MANAGEMENT TEAM DUE DILIGENCE: MEASURING THE INTANGIBLES

ABSTRACT

The founders of a company — the team — can make or break the company. There are many reasons companies fail. Big reasons for company failure include running out money and products or solutions with no product-market fit. Research shows that human issues are the cause of failure nearly 50% of the time. As a startup grows, it becomes necessary for the leadership to mature as well. Understanding of the management team is both science and art. Even though a founder may have impressive technical skills or an equally impressive background, they may not be successful in running a company. The real questions clouding the minds of investors are often the toughest to answer. Effective management team due diligence is a multiphasic process that includes surfacing the intangibles, assessing strengths and weaknesses, fit for role and much more. If done correctly, this process can also provide both founders and investors with valuable insights on the team, an individual analysis of each leader, and identification of improvement areas. Effective management team due diligence gives investors a deeper and wider pool of information on which to base investment decisions and add value to the startup in the future following an investment.

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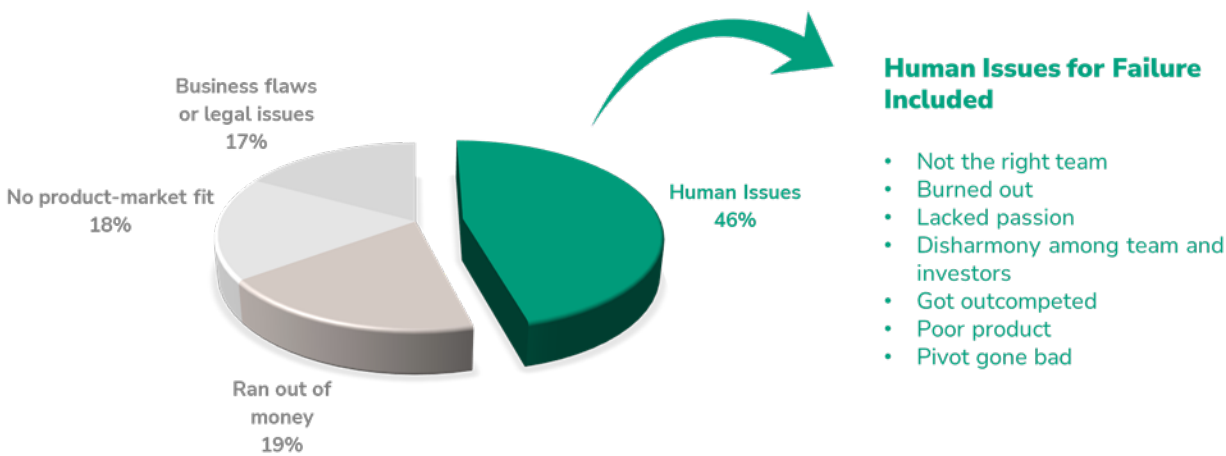
THE TEAM MAKES OR BREAKS A COMPANY

Due diligence is the structured process of investigating and verifying information about a business or opportunity to understand as much as possible about the business and any associated risks before entering a relationship. Unlike the legal, technological, or other business parameters of the due diligence process, the management team due diligence is often the vaguest or most overlooked part of the process. Assessing the management team involves trying to resolve complex questions for which there are often no straight answers or quantifiable metrics.

The founders, or leadership team, of a company are critical to its success. Even the wildest stories about successful companies with unruly, unconventional, or even destructive founders involve multiple people who understand the founders and the situation and intervene before the company derails. In the best cases, the company can grow and pull through — making for a great redemption story of a renegade founder. In the worst cases, the company fails, and the founders and investors lose everything.



REASONS FOR COMPANY FAILURE

(FROM A SAMPLE OF 111 STARTUPS BY CB INSIGHTS, 2022)

Much of the time, company failure is due to human issues, including having the wrong team in place. These issues can be identified and addressed long before company failure occurs.

Harvard Business Review published results of a survey of 900 venture capitalists capturing how they made decisions and what they looked for in target investments. When asked what the most important factor was in making an investment decision, 95% of them pointed to founders.

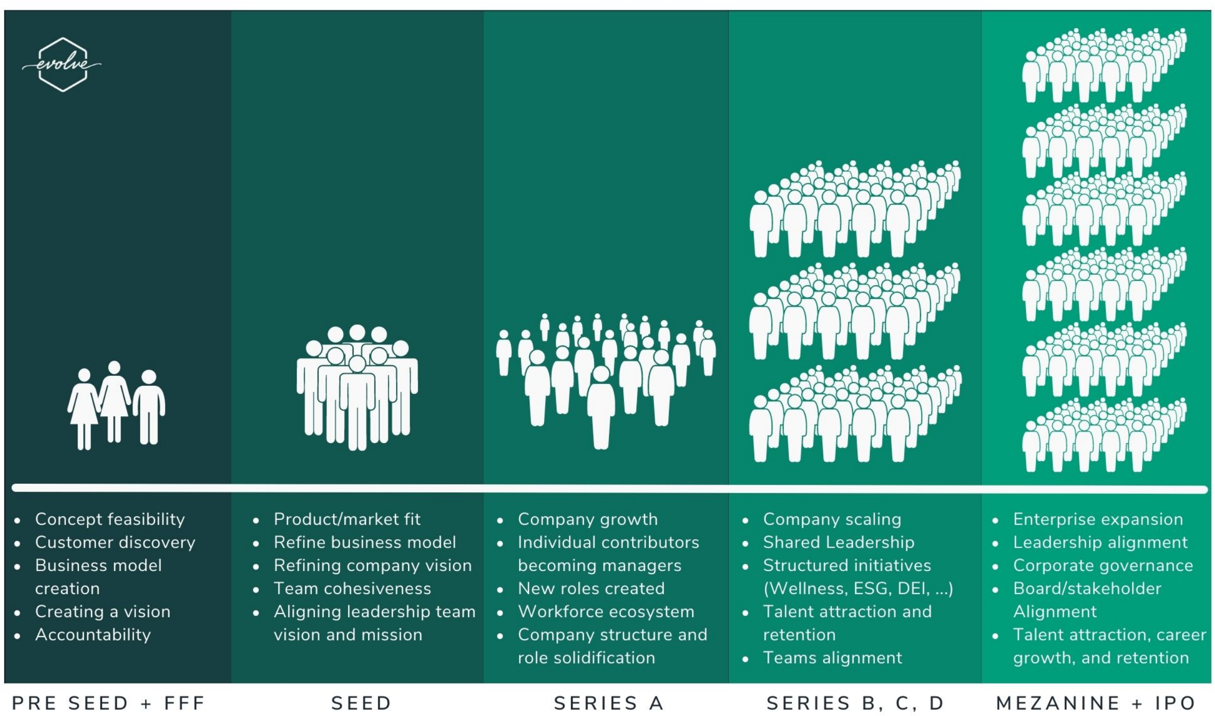
Survey of 900 venture capitalists (VCs), listed as an important factor in making an investment decision

(Harvard Business Review, 2021

1. Founders **(95%)**
2. Business Model (**74%)**
3. Market (**68%)**

Entrepreneurial leadership requires a different skill set than traditional leadership of a large enterprise; moreover, this skill set evolves over time, expanding a person's capacity to lead a larger and more complex organization.

A key goal of the assessment process is to evaluate and determine if the founder has the prerequisite characteristics to grow and scale a business. There is no straightforward path to ascertaining this information and few, if any, metrics are available to quantify such an analysis. Effective leaders grow as the company grows. Dvalidze and Markopoulos (2019) suggest that the leadership of a startup must change across the lifespan of the company and that there are distinct characteristics for entrepreneurial leadership within each new stage of growth. (See above graphic.) Like the startup company going through its stages of funding (Pre-seed, Seed, Growth - Series A, B, C, and Maturity - Mezzanine to IPO), a leader passed through their own stages of growth. In the early stages of a company, its leader must exhibit passion, courageousness, and resilience to push their idea forward into a viable business venture. Later stages of company growth involve the leaders building the right team, empowering people, and sharing responsibilities as the headcount of the company grows along with its offerings to customers.



Leaders that have done this well tend to build strong teams and healthy companies. Likewise, leaders that have not matured along with a company tend to make decisions and staffing errors that lead to unhealthy or failing companies.

Investors look for specific leadership traits early on to try to understand the risks a company is facing and how its leadership is handling processes and decisions. The World Economic Forum, in collaboration with Forbes, surveyed thirty top leaders from successful pioneering technology companies to assess what leadership traits comprise great leaders. Yoon, 2022, states the top 3 traits were 1) having a clearly articulated vision, 2) patience and tenacity, and 3) authenticity and a high degree of self-awareness. Leaders who understood their own weaknesses and were honest with themselves were better able to surround themselves with other leaders who could fill their unmet needs. The World Economic Forum study reveals that for startups, a capable leader — who demonstrates strong leadership traits — is even more crucial to a business since uncertainty prevails in nearly every area of that business. Comparing traits of successful leaders creates an understanding of what they may have had in common. But what should one look for in evaluating founders of target investment companies? Understanding leading indicators of what defines good leadership is a critical part of management due diligence.

Survey of 30 high-growth startup CEOs, identified leadership traits deemed to be the most important

(World Economic Forum, 2022)

Top three

1. Having a strong vision (32%)
2. Being patient and tenacious (23%)
3. Being authentic with a high degree of self-awareness (13%)

MANANGEMENT TEAM ASSESSMENT RATIONALE

According to Maria Palma (*Forbes*, 2019), one principle that investors and startups can both agree on is that the people on your team can make or break your business and that understanding the founders is critical to an investment decision.

Due diligence efforts collect documented information on founders, employees, and employee programs in an attempt to satisfy the human side of the investment equation. Most of these efforts collect basic information about employees and programs and a compilation of technical capabilities of the founders. Documentation summaries of employees, programs, and technical credentials are not an evaluation of leadership capabilities.

The technical skills and capabilities of a team of founders are important. These skills are applied to the development of any systems created by the venture. If founders lack specific technical skills needed, these skills can be improved through training and gained through hiring the right people possessing the technical competencies needed to get the job done. It is rare that the technical competencies of individuals are behind a failure. In many cases, the reasons for failure come from what are commonly called soft skills.

Even though a founder may have impressive technical skills or an equally impressive background, they may not be successful in running a company. The real questions investors are trying answer are often the toughest to address, including:

- How well will these founders make decisions as a team?
- How committed are the founders and how accountable are they?
- What happens to the leaders when they are under a great deal of stress?
- How do they navigate through hardships?
- Can I trust the leadership of this company?

Assessing the management team involves trying to resolve complex questions for which there are often no straight answers or quantifiable metrics.

No amount of employee programs or services, or even information included in resumes or lists of technical skills, will answer tough questions about leadership, trust, and other character traits critical for running a business. One example deep dive question as part of management due diligence from the *Keiretsu Handbook of Due Diligence* is to answer for investors what the company culture is and how well they communicate. This can be difficult to ascertain. The handbook contains no information on how to do this and assessment techniques are left up to whomever is conducting the assessment.

MANAGEMENT DUE DILIGENCE PROCESS

Understanding of the management team is both science and art. It includes surfacing the intangibles, assessing strengths and weaknesses, fit for role and much more. The attributes of strong management teams and the chief executive are difficult, if not impossible, to assess in a few meetings. A lot of startup CEOs are unproven rookies, and investors have very little relevant data to make a judgment call. Even seasoned entrepreneurs need to demonstrate personal management, shared vision, and a learning orientation to investors. At the same time, everyone is in a rush to close the investment so there is a great deal of decision bias going on. Therefore, it is important to have an unbiased independent assessment.

Effective management team due diligence is a multiphasic process. **Phase One** involves collecting basic information about the management team and employees of the company. This information includes:

- Resume and bios for founders and key employees
- Information about key employee events
- Information about current staff, recruitment and retention, and performance assessment

- Procedures and documentation for employee programs and trainings

This basic information offers an understanding of where a company currently resides on its people growth journey. It does not provide answers to the more challenging and arguably more important questions about the company's leadership.

Phase Two digs more deeply into assessing information about the leaders themselves, their current level of development, their approach to leadership, and how they are likely to respond under stress. This phase involves a combination of interviews and psychometric assessments designed to assess:

1. Individual tendency towards learning or judging
2. Individual tendency towards blaming or taking accountability
3. The extent to which the individual tends to either ignore or exaggerate reality

We answer these questions through a rigorous observation of what is said and not said, through words, body language and attention patterns. Higher personal levels of development equal better leadership. This process also sheds light on their leadership style, what experiences they bring, and where they will likely break down under stress. This, coupled with an assessment of character strengths, provides a clear picture of how an individual approaches a given situation.

Phase Three involves understanding the team dynamic. Like an individual, the team — as a body of leaders — has its own personality. Here, we assess degree of cohesiveness, including:

1. Communication styles and effectiveness
2. Alignment or friction around a shared vision
3. Other interpersonal dynamics

This part of the process is designed to uncover areas where gaps or opportunities exist. For example, if a team is not following a clearly defined vision, each will follow their own interpretation. If their interpretations differ, even slightly, then the team will not be aligned, and decisions made by the team are likely to be in conflict. This creates a friction that will slow down the momentum of the company.

Each of the phases is designed to address the levels of development of the company, its founders, and the leadership team. All three phases provide a detailed baseline assessment of where a company and its leaders are on their journey. If done correctly, this process can also provide both founders and investors with valuable insights on the team as a whole, an individual analysis of each leader, and identification of improvement areas. This, in turn, can provide investors with a richer set of information on which to base investments decisions and add value to the startup in the future following any investment.

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About the Author

Jeremy Spaulding is Evolve's Chief Operating Officer and management due diligence lead. He has spent his entire career studying people. His focus has been on understanding human capabilities and limitations related to engineering and sociotechnical systems design. He is an industrial engineer and operations leader with more than twenty years of success in technical innovation, organizational design, systems design, and human-centric engineering. Jeremy has authored more than a dozen patents and numerous scientific publications in new and emerging technologies for product solutions across markets.

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