The Down Side of Due Diligence

BME CAPITAL MANAGEMENT

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"Due-Diligence" is a term commonly used to describe the process of checking and evaluating the various aspects of an investment opportunity prior to committing funds to it.

The assessment typically covers aspects such as: Potential market size and growth rate, competition, market segmentation, technology validity, technological depth, intellectual property, financial qualities of the proposed investment, legal accounting, tax aspects and, very importantly-managerial and human qualities of the team and its fitness to the job.

Common wisdom and common practice have it that the more detailed and, methodological the due diligence is, the better is the decision that follows it of whether to invest, how much, and on what terms. "Better", in the sense that it entails higher probability of success. This argument is particularly common in private equity and venture capital, where the relevant information is less visible than, say, while investing in the public market and needs to be unearthed by way of meticulous due-diligence. We wish to submit here that this is not necessarily the case, in other words, we advocate that more meticulous due-diligence does not necessarily lead to "better" investment decisions, i.e. more successful ones. The reasons for this inverse effect may include:

1. The more engaged an investment manager is in the due-diligence process, the more he/she comes to identify with the opportunity under assessment. He/she becomes increasingly attached to the opportunity and to the entrepreneurs who lead it. Let one keep in mind that the investment manager who performs the due-diligence, must also “sell” it to his/her partners in the investment firm. This selling, forces the said individual to increasingly identify with the opportunity, to the extent of becoming emotionally involved and finding it increasingly difficult to step away from the opportunity and decline it. Simply put, extensive due-diligence tends to make the person performing it, to "fall in love" with the project under assessment and commit to it.

2. More often than not, investment managers have financial background and are not well-versed in the technological and scientific basis of the opportunity under their assessment. The more such person advances in the due-diligence process, the more he/she gets trapped in a false sensation that he/she well-understands the science/technology that stands at the basis of the project. People with financial background love to think they well comprehend a particular area of science or technology, to the extent of being able to explain it to their partners in the investment firm and to their own investors.

These may be some of the reasons that more due-diligence does not necessarily yield better investment decisions or better financial returns on investment. Differently put, due-diligence does have its downside.