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Investment guide: Due Diligence

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Introduction

Due diligence is defined as 'the process of verification, investigation, or audit of a potential deal or investment opportunity to confirm all relevant facts'[1]. In the capital raise process, it is the analysis of data points that support the company's investment case and the investors' decision. The due diligence process can be daunting, confusing, and time-consuming. This guide provides an overview of due diligence, including the types, why it is conducted, and how to prepare for the process.

Two approaches to due diligence

The due diligence process is undertaken from both sides of the transaction, ***sell-side***, i.e., from the perspective of those selling investment in the company – the entrepreneur, and ***buy-side***, i.e., those who wish to buy a stake in the company – the investors.

Sell-side due diligence is the process of preparing a business for approaching investors and raising capital. It typically occurs during the preparation phase of the capital raise process, where a business makes a case for why it is a good investment opportunity.

Sell side due diligence is crucial for a company as it allows it to review its operations and address weaknesses, to position itself more favourably to investors. Additionally, this internal review ensures a company can maximize deal value by de-risking ahead of investor engagement and anticipating investor queries to improve its negotiation position. Investors take a buyer's approach when assessing an investment opportunity. They seek to understand how the opportunity aligns with their investment criteria, the benefits associated with the investment, and risks to their capital that need to be mitigated.

Buy-side due diligence is conducted from the investor's perspective and typically occurs during the investor engagement phase of the capital raise process.

The importance of due diligence: key investor considerations

Due diligence is crucial for investors evaluating potential investments. By delving into a company's business model, market dynamics, and growth potential, due diligence helps investors to make informed decisions. In this section, we explore why due diligence is important.

[1] *Corporate Finance Institute, Due Diligence, 2023.*

Key	Investor consideration	Description
	***Mitigating information asymmetry***	Due diligence helps investors address the information gap between their knowledge and that of the business management. It allows them to assess the business and market dynamics on the same basis as the company's owners.
	***Evaluating opportunities***	Through due diligence, investors can identify and evaluate the potential opportunities presented by startups. This includes assessing the viability of the business model, market demand, competitive landscape, and growth potential.
	***Assessing risks***	Due diligence enables investors to identify and assess the risks associated with investing in a company. Risk assessment involves analysing factors such as market risks, operational risks, legal and regulatory compliance, financial risks, and intellectual property protection.
	***Determining targeted returns***	The due diligence process helps investors estimate the potential returns they can expect from investing in a startup. This involves analysing the financial projections, revenue models, profitability, and scalability of the business.
	***Supporting investment decision making***	The findings and insights derived from due diligence serve as a foundation for investment decisions. Investors use the due diligence report or memo to make informed choices about whether to invest in a startup or not.

Preparing for due diligence

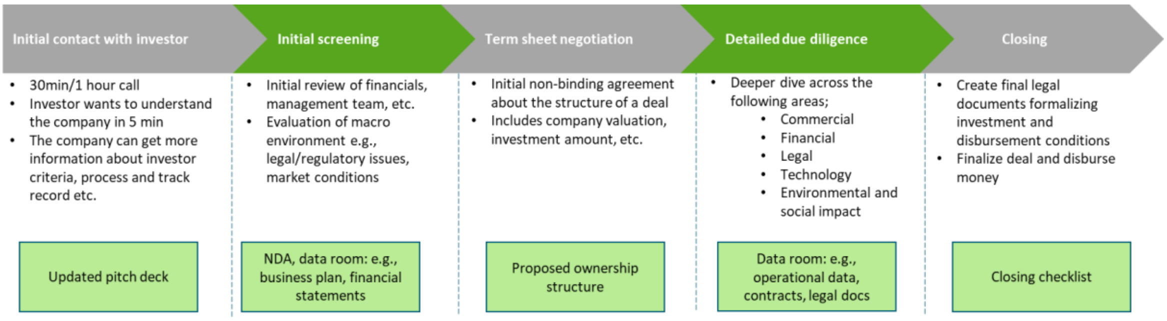
For early-stage companies seeking funding, effective preparation starts with creating a data room, a centralised repository for managing investor information requests. Through the data room, a company can efficiently and securely share materials during investor evaluations, interviews, and site visits. A complete data room allows all interested investors and their advisors to assess the investment opportunity fully.

Whilst some due diligence processes can be accelerated and completed in weeks, a company should be prepared for the process to take 3-12 months or even longer. As such, it is important to begin the capital raise process with enough runway of available capital. This will strengthen the negotiating position of the company and avoid any 'bridge' financing requirement that may distract from the full capital raise. For investors, time itself is often one of the most useful tools in the due diligence process as it provides a window against which to compare actual performance or milestones to those set out in investment documentation.

Where internal expertise is not available, a company raising capital should engage external advisors. For instance, legal counsel should be sought to review and advise on contracts proposed by investors while financial advisors may provide guidance on key term-sheet points or can be used to manage the transaction during investor conversations.

The two stages of due diligence

During the capital raise process, particularly in equity-focused investments, investor due diligence typically consists of two main stages: **initial screening** and **detailed due diligence.**



Initial screening involves review of data room documents and interviews with management to get insights into the commercial, operational, and financial status of the company and its expected performance in the future. Initial management interviews provide context and 'colour' to early document reviews – describing strategy and potential challenges. Upon discussion and alignment on initial terms through a non-binding term sheet, investors perform a more detailed assessment of the focus areas as detailed below. Detailed due diligence also involves additional cost for investors including site visits and hiring of expert external advisors. Investors will often also consult industry experts to bridge key information gaps.

Due diligence categories

Category	Areas of focus	Investor consideration
Commercial due diligence		
Market and industry	Nature and size of market Industry characteristics Competitive landscape Market saturation	The business operating environment including: a) Opportunities and threats associated with external factors b) Benchmarks against which to compare actual business performance e.g., a company's market share

Category	Areas of focus	Investor consideration
Business strategy	Company background Recent history Strategic perspective Products and services	How the business model has evolved overtime, including assessment of: a) Internal and external factors that have impacted business strategy to-date b) Products and services offered and their relative success
Marketing and Sales	Sales forecast Pricing approach Customers Advertising Sales activities	Revenue generation and how volume and price can be influenced to maximize growth by considering: a) Increased market penetration, customer segmentation to tailor customer needs b) Product and market development
Operations	Facilities Operating costs Production Distribution	The operating costs and process to identify: a) Cost structure, direct and indirect operating costs b) Bottlenecks in processes that will need to be addressed to increase volumes
Talent	Organizational structure Management capacity Board and governance Succession planning	Internal capacity and risks including: a) Key gaps in the organization structure to be hired for, or succession planning to mitigate key personnel departures b) Ensuring alignment of management and investor objectives
Financial due diligence		
Historic and projected financial performance	Revenue growth Profitability Capital expenditure Capital raised to date	Audited and management accounts compared with projected financials to understand: a) Asset and liability base of the business, cash burn ratio, and associated impact on raising further capital b) The reasonability of projected financials
Capital raise	Working capital need Capital expenditure Use of funds Transaction structure	Investment asks and use of funds including: a) Sensitivities to key assumptions and need to raise additional capital b) Benchmarking of investment terms for alignment to market rates
Technological due diligence		
Technological returns/ expenses	R&D expenditure Technological risks Hardware and software IT organization	Ownership and access to intellectual property that is essential to growth and differentiation on: a) The book value and intangible assets of the business b) Use of technology to enable scaling of the business
Environmental due diligence		
Environmental benefits and risks	Scrap / Waste produced Pollution permits Environmental reports Inherited waste	Environmental risks and benefits including: a) Liabilities from historic operations and risks associated to future operations b) Opportunities arising from environmental impact that can be leveraged by the business
Social impact due diligence		

Category	Areas of focus	Investor consideration
Social impact	Impact focus and metrics Theory of change Measurement of results	The company's theory of change including: a) The metrics used to track impact, e.g., number of jobs created, women impacted, etc. b) The impact achieved so far and forecasts

Establishing a data room

Before the due diligence process begins, it is important to set up a data room. A data room serves as a centralised repository for managing investor information requests.

Setting up a data room requires ensuring confidentiality, implementing version control, organizing folders efficiently, and utilizing insights to track investor activity and interest. An organised and comprehensive data room fosters investor trust, enables prompt responses to inquiries, and enhances overall efficiency.

Data room checklist

Document	Definition
Organization documents	
Certificate of Incorporation	Legal documentation related to company formation and registration in all regions of operation
Articles of Association	Legal documentation relating to how the company is governed, its operations, the distribution of power, etc.
Shareholder agreements	Documentation on the distribution of power and responsibilities and the distribution of profits and losses
Capitalization table	Table of all current preferred/ common stock, convertible debt, options, etc. as well as all applicable exercise prices
Business Operations	
Business plan	A description of the business, its objectives, and strategies to achieve them
Management reports	Any board of directors' presentations or internal management reports outlining company KPIs, progress, and strategy
Management bios	Biographies of the management team and the board of directors
Product portfolio	A detailed list of products and services offered, customers, marketing strategy, and methods of distribution
Supplier portfolio	Comprehensive list of suppliers, amount purchased, and supply chain process
Contractual agreements	Commercial contracts e.g., supplier and customer agreements, lease agreements

Document	Definition
Compensation structure	Compensation packages for the various levels of employees within the firm, with special emphasis on the compensation packages of senior management
Use of proceeds	Capital raise history and a detailed breakdown of the use of raised capital
Investor agreements	Terms of any ongoing investor agreements and previous capital raise
Financial documents	
Profit & Loss statements	P&L statements to date, including costs and revenue broken down by sales channel/client types if available
Balance sheet statements	Balance sheet statements over the past 3 years to date, which should include the value of all assets, liabilities, payments, and receivables due
Cash flow statements	Cash flow statements over the past 3 years to date, which should include previous budgets vs actual cash used plus the budget for the next fiscal year
Debt & liability agreements	Description of both current and long-term debts laying out their repayment history
Financial model with projections	5-year, three-statement (i.e., profit and loss, cash flow and balance sheet statements), projection of financial performance by sales channel, client type, and/or product category. If unavailable, projected revenue for the next financial period

Optimizing the data room and the due diligence process

When setting up the data room, consider the following steps to be fully prepared for the due diligence process:

Key	Consideration	Description
	***Designating a pivotal point of contact***	Assign a pivotal point of contact, such as the CFO or CEO, to facilitate communication and coordination of investor requests.
	***Accurate tracking of information***	Track information requests and answers, so that you respond promptly and consistently to investor questions.
	***Engaging external advisors***	If the team does not have fundraising experience and expertise, engage legal counsel and financial advisors (as appropriate). They can review contracts, advise on term-sheet points, and manage the transaction process.
	***Anticipating challenging questions***	Identify potentially challenging questions investors are likely to ask during due diligence and address them proactively in the materials shared in the data room.

Key	Consideration	Description
	***Validating key assumptions***	Research the data that validates your key assumptions, such as management accounts to show historical performance or pilot sales reports for new products.

Due diligence process

This step-by-step guide outlines the typical progression of the due diligence process which starts with initial screening which involves document reviews and management interviews, followed by detailed due diligence which involves more comprehensive assessment and potential site visits.

1. Initial investor outreach

Investors express interest in the company by contacting management and indicate their intention to conduct due diligence.

2. Engagement of independent advisors

Investors may seek assistance from financial advisors, law firms, or consultancies to provide expertise in specific areas during the due diligence process. At the same time, the target business is encouraged to engage an external consultant to support them with the due diligence preparation process, negotiation, and deal closure process.

3. Review of company materials

Investors gain access to a data room where company materials are made available. Investors review the provided documents and information.

4. Information request and question clarification

Investors share a specific information request list or checklist of due diligence documents. Investors may seek clarifications and ask questions via email regarding specific elements or data points.

5. Senior management interviews

Investors conduct high-level interviews with senior management to deepen their understanding of the data room materials.

6. Site visit

Investors visit the company's physical location to meet with a broader set of team members. Investors review processes, controls, and audit fixed assets. The site visit allows investors to validate findings, address outstanding questions, and gain a comprehensive view of the business. Site visits help to unearth more contextual information that cannot be cleaned from desk research and remote interviews. The investors' advisors for example ESG consultants, may also visit the physical location.

7. Engagement with key stakeholders

During the site visit, investors may also meet with key customers, suppliers, and other stakeholders, such as financing institutions. This provides investors with insights into external influences on the business and its ability to execute projections.

8. Further document requests and analyses

The site visit may result in additional document requests and further analyses being conducted by the investors.

9. Negotiation of investment terms

Negotiation of investment terms may begin before the site visit, but typically the details of a term sheet are finalized after the site visit. Investors may require a term sheet to be signed before proceeding further. Reviews can vary in depth based on investor requirements throughout the due diligence process and different investors may spend more or less time on some parts of the process. Engagement with investors during due diligence is an iterative process with focus on answering key investor concerns.

Completing due diligence

Once most of the due diligence process, including the site visit and related analyses, has been finalized, it is typically considered complete. However, in addition to these steps, there are specific outputs and documents that mark the completion of due diligence.

One key output is a comprehensive due diligence report. This report provides a detailed overview of the investment opportunity, covering financials, operations, legal matters, market potential, risks, and other relevant factors. Its purpose is to inform investors and aid them in making informed decisions. Additionally, an updated term sheet may be created to reflect any changes or adjustments made to the investment terms based on the due diligence findings.

Completion of due diligence involves a final review and approval process. This ensures proper documentation is done, and outstanding queries are addressed. Once this review is satisfactorily completed, and any required approvals are obtained, due diligence is completed.

Further reading

Corporate Finance Institute, Due Diligence, https://corporatefinanceinstitute.com/resources/valuation/due-diligence-overview/

GIIN Conducting Due Diligence - https://thegiin.org/conducting-due-diligence

Investor memorandum template - https://corporatefinanceinstitute.com/resources/knowledge/deals/offering-memorandum/

Sample Due Diligence Request Checklist http://www.klgates.com/files/Uploads/Documents/MA_event/RTAC-ACC_CLE_SampleDueDiligenceList.pdf

Term Sheet Guide - https://corporatefinanceinstitute.com/resources/templates/word-templates-transactions/term-sheet-guide/

Term sheet template - https://www.forbes.com/sites/alejandrocremades/2018/08/01/term-sheet-template-what-to-include/#64f9be8f14ed