Capital Investment Due Dilligence
Looking Beyond the Numbers

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Whether you are considering the buyout of a high-growth company, or capital-intensive organic-growth projects in your portfolio businesses or operating units, or new market R&D, or even considering a start-up venture to boost fund performance, this capital deployment ("venture investing" for clarity and conciseness in this article) is a leap of faith even for the most experienced investor or management team.

When a colleague or a voice on the phone suggests the perfect new investment vehicle, the odds are extremely low that the deal will pay off and, worse, traditional disclosures offer little insight in terms of ultimate success potential.

Offering documents provide essentially the same insights for just about every investment opportunity:

1. This is what we make.
2. These are the people leading the company (and a board we put together for marquee value).
3. We have lots of competitive strengths.
4. Here is how we plan to use your money.
5. And, finally, we've listed 500 reasons we are guaranteed to fail, placed here so you can't sue us later.

Of course, The Missing Guest in offering documents is the insight that would let investors know the true likelihood of success. That Missing Guest is the perceptions, valuation, and loyalty of the customer base.

No matter how large the entity or how long its tenure, the most important question to be answered is: Will anyone pay for this stuff? Yes, it's important to know how profitable the company would be at $x of sales and it's important to understand how earnings would be divided among investors. Before any of those questions become relevant, though, the investor must know who is willing to buy the product in the first place.

This due diligence step is completely investor driven, as it should be, because the investor is seeking independent verification that is not filtered by the offering company. Some cooperation and introductions are required, of course, but the investor should pursue insights on his own terms and with his specific investment parameters in mind.

The costs of such assessments can vary from a few thousand dollars to more than $50,000, although the roughly $15,000 range that applies to our own firm's assessments is closer to the norm. When an investor is putting as little as $500,000 at risk, the relative cost of the inquiry is quite low and the risk management value can be very high.

What does a customer inquiry include and how does it add value? The answers will vary by both investment and resource, but fundamental items will include:

Identification of A-List customers. First, the process should help to focus attention on the customers who mean the most to the long-term success of the investee. These might be newer customers, customers in a fast-growing industry, customers with secure contracts of their own, etc. It's not simply a matter of calling customers. First, we need to know which customers to call.

Customer Commitment. How loyal are these customers to the investee? Does the investee get most of their business or are they really a reserve supplier? Has the customer ever brought another client to the investee? Is the customer loyal to any of its vendors and is it most loyal to the investee?

Customer Plans. Is the customer planning to expand or contract, bring production in-house, outsource to other nations or make other changes that will affect its relationship with the investee?

Competitive threats. What does the customer like that other vendors provide, even if these vendors are not currently competitors of the investee company? Does the investee company provide these values and does the customer recognize this value? Who is knocking on the customer's door today and why has the customer decided to hear what they have to say?

Whatever the product or service provided by the investee company, the process of customer assessment is fairly consistent. It's important to be sure to ask the right questions of the right people and, whenever possible, place a greater emphasis on the customers' actions than on their opinions. Often, customers will express one view about their relationships and behave in a way that belies that view. The person who said actions speak more loudly than words had excellent business insights.

If it's a revolutionary new invention or a development-stage entity, there might not be any customers yet for the company. If the investment is being made to support a new competitor in an existing market, customers of operating entitites could be the analog for the customers the start-up will seek.No matter what the complications are, though, the simple question never disappears. Who will buy this product from this company?

Venture investing is a risky exercise with short-term risk, oft-delayed returns, and nearly zero liquidity in the middle. Knowing what the customer thinks and, more important, what the customer will do, can raise the probability of success.

About the Author

Michael Rosenbaum is founder of Quadrant Five (www.q5works.com) and a highly experienced consultant to corporate management teams. His newest book, Six Tires, No Plan, chronicles the life and management style of Discount Tire Company founder Bruce Halle.