WHITE PAPER

The Most Important Thing You Don't Know About Market Due Diligence

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Introduction

When it comes to venture capital and growth equity investments, the bottom line is the top line. If a company can grow its revenue, then odds are it will generate a strong return for its investors. Market due diligence is a key component of determining the growth prospects, and therefore the return prospects, of an investment. However, the tried and true methods of market due diligence typically leave out one of the most important elements of measuring the opportunity – Pipeline Interviews.

In our experience, Pipeline Interviews – interviews with accounts that fell out of the pipeline without making a purchase – are rarely conducted during a market due diligence effort. However, they provide vital insight into the true market potential of the company, a perspective that cannot be gained elsewhere. To understand why, we'll start by looking at what is typically included in a market due diligence effort.

The Standard Market Due Diligence Process

The typical market due diligence effort generally includes three components. To help explain each component and how they fit into the overall market assessment, we'll illustrate this section using an example company that provides CRM software for law firms.

A Market Sizing Analysis

Market sizing analyses are generally quantitative exercises aimed at establishing the Total Available Market. The figures are normally developed bottom-up based on the size and industry segmentation and are supported with top-down data

Example: CRM for Law Firms

Bottom-Up: The solution is targeted at law firms with 100 or more lawyers. There are 1,000 law firms in the US of that size and on average they will spend $100K/year on our solution. Therefore, the market potential is $100 million/year.

Top-Down: Gartner Group estimates the market for legal software is $1 billion and this solution could be about 10% of wha a firm spends, or $100 million/year.

Market Sizing Analyses Establish the Total Available Market

Customer Interviews

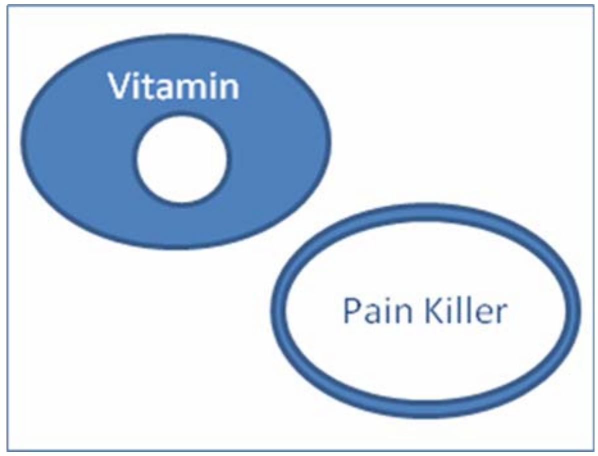
While customer interviews serve several purposes, when it comes to market due diligence, their primary function is to establish whether the company is selling a pain killer that is likely to be widely adopted across the industry or a vitamin that will be purchased by just a select few.

Example: CRM for Law Firms

Pain Killer: "Our client relationships are managed by teams of attorneys. There is no question that unless each attorney working with a client has access to all of the contacts and opportunities at the account, we lose business."

Vitamin: "The CRM has made the client management process easier and saves us time. Do we win more business because of it? I'm not sure I'd go that far."

Customer Interviews Help Determine Whether the Company has a High Penetration Pain Killer or a Low Penetration Vitamin



Loss Interviews

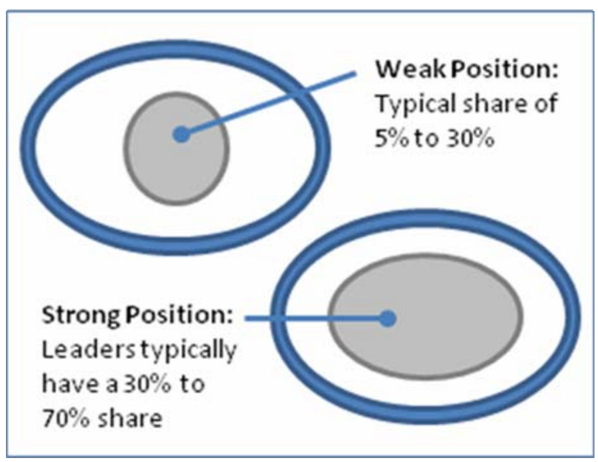
The flipside of customer interviews is loss interviews. Loss interviews provide excellent insight into how the company stacks up against competitors. Understanding whether the company has a strong or weak competitive position helps determine the share of the market they can expect to win.

Example: CRM for Law Firms

Strong Position: The loss interviews uncover that losses are largely attributable to factors that have to do with the company's core offering such as competitors buying the business and relationships.

Weak Position: The loss interviews uncover that losses are largely attributable to a systematic limitation of the company's offerings.

Loss Interviews Provide Insight Into the Company's Potential Share

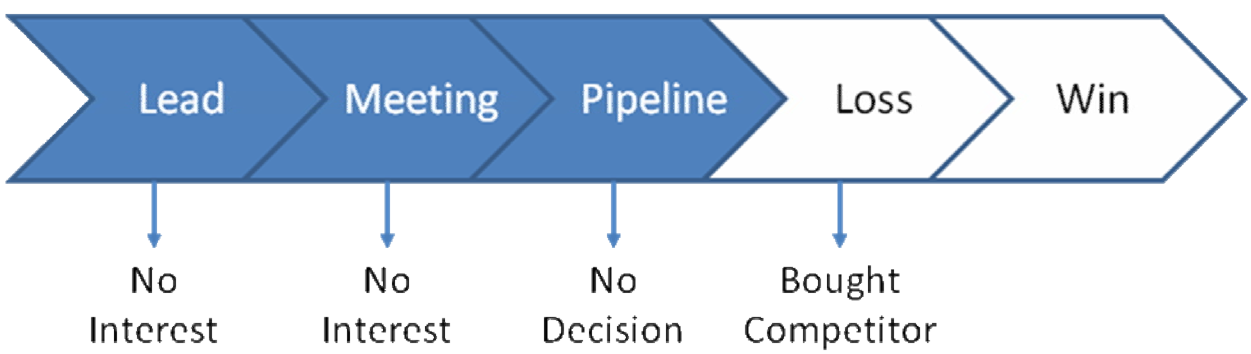


Pipeline Interviews: The Missing Piece

At this point, you may be thinking, "The analysis addressed the overall market size, the potential penetration of the market, and the company's likely share. Shouldn't that be enough?" Actually, it isn't. The typical due diligence process is based on the critical assumption that the accounts that have purchased a solution from the company or its competitors are fundamentally the same as accounts that have not yet purchased. Given enough time, the non-buyers will eventually buy a solution if it has a strong value proposition.

But what if that assumption is wrong? What if the accounts who haven't bought are somehow fundamentally different than the ones that already have purchased in a way that isn't obvious from segmentation factors like size or industry? If that is the case, then 'I haven't purchased yet' becomes 'I'm never going to purchase' and the market is far smaller than calculated. And, if the market is smaller than you calculated, the company may never reach its revenue projections.

Pipeline Interviews: Interviews with Accounts that Fell Out of the Pipeline without Making any Purchase



So how do you sort out whether or not you have an 'I'm never going to purchase' problem? The answer is through Pipeline Interviews. Only prospects that have had sales interaction with the company but decided not to purchase anything can answer this question. They know whether their decision not to buy is primarily a timing issue or is due to something more fundamental.

Continuing with the CRM for Law Firms example, it turns out that approximately 30% of law firms with over 100 people have a fundamentally different selling model than one that is supported by a CRM. Examples include firms who primarily serve consumers and those that focus on a very narrow subspecialty and act as a subcontractor to general practices. These types of firms will never buy a CRM system since it doesn't fit their business.

In this case, the market turns out to be about 70% as large as calculated using traditional methods. We have conducted numerous due diligence projects over the years where the market turned out to be a fraction of the size originally believed, including:

- A company providing translation management software where the real market turned out to be only 10% of the original target: $1B+ companies with 25% or more of their sales overseas. Many industries, such as aviation, do business solely in English everywhere, regardless of local language and do not need translation. Others, such as packaged goods companies, develop custom materials in each market and do not need translation either.

- A company providing software simulations for training repair technicians on maintaining products found that the real market was only 25% of the original target: $500M+ companies that provide low and medium tech equipment such as lawn mowers, pumps, and oil field equipment. Because the process of repairing each product is unique, a separate simulation is required for each product. For the cost of a simulation to outweigh its benefits, the product either has to have very large sales (over $100M/year) or a very long lifecycle (10+ years). The Pipeline Interviews revealed that most companies did not have a single product with sufficient sales (they had a wide range of smaller products) or a long enough lifecycle to make a simulation economical.

Conducting Pipeline Interviews

There are two keys to conducting Pipeline Interviews. First, make sure to interview accounts at a variety of stages in the pipeline. The reasons why prospects don't progress past the first meeting usually concern the fundamental fit of the product while prospects that drop out later in the pipeline typically don't close due to issues related to value proposition. You have to conduct interviews with accounts at different stages to get the whole picture.

Second, never interview live prospects. Since they haven't yet fallen out of the pipeline, you don't know for sure that they aren't going to buy. Therefore, they aren't reliable data points as to why prospects don't buy. In addition, the last thing you want to do is interfere with a sales opportunity.