abandon the application rather than attempt to change the process.

## **Conclusions**

The due diligence review provides a point-of-view from the transactional perspective which is both forward looking and external. This perspective provides the objectivity required to understand whether the future is aligned with what the company asserts or if problems lay ahead. *Learn some simple lessons and the due diligence process will likely progress without significant issue and may even net an increased valuation for your company!*

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