Series Report – April 2024

Doing Diligence Well in Venture Investing:

Going back to the future

"The intent of due diligence is to thoroughly evaluate an investment opportunity and develop a high-conviction investment thesis."

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Introduction

Due diligence in venture investing has made a comeback.

For investors and startups, 2021 was a frothy “funding party.” It was marked by **high-velocity investing by crossover hedge funds**, which set the pace for the industry. It was not uncommon to get to a term sheet in as little as 48 hours and overpay to get into a deal. While diligence didn’t fully go out the window, **the accelerated pace certainly compressed vetting and decision-making cycles**.

In the wake of the tumultuous investing environment over the past two years, however, investors are now being more conservative when offering term sheets. With that, **high-quality due diligence has returned as an art and a science**.

In our view, **due diligence mitigates risk not only for venture capital (VC) but also for founders**. If well-managed, it can be a positive experience for all parties involved – a process that balances speed and rigor, and from which both sides can emerge with greater insight into how the startup’s business actually works.

This report is the second in a series, developed as a collaboration between TDK Ventures and 6Pages. It builds upon our first report, which set the stage around the current state of venture and CVCs. In this second report, we explore how corporate venture capital (CVC) handles due diligence differently than VC in general, and the implications for startups.

What happened to due diligence?

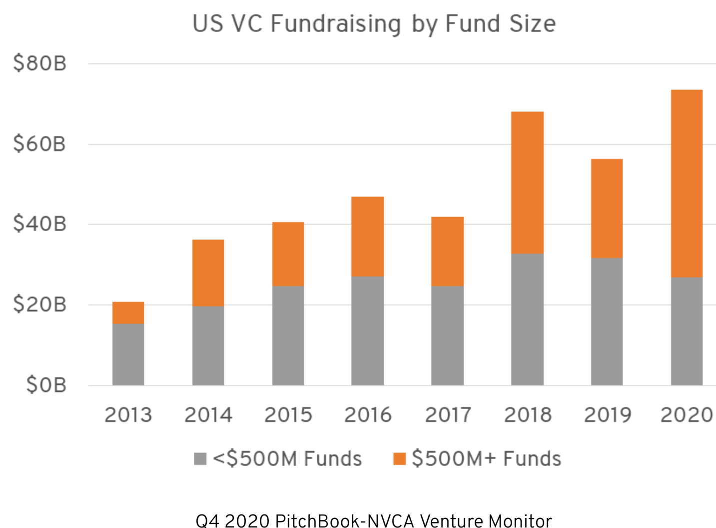
Let’s start with some context around today’s renewed enthusiasm for due diligence.

According to a study of about 700 VC firms conducted 8 years ago (Nov 2015-Mar 2016), **a typical deal once took 83 days to complete**. During that period, VCs would spend an average of **118 hours on due diligence** for just one deal. As part of the diligence process, a VC would call an average of **10 references** for each deal closed.

Back then, the median VC firm – which was small at just 14 employees (5 senior investment professionals) – closed just 4 deals a year. **A VC firm evaluated an average of 101 opportunities for each deal closed.**

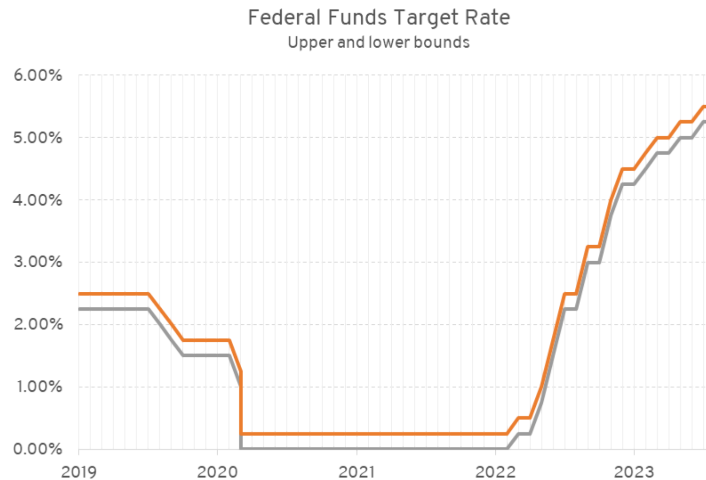
A harbinger of change came in Oct 2016 when SoftBank unveiled the **$93B SoftBank Vision Fund**, which was dubbed the world's largest tech-focused investment fund. At the time, the size of the Vision Fund was roughly equivalent to the top 5 private equity funds combined. Over the next few years, it would face criticism that it was adding froth to a market already laden with "dry powder," and that its role as a **"big stack bully"** was contributing to a valuation bubble.

Investors began steering away from the view that "size is the enemy of performance." **Mega-funds** – generally considered to be $5B+ for private equity and $500M-$1B+ for venture capital – saw growing momentum from 2016-2020. 21 venture mega-funds closed in 2019, some with big raises of over a billion dollars. In Q1 2020, mega-funds comprised half of all capital inflows into venture funds, even as SoftBank's mega-fund was going through a historic implosion.



Q4 2020 PitchBook-NVCA Venture Monitor

Then, in response to the pandemic, the Fed slashed interest rates in Mar 2020 – giving rise to a "**zero interest-rate period**" (ZIRP) that lasted until Mar 2022. Throughout 2021, **dealmaking – and due diligence – experienced historic changes**. Cheap capital turned 2021 into a "bonkers, record-setting year" for venture capital. By one count, 390 new unicorns were anointed in just that one year.



FOMO (fear of missing out) was rampant. Large funds wrote checks at outsized valuations to buy an option into later funding rounds. The acceleration in dealmaking came with compressed deal cycles and less robust vetting. Power dynamics shifted to founders, and there was a **growing sense that rigorous, time-consuming diligence was not "founder-friendly**."

To get in on hot deals and look good to their LPs (limited partners), **VCs began prioritizing speed and cutting corners on diligence**. For instance, they would skip the background checks on founders or opt not to get a legal opinion on the startup's governance structure and cap table. There was often an **assumption among VCs that someone else had already done the diligence**, especially for startups that had a lot of hype surrounding them. Preemption became the norm as VCs rushed to get founders term sheets ahead of a round.

This frenetic pace of investing was embodied by crossover hedge fund **Tiger Global**. Tiger Global closed 354 VC deals in 2021, nearly one per day. In some cases, it would **get to a term sheet in as little as 48 hours**. To invest at this aggressive pace, Tiger Global would conduct "pre-diligence" research (sometimes with support from consultancies such as Bain and Ernst & Young) or would outsource diligence by following reputable VC firms into a deal. **Tiger Global was also known for not seeking a board seat or even a board observer seat**.

In 2022 and 2023, however, as interest rates rose and venture capital contracted in back-to-back years, **the results of the earlier investment froth and less rigorous vetting became more clear**.

Perhaps the most glaring indictment of slipshod diligence was the **Nov 2022 collapse of crypto exchange FTX**, whose CEO Sam Bankman-Fried was later found guilty of fraud. Earlier that same year, FTX had a $32B valuation after backing from established investors such as Sequoia Capital, Tiger Global, Thomas Bravo, New Enterprise Associates, and SoftBank Vision Fund. Following FTX's bankruptcy, investors were forced to apologize, in one case admitting that FOMO was a factor in driving a poor investment decision. As industry watchers have suggested, **basic flaws in FTX's governance could have been exposed with even "minimally adequate" diligence.**

In all 4 quarters of 2023, **19-20% of startup financing rounds were down rounds** – more than double the average in 2021 and well over the 10-12% typical in the pre-pandemic era. Looking at 409A valuations, there was a rising percentage of flat rounds as well, which reached a high of 55% of rounds in Q4 2023. While this was emblematic of the tightened capital environment, it also was an indication that **the "incredible valuations" of 2021 were falling back in line in a reversion to the norm**.

While it's too early to say how the 2021 vintage will pan out, it seems unlikely – given the valuations that year – that it will be among the 22-30% of vintages that drive 80% of VC returns. Of the approximately 250 startups that Tiger Global invested in from its $12.7B venture mega-fund, which launched in Oct 2021 near the peak of the boom, 170+ had fallen in valuation by Dec 2022. **As of Nov 2023, Tiger Global's fund was reporting a paper loss of 18%.**

On the other hand, **2024 could be one of the power-law vintages** – assuming valuations stay at reasonable levels and investors learn their lesson from 2021 on diligence. It's no wonder that diligence is "the new black."

The art and science of due diligence

There are no hard and fast rules about due diligence. In venture investing, the intent of due diligence is to **thoroughly evaluate an investment opportunity and develop a high-conviction investment thesis**.

Like many human endeavors involving judgment, **due diligence is both an art and a science**. Diligence can involve, for instance, activities such as vetting founders, calling references, getting hands-on with the product(s), analyzing financials, and

sizing the market. How it is conducted will vary based on the investor, the VC firm, and especially the investment opportunity.

Speed is usually a factor, given that startup investing is often a competitive game. While diligence should be rigorous and thorough, that's not the same thing as being comprehensive. A checklist can be useful but **the "art" of due diligence is about homing in on the key issues involved in assessing the upside and downside of the opportunity.** For one startup, this could be about validating market traction, whereas for another, it could be about the cap table and governance risk.

There are patterns when it comes to diligence practices. In a survey of venture capitalists, **founders** were far and away cited the most often as an important factor in investment decisions, with 95% of VCs agreeing. This was followed by the **business model** (74%), the **market** (68%), and the **industry** (31%).

Other areas that investors may consider include the **competitors and market dynamics**, **technology/IP and product**, **customers and sales**, **financials and operational metrics, talent retention and agreements, go-to-market plan, regulatory risk, board and governance structure, cap table, and deal terms**, among other considerations.

Reference calls are typically needed to substantiate what investors are being told, both with **contacts introduced by the startup as well as backchannel reference checks**. Thorough diligence might involve dozens of calls with current, churned, and potential customers to gain perspective on the product. This can be supplemented with conversations with employees and industry analysts.

Diligence can look very different for a smaller seed or Series A investment vs. a larger later-stage investment. Early-stage startups may be pre-revenue or even pre-product, which means investors will tend to index more heavily on the founders and market. 31% of early-stage VCs don't even forecast company financials when making an investment. Instead of a traditional valuation based on discounted cash flows, they tend to look for a large exit with a sizable cash-on-cash return.

Due diligence takes place both pre-term sheet and post-term sheet. The diligence that takes place before the term sheet is enough to determine a valuation and basic terms, and can move quickly. The confirmatory diligence that takes place after the term sheet is more thorough and intended to confirm the investor's

assumptions. When time is of the essence, such as in a competitive situation, investors might shift more of the diligence to post-term sheet.

A later-stage venture investment takes longer to close and might look more like a private-equity deal with a structured data room. Investors will look for the full gamut of detailed financials, revenue breakdowns, contracts, corporate documents, IP portfolio, and more. For later-stage deals, they will be more likely to dive deep into **technical due diligence** using in-house experts or contracted 3rd-party specialists to examine the quality and scalability of the startup's code, the R&D and product roadmap, and cybersecurity.

A growing number of venture investors (e.g. Coatue, SignalFire) are **analyzing publicly available alternative data as part of their due diligence.** This includes market data such as credit card data and customer lists as well as open-source intelligence (OSINT) for cyber diligence, reputational risks, and fraud detection. These VCs are applying machine learning and AI to surface insights and help the human investment team make higher-quality, less emotional decisions.

While many VC firms have an established process for diligence, there are still challenges and misses. For example, the **FTX debacle** had established investors like Sequoia Capital and Temasek claiming in the aftermath that they had conducted adequate due diligence. In the case of Sequoia, partners claimed that they had been misled. **Being misled, however, is a perpetual risk in due diligence** since most of the documentation gathered comes from the startup itself.

Making diligence work for startups

While intense scrutiny can be placed on startups and founders during the vetting process, as one investor put it: "**Due diligence is a mutual process**." It validates a commitment that can last as long (or longer) than a marriage. As we've seen recently with OpenAI's dramatic boardroom drama, investors – and their role on the board – can make or break a startup. **Founders are increasingly turning the table and conducting their own reference checks and diligence on VCs** – including on the latter's failed investments.

On the other side, while VC diligence can involve a lot of document-gathering, **it doesn't have to be a painful "homework" process for founders**. Smart investors

will actively work to make the experience a positive one for founders, recognizing that good diligence is part of the relationship-building process.

For early-stage founders, answering the due diligence questionnaire and responding to the data request can be a **useful forcing mechanism to get their house in order**. Discussing the sometimes tough questions on the questionnaire (e.g. around capex or differentiation vis-à-vis competitors) with investors can also **help founders confront and think through their strategic issues**.

Investors should **acknowledge that diligence is a time-intensive and disruptive endeavor for a startup, and consider ways to provide support through the process**. For instance, they may want to talk through the data request with founders and demonstrate flexibility on lower-value, high-work items. Investors can also help make introductions to specialist contractors and vendors to help fill in holes.

Investors that take an **early partnering stance** (rather than an adversarial one) and seek to be helpful throughout the diligence process are better positioned later if the round is competitive. For instance, **they can make introductions, provide product feedback, and share learnings along the way – especially if they are conducting customer reference calls**. Ideally, investors are communicating to the founders throughout about how they can add differentiated value.

A good investor will be actively managing founders' expectations and their emotional journey. Rigorous diligence followed by a "no" answer can be exhausting for the startup team and damaging to morale. Being forthright about what the investor is looking for in an investment – and signaling the "answer" when the writing is on the wall – can help avoid a bitter taste in founders' mouths.

This is especially true when it comes to **due diligence that involves competitively sensitive data**. The world of venture capital is rife with stories of investors who asked startups to "open the kimono" on their books and code base, and then invested in one of the startup's rivals. Due diligence comes with some risk for founders, but investors can mitigate that risk by holding off on asks for sensitive data until they're reasonably confident in their "yes" decision.

The same goes for **whether and when investors are asking for a board seat**. If a venture firm is taking a significant stake, they may want a board seat as a responsible fiduciary – especially if there are open questions with respect to governance. A startup founder, on the other hand, will want board members who are aligned with their vision and can provide support on their strategic issues.

Investors will want to time the ask for a board seat so it comes after a collaborative partnership has already been established.

Saying no well is as important as saying yes – especially since most of investors' time is spent saying no. Given that founders have invested time and energy in the diligence process, **investors saying "no" have the responsibility to make that signal as rich and valuable as possible**. This might include insight into what was compelling about the startup, what would have been useful to see in the pitch, and an explanation of why the opportunity isn't right for the investor at this time. After all, while the investor may be passing on the startup now, **they may later want to invest if the startup resolves their open questions**.

How is CVC diligence different?

As we discussed in our first report, **most corporate venture capital (CVC) firms have just one limited partner – their corporate parent**. Investments are typically governed by a small investment committee that includes parent company executives, who keep them accountable for their objectives.

As a result, **CVCs typically have a broader set of investment motivations than traditional, financially-driven VCs**. In one study of CVCs, 66% had "mostly" or "purely" strategic motivations, which consider whether a potential investment is aligned with the CVC's corporate parent.

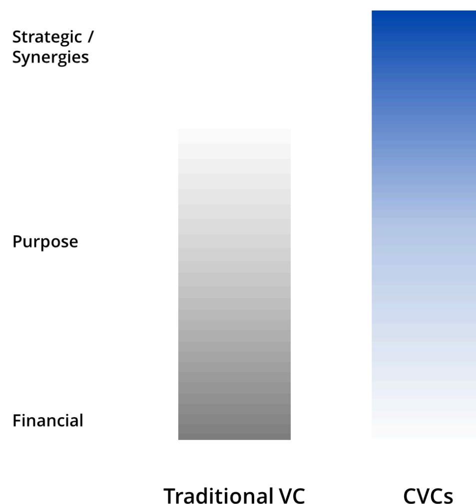
The due diligence process for CVCs, then, can look a little different than for traditional venture firms. In addition to the standard diligence items, **CVCs will spend more time validating areas of strategic overlap between the startup and the CVC's corporate parent.** For instance, they may consider the complementarity of the respective product portfolios, the CVC's ability to add value by leveraging its distribution channels and customer base, the potential for R&D collaboration, the value of locking in privileged access or even exclusivity, the options opened up for technology licensing or future acquisition, and the opportunities to learn about emerging technologies.

CVCs, even at an early stage of the investment process, are often considering how they might start working together with a startup. This could include customer pilots, bringing them into existing events or conferences, distributing or

bundling products, engaging in product collaboration, or connecting them to industry relationships.

CVCs are also evaluating how the culture of the startup and the CVC's corporate parent will mesh. As in acquisitions, where culture is responsible for as much as 30% of failed integrations, issues of culture can make or break the "success" of a venture investment. This is especially true when the decisions on both sides may be heavily reliant on strategic considerations.

Depending on the corporate parent and its mission/values, **some CVCs may incorporate a broader purpose into their investment criteria**. As part of the diligence process, these CVCs might spend time understanding the scale of the startup's potential impact, assessing the founders' level of commitment, and defining related KPIs (key performance indicators).



Given that CVCs are often taking a deeper look and are beholden to an investment committee, there may be an assumption that CVCs will take longer than a traditional VC firm to get to a decision. This, however, is not an inevitability with CVCs. In some cases, **CVCs may have prior knowledge and industry context that enables them to get to an investment thesis more quickly than a traditional VC**. TDK Ventures, as one example, can move from a first meeting to confirming an investment within just 10 days.

Diligence during a hype cycle

Every so often, a new technology enters the scene that shows immense potential and gets VCs salivating. For instance, we are in the midst of that now with generative AI. There's no doubt of the extraordinary promise of generative AI, which will change how humans write, create, code, and do business. The generative AI gold rush is on – despite the recent downturn in startup funding.

Just because a technology shows great promise, however, doesn't mean that diligence should go out the window. The VC truism that "entry price doesn't matter" as long as a startup is an outlier was, in part, responsible for the inflated valuations of 2021. In fact, **diligence in the midst of a hype cycle is even more critical, as it can uncover flaws in a technology or business model that are being overlooked in the heat of the moment**.

For instance, after Bird kicked off the e-scooter craze in 2017, **VCs pumped $5.4B into micromobility the following year, driving a rapid global expansion**. There was one key issue, however – **e-scooters were largely unprofitable**. During the hype cycle, investors skimped on diligence and overlooked the fundamental economics that e-scooter rentals often were not bringing in enough money to cover their cost.

Since then, VC-backed Skip and Bolt have both shut down. Once high-flying **Bird, after reportedly "losing money on every ride,"** has gone through multiple layoffs, was delisted from the NYSE, and has filed for bankruptcy. Lime is still claiming marginal profitability, although it's not sharing other metrics to substantiate that.

This history lesson from the realm of micromobility should serve as **a reminder of what happens in virtually every hype cycle**. FOMO rears its head, investors cut corners on diligence, and outsized valuations become the norm. Even when the technology promises a new paradigm, there will inevitably be winners and losers – even in generative AI.

Writing a high-conviction investment thesis

If the intent of due diligence is to thoroughly evaluate an opportunity and help investors come to a high-quality decision, **the end result is – or should be – a high-conviction investment thesis**.

A typical investment memo might include elements such as the key reasons to invest, key risks, deal terms (including board seat), other investors in the round, cap table, and liabilities. Ideally, **an investment thesis should lay out an informed perspective from first principles on why the opportunity will generate outsized returns**. In the case of a CVC, the thesis might also include how the investor will add strategic value and align with its purpose.

Starting from first principles, **an investment thesis starts with "what we know," as well as "what we don't know."** Due diligence serves as the bedrock and sets the parameters for the facts within a given space. From there, the thesis presents "what we believe" and – on the condition that "what we believe" is true – the opportunity to invest.

For instance, TDK Ventures regularly embarks on **"Deep Explorations."** These are intensive research efforts that involve building market insights, developing competitive landscapes, understanding the technology arcs, identifying strategic relevance for the firm and how it can offer value to startups, and analyzing what it takes to commercialize.

These Explorations help lay out a **map of the future arc of the industry or landscape**, in the context of potential solutions. Combined with industry interviews and KPIs, it becomes part of **a framework for the startups/investments that TDK Ventures will pursue within the space**.

In summary

We should remember that **the heart of venture capital is making high-quality decisions in the context of risk**. The outsized returns expected of venture capital are a function of the inherent risk of entrepreneurial ventures – i.e. failed investments are a feature, not a bug.

At the same time, how you win in this game – at least in a non-ZIRP environment – is by staying on the right side of a system in which 75% of venture-backed startups fail and only a few garner outsized returns. Threading this needle consistently requires **an investment process that turns out high-quality decisions over and over**.

Through this lens, **due diligence is the yeoman's work of venture capital**. During the "funding party" of 2021, when everything seemed to be heading up and to the right no matter what, due diligence was often neglected. As reality has set back in, investors are rebuilding their muscle memory of how to do diligence well.

The good news for investors is that their jobs are unlikely to be taken over by generative AI, although newer technologies will inevitably come into play. **Diligence – being as much an art as a science – will remain a very human endeavor involving the framing of context, judgment, and social intelligence.** The bad news is that investors are still human and FOMO has a pernicious way of creeping back in.

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