

# **DUE DILIGENCE**

## **Steps to take prior to talking to investors**

**Mergers & Acquisitions**



**Due diligence is a form of research conducted by investors to make certain they are getting exactly what they agreed to buy.**

**Investors want to see your business plan and other information. If you have it ready before they ask for it, this may speed up the due diligence process and increase your chances of raising capital as they see your company is competent and keeps excellent records.**

**During the due diligence stage they may see factors they don't like so will use it to either to negotiate better terms for their investment, or to exit and you get no cash.**



# Aims of Due Diligence

- Establish and confirm the *current* value and condition of the Company today
  - And risks to that value and condition
- Establish an opinion regarding the *future* value of the Company
  - And risks to that value

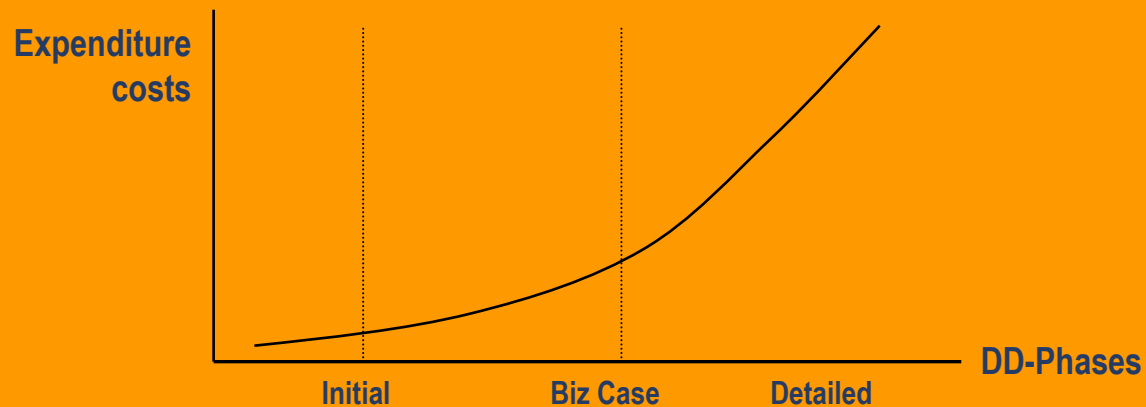
**What am I really buying? What risks do I need to mitigate?**



# Phases of Due Diligence

1. Initial Screening
2. Business Case Analysis
3. Detailed Analysis (Due Diligence)

Terms: As much expenditure as needed;  
As few costs as possible



# Initial Screening

## ■ Elements

- Business plan or Executive Summary
- Meeting with Management
- Some additional documentation (brochures, articles)
- Initial consultation by venture capitalist with trusted advisors/partners

## ■ Basic Aims:

- Establish fundamental soundness of team and business plan
  - Quality of business plan/exec summary
  - Initial appeal of business proposition
  - Professionalism and comporment of management team



# Initial Screening

- Establish basic fit with investment objectives
  - Stage of company (seed, early stage, development stage, etc.)
  - Industry fit
  - Synergies with strategic partners (for corporate venture capital)
  - Size of investment
  - Financial return potential
  - Physical location of Company

**Should we spend any time on this opportunity at all?**



# Business Case Analysis

- Goal: To determine whether the business case is ‘investment grade’
- Gathering and detailed analysis of documentation
  - Business plan and related documentation
  - Additional requests for information from management
  - Market analysis (top down *and* bottom up)
  - Search for comparable businesses and business plans
  - All market and industry information readily available on internet
  - Consultations with industry contacts/technical experts



# Business Case Analysis

- In person visits to confirm business case with
  - Actual or potential customers
  - Actual or potential suppliers or other financing sources
- Decision about next steps
  - Allocation of tasks, establish project team structure
  - Fix due diligence/investment timeline
  - Basic term sheet outline

**Basic investment decision is made at this level**



# Detailed Analysis (Due Diligence)

## ■ Current Business

- To confirm the current state of the company
- To determine and manage risks to the current value of the Company
  - Existing
  - Contingent

## ■ Future Business

- To confirm the business plan in detail
- To determine and manage risks to the business plan in detail
  - Market (External)
  - Organizational (Internal)

## ■ Questions to Answer

- Am I buying what I think I am buying?
- Is it worth as much as I believe?
- What risks exist to the my acquisition and its value, and can these be managed?
- Is there any reason *not* to do this deal?



# Analysis of Current Business

- Analysis of current business depends on historical information
  - Objective – Documentary
  - Subjective – Interviews and impressions

# Historical Documentary Sources

- Objective Historical Information
  - Financial statements
  - Contracts
  - Records of performance (invoices, shipment records, reclamations, etc.)
- Every statement about you and your company's track record, and every line of the historical balance sheets and income statements is an assertion about what the investor is buying
  - And each line or historical statement is associated with documentation

**If it's in your historical financial statements or business history,  
you are asserting that it is materially true!**



# Balance Sheet Documentation – Assets

- Cash and cashflow
  - Bank and brokerage records
- Trade receivables
  - Client contracts & customer lists
  - Accounts receivable lists
  - Accounts aging
- Inventories
  - Inventory list and aging
  - Latest physical inventory report
- Other receivables
  - Loan contracts and repayment history
  - Tax records and correspondence
- Intangible Assets
  - Patents, copyrights and trademarks
  - Employment or similar contracts with key employees
- Fixed Assets
  - Legal title & leasing contracts



# Balance Sheet– Liabilities & Equity

- Trade Payables
  - Supplier contracts
  - Outstanding and paid invoices, payment terms
  - Non-invoiced payables
  - Tax records and liabilities due
  
- Credit
  - Banks or other creditors
  
- Equity
  - Articles of Association
  - Shareholder agreements
  - Share subscription documentation
  - Audited financial statements



# Balance Sheet– Invisible Risks

- Off balance sheet liabilities
- Contingent liabilities (lawsuits, product liability)
- Environmental liabilities
- Contested or unproven title (land)
- Pension liabilities
- Invisible balance sheet risks are particularly scary to venture capitalists – because they cannot be proved not to exist and they can be large
- Expect severe sanctions for later disclosure of pre-existing liabilities of any sort



# Income Statement - Revenues

- Revenues
  - Client contracts
  - Bank statements
  - Audited financial statements
  - Product and price lists
  - Market segmentation analyses
- Accounting Treatment Issues
  - Recognition (are discounts an expense or simply left out of revenue, for example)
  - Timing of events (when does revenue recognition occur?)
  - Are revenues really revenues?
- Other Revenues
  - Recurring or one-time?
  - Do they properly reflect the underlying performance of the business?



# Income Statement - Expenses

## ■ Expenses

- Supplier contracts
- Bank statements
- Audited financial statements
- Profitability analyses
- Warranty reclamations, log of complaints
- Record of performance problems (can enhance credibility!)
- Tax statements

## ■ Accounting Treatment Issues

- Recognition (capitalized or expensed)?
- Timing of events (when does expense recognition occur?)
- Matching: are expenses properly matched to the revenues they are generating?
- Clarity: volume of expenses in 'Other Costs' and 'Other Expenses'



# Historical Documents – Key Lessons

- Keep in mind that the investor will ask to see your historical documentation.
- Material items are most likely to be checked.
- Make sure that such documents present a fair and balanced picture of your business
  - If statutory accounts do not present a fair picture of your business, make the appropriate management adjustments to create a reasonable picture of your activities—do not wait for the investor to ask you!
  - Keeping track of potential problems areas—customer complaints, outages, and reclamations—can win you points with the investor, because it indicates that you are actively looking after your customers.
- All surprises are by definition bad!



# Future Business

- Goals – Future Business
  - To confirm the business plan in detail
  - To determine and manage risks to the business plan in detail
  
- External Issues
  - Market
  - Customers
  - Comparative advantage
  - Barriers to Entry
  - Exit
  
- Internal Issues – *focus will be here!*
  - Management
  - Key employees
  - Organization
  - Policies and procedures
  - Management information



# Products and Markets

## ■ Comparative Advantage

- competitors by size and market share
- rate of profit and revenue growth
- (international) market potential
- special growth influence factors (e.g. monopoly position due to legislation)
- sales and marketing strategy
- patents, trade marks, copyrights
- pricing strategy (calculation based)
- customer structure
- production method

## ■ Maintaining Barriers to Entry

- R&D concept
- product-succession
- strategic partnerships
- know-how extension
- securing of location
- securing of liquidity



# Management/Entrepreneurs

- Objective (Documented) Profile
  - salaries and compensation schemes
  - other benefits
  - shares, acquisition rights, preferred rights
  - personal promises or guarantees
  - participation in profits
  - financial obligations to the company (loan)
  - key-man policies (insurance)
  - performance reviews
  - managers' personal (financial) situation
  - commission and license contracts
  
- Subjective Profile
  - others' estimation of track record
  - professional and personal reputation
  - relationship with employees
  - private interests, hobbies (dangerous to life?!)
  - personality (behavior, management talent)
  - physique and psyche



# Key Employees

## ■ Objective Profile

- Employment contract
- Pay compared to market rates
- Rights to product of own intellectual efforts
- Share ownership, profit participation
- Job description
- Track record at company

## ■ Subjective Profile

- Importance to company (dependence of company on the employee)
- Relationship with entrepreneurs
- Satisfaction with position and pay
- Degree of replacement (can the employee be quickly replaced?)
- Near term ambitions
- Appetite for risk
- Hobbies, other interests
- Stage of life (are children planned?)



# Organization

## ■ Internal Structure

- job descriptions, hierarchy and policies
- R&D, production, and sales controlling
- working conditions and power relationships
- management committee
- influence and competence of supervisory and advisory board
- qualification of consultants
- staff and employee information: qualifications, further education, salary, period of employment, average-age, illness level, absence time and employee turnover rate
- strikes and other labor unrest

## ■ Controlling/management information systems

- internal and external reports
- policies of administration and organization
- strategically and operative planning
- plan-actual comparison
- modification analysis and consequences
- IT tools (hardware and software)



# Organization

- Organizational issues are generally not well understood by either entrepreneurs or corporate finance advisors
  - Entrepreneurs are often building companies for the first time - at least with scale
- Entrepreneurs tend to underestimate the time - and to a lesser extent, the resources needed to establish organizational routine
  - 'Before you do anything, you have to do something first.'
- Organizational issues have to do with execution - can the company execute the business plan?



# Detailed Analysis – Due Diligence

- Like the negotiation of the term sheet, due diligence tends to create an inherently adversarial context between the investor and the entrepreneur
  - Focus is on disqualification, not qualification
- Tends to be very intrusive - but necessarily so
- Easy for entrepreneur to get lost in the details and focus on non-material issues
- Easy for entrepreneur to lose credibility during this period because it is easy for the advisor to find some real or perceived inconsistency

**The advisor has to take a holistic long-term approach to corporate finance and strategy, rather than regarding it as a collection of disparate elements and extraordinary events**





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