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Investment Guide: Due Diligence

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Investment guide: Due diligence

The due diligence process can be daunting, confusing and time-consuming. This guide provides an overview to due diligence, including what it is, why it is conducted and how to prepare for the process. By understanding the context of due diligence, companies can improve the chances of a successful raise and reduce the time taken to access financing.

Overview of the capital raise process

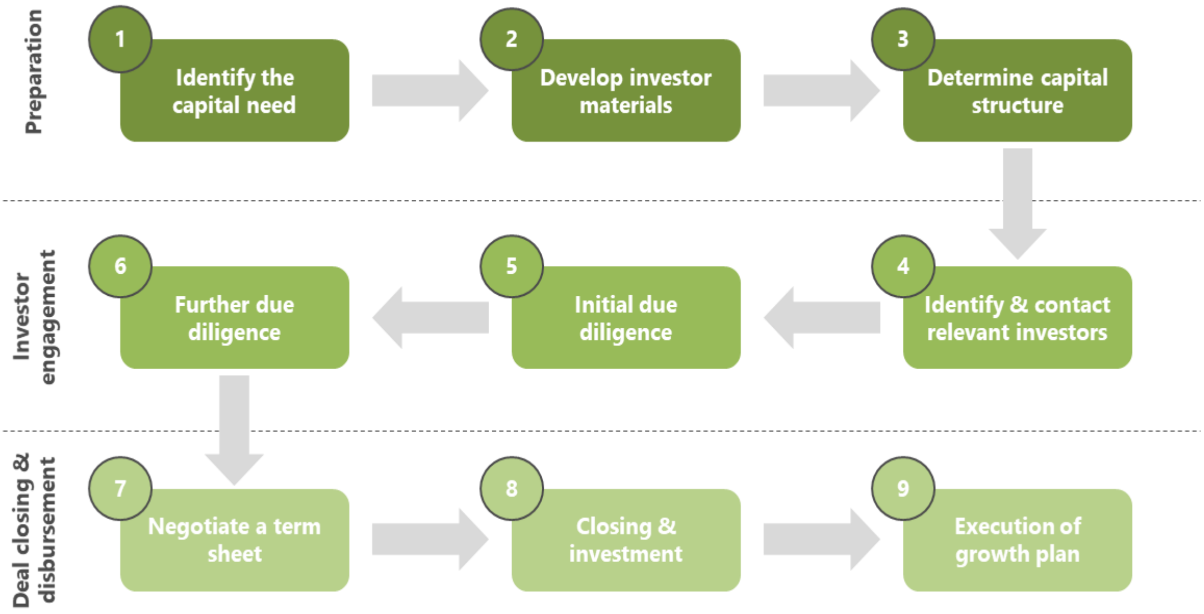

Figure 1: The capital raise process

Raising external capital, as detailed in the "Investment readiness" commercialisation guide and in Figure 1 above, is a multi-step process that typically takes between 3-18 months to complete.

Preparing to raise capital

Businesses require capital to **maintain current operations** and **finance growth**. A company may seek to raise external capital from investors when internal capital, generated from company profits, is insufficient to meet company need or is more expensive than other sources of financing.

When preparing to raise external capital, a company will draft a business plan that sets out the business model and growth strategy. This business plan forms the basis of a high-level **Investor Teaser** and detailed **Investor Memorandum** that sets out the opportunity to potential investors.

A well-defined growth strategy can be translated into a forward-looking **financial model** that enables a company to understand the capital needed to finance growth, as well as for investors to understand potential returns. Capital need is the basis on which a company can identify and prioritise relevant investor outreach.

Preparing to raise capital, sometimes referred to as 'investment readiness' or 'sell-side due diligence' is detailed further in the the "Investment readiness" commercialisation guide.

Engaging with investors

Initial outreach should be tailored to each investor, setting out why the opportunity is relevant to their investment criteria. This can be facilitated through introductory conversations and the sharing of high-level information such as the investor teaser.

Once initial interest has been ascertained, detailed information, such as the Investor Memorandum and Financial Model, and access to an investor data room may be shared. When sharing detailed company information, consideration should be given to confidentiality and the signing of a non-disclosure agreement (NDA).

An initial due diligence (DD) process enables investors to understand the market opportunity, business model, company traction, growth strategy and capital need. Investors proceed to conduct further due diligence once investment fit has been determined.

During **further due diligence,** an investor may engage external service providers such as financial, technical, or legal advisors to conduct deep reviews of the business in specific areas. This process serves to de-risk the investment and validate key points raised during the initial due diligence period. Thereafter, the company and investor may begin to negotiate the terms of an investment.

A **term sheet** is a non-binding document that sets out the commercial terms for investment. It includes conditions expected of both parties under which an investment will be made. Though the term sheet is a non-binding document, it serves as the basis on which final legal documents are drafted. Agreement on a term-sheet may grant a period of exclusivity to the investor during which terms are finalised.

Post-investment execution

On agreement of legal documents, funds are typically disbursed to a schedule set out in the term sheet. This may require the business to achieve certain milestones before capital is received. Additionally, an investor will likely require ongoing reporting from the business over the course of the investment to monitor business performance against expectations. A company may develop '100-day plans' and roadmaps to support execution against growth targets set out in investor materials.

Due diligence

Due diligence is defined as, "investigation and analysis in support of a recommendation." In the capital raise process, it is the analysis of data points that support the company's investment case and the investor' decision making process. This process is undertaken from both sides of the transaction, **sell-side** and **buy-side**.

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.

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

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 investment, and risks to their capital that need to be mitigated.

Why perform due diligence?

Investors, typically managing capital on behalf of Limited Partners (LPs), as well as their own capital, are governed by criteria and processes to ensure integrity in their investment decision making. Information asymmetry, whereby an investor's knowledge of a business and market is less than that of the company's management, is mitigated by investors through a due diligence process.

Findings on opportunities, risks and targeted returns from the due diligence process are used as a basis for the decision to invest and to negotiate the terms of investment. A due diligence report, or memo, is typically presented to an Investment Committee, or Investment Board, which has ultimate responsibility for approving investment on behalf of the LPs.

Due diligence categories

Table 1: Due diligence categories

Category	Areas of focus	Investor consideration
	Commercial due diligence	
Market and industry	Nature 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
Business strategy	Company background Recent history Strategic perspective Products and services	How the business model has evolved over time, 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 maximise growth by considering: a) Increased market penetration and 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	Organisational structure Management capacity Board and governance Succession planning	Internal capacity and risks including: a) Key gaps in the organisation's 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 ask and use of funds including: a) Sensitivities to key assumptions and likely need to raise additional capital b) Benchmarking of investment terms for alignment to market rates
Legal due diligence		
Legal consideration	[Placeholder for DWF entry]	
Technological due diligence		
Technological returns/ expenses	R&D expenditure Technological risks Hardware and software IT organisation	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 with future operations b) Opportunities arising from environmental impact that can be leveraged by the business
Social impact due diligence		
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

The due diligence process

The due diligence process begins after interest has been established on initial investor outreach. Investors typically lead the due diligence process but may refer to independent advisors, such as financial advisors, law firms and consultancies to provide expertise in specialist areas.

Typically, an investor will begin due diligence through a review of company materials made available in a **data room**. Investors will likely share a specific information request list, although a checklist of due diligence documents typically required by investors is also provided in this guide.

To deepen understanding of data room materials, investors may conduct high-level, senior management interviews. In addition, investors may request clarifications and share questions over email on specific elements or data points.

Investors will typically conduct a site visit, to meet with and interview a broader set of team members, review processes and controls, and audit fixed assets. This intense process is used by investors to validate findings and answer outstanding questions from the data room review. In addition, investors may use the site-visit process to meet with key customers, suppliers, and other stakeholders, such as financing institutions. This provides investors a 360° view of the business, the way that it operates and ability to execute on projections based on external influences. The site-visit process may result in further document requests and additional analyses being conducted.

Negotiation of investment terms may begin ahead of a site visit, and some investors may even require a term-sheet to have already been signed. However, in general the details of a term-sheet are negotiated after a site visit, when a significant portion of due diligence has been completed.

Preparing for due diligence

A data room is a central repository from which investor information requests can be managed. They are typically online platforms shared with investors, where the business holds ownership rights over the editing and sharing of information. A data room can be established in free of charge file-sharing platforms (e.g. Google Drive, Dropbox) or though dedicated paid-for platforms (e.g. HUBX, Intralinks). Factors that should be considered in establishing a data room should include confidentiality, version control of documents and managing folder structure as information requests increase.

A data room can be established and populated ahead of investor outreach. Readily available information and timely responses to investor requests help build investor trust and confidence in company governance and controls. Allocating a central point of contact to manage investor relations, typically the CFO or even the CEO, may support in this process. Additionally, the person responsible for managing the capital raise process should ensure adequate tracking of information and answers, to ensure timely and consistent responses to different investor requests.

Table 2: Data room checklist

Document	Definition
	Organisation 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 distribution of power and responsibilities and the distribution of profits and losses
Capitalisation 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 bios	Biographies on the management team and the board of directors
Product portfolio	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
Compensation structure	Compensation packages for the different 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 for the use of raised capital
Investor agreements	Terms of any ongoing investor agreements and previous capital raises
	Financial documents
Profit and loss statements for last three years	Profit and loss statements over the past three years to date , including costs and revenue broken down by sales channel/client types if available
Balance sheet statements for the last three years	Balance sheet statements over the past three years to date, which should include the value of all assets, liabilities, payments, and receivables due

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Cash flow statements for the last three years	Cash flow statements over the past three years to date, which should include previous budgets vs actual cash utilised, plus the budget for the next financial year
Debt and liability agreements	Description of both current and long-term debts laying out their repayment history
Financial model with projections	Five year, three-statement (i.e. profit and loss, cashflow 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
Budgets	Budget for the last two financial periods and explanations for any significant variances in actual spending

A company should anticipate challenging questions that investors are likely to ask during due diligence and identify any inconsistencies in materials shared. For instance, investors may look to validate key assumptions in financial projections based on the historical performance achieved by the business. As such, a company should source relevant data points that can be used as evidence to support projections, such as through the piloting of sales for new products.

Whilst some due diligence processes can be accelerated to complete within weeks, a company should be prepared for a capital raise process that typically takes 3-18 months or even longer. As such, it is important to begin the capital raise process with enough runway in already 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 to those set out in projections.

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.

References and further reading

20 Key Due Diligence Activities in a Merger and Acquisition Transaction
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GIIN Conducting Due Diligence
https://thegiin.org/conducting-due-diligence

Nairobi Garage Due Diligence Checklist for your Startup
https://nairobigarage.com/due-diligence-checklist-for-your-startup/

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

Data room resources
https://www.forbes.com/sites/allbusiness/2016/08/15/the-importance-of-online-data-rooms-in-mergers-and-acquisitions/#5af33afa3566

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

Pitch deck sample structure
https://thegiin.org/creating-marketing-materials

Financial model template
https://corporatefinanceinstitute.com/resources/templates/excel-modeling/financial-model-template/

Useful contacts

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