

Be Prepared: Commercial Due Diligence



Due diligence (or "DD" as it is often called) is the process where a potential investor makes enquiries to ascertain whether the business meets their risk vs reward threshold.

Due diligence might involve research, examining documents or asking questions of the business, customers, other investors or even competitors. Throughout the due diligence process, not only are facts being tested, but so also is the character and abilities of the founding team.

Types of Due Diligence

Typically due diligence covers both commercial and legal matters.

Legal matters might include when and where the company is incorporated, who the shareholders are (according to ASIC or other corporate records), proof of IP ownership, details of commercial agreements, history of legal disputes and other matters.

For large transactions it often makes sense to engage an external law firm to conduct legal due diligence on behalf of an investor. For early stage transactions this is quite rare, as the business and market risks are often much larger and it is little value in focusing on all the legal risks.

I'll focus here solely on commercial due diligence, although, practically there is a fair degree of overlap (eg customer contracts not only prove a deal was done but have commercial details about the customer's commitment to paying over time). We'll cover legal due diligence in more detail in another blog post.

Pre-diligence

This is the process an investor undertakes before requesting access to due diligence materials and is equally important. An investor will require a threshold level of information before committing time to due diligence.

Pre-diligence includes:

- Your initial pitch, calls and Q&A.
- Accessing publicly available information including your website.
- Customer reviews.
- Talking to the person that referred the opportunity and other people in their team.
- Looking at other opportunities and companies in the space.

What will investors ask?

Every investor is different and has a different process however there is a fair level of commonality.

The stage the company at also has a large bearing on what to ask. For example, if the company has no revenue, then financial statements are less important. If the company is a deep tech company then focusing on the IP and the market are more important.

Often it makes sense to break the due diligence process into two – initial key documents and then a more detailed set of documents if both parties agree that going deeper makes sense. Sometimes there is information that is so secret it should only be disclosed much later in the deal process.

I've seen investors ask for psychometric testing of founders, police and financial checks on key management and/or a lengthy process to get to know the founders over time.

As a founder you need to work out the right balance between giving away information and spending time with individual investors vs where they (and others) are in the capital raising process. Going too deep too early with an investor can, paradoxically, affect your ability to raise as it may lead to a loss of competitive tension in the deal.

Key Areas for Due Diligence

It's best if investors try to limit their enquiries to only those areas they need to make a decision on whether to progress to the next point. That said, each

investor might be different and have areas they want to focus on, so be prepared to quickly provide more information as you go through the process.

The first few areas I look into are:

- **Capitalisation (Cap) table:** who's on the register, what forms of financing have been used before, who are the decision makers, how much do the founders still own? Do I believe it is possible (and sensible) to offer a term sheet to this company?
- **Financial statements:** any historical financial statements (particularly focusing on the revenue sources and historical growth) plus a basic model forecasting out at least 12-18 months. This gives a sense of whether the company is predicting it will have VC like growth and can often show issues including loans (that sit in front of equity on liquidation), product margins, differences between what is SaaS revenue vs consulting or transactional revenue, and whether costs scale linearly or there is some inherent leverage in the business model. My assumption is the forecast will be wrong but the way the model is put together tells me a lot about how the team think about the business.
- **Customer and pipeline analysis:** information about what each customer has spent over time and how that contributes to MRR. This is helpful for showing any customer concentration issues and seasonality in sales. Ideally, also a pipeline for enterprise SaaS businesses showing forecasted revenue by month by customer.

Further Due Diligence

Depending upon what I learn from that process, I will often ask for more information to expand my knowledge of the business, the market and the team. This might come in the form of asking for additional documents, or talking to current and/or former customers, talking individually to team members (eg head of sales, CFO or CTO) or asking questions to help me understand the market structure and competitive situation.

All these questions will give me less or more confidence that the company has what it takes to be successful and meets the standard I've set before investing. Occasionally, due diligence will reveal discrepancies between what I've been told and what I've found. Sometimes these can be material enough to end a deal. More

often, what is learnt in due diligence is that the opportunity is more complex and the chance of success is lower – this can also end the deal.

How can I be prepared?

The best way to prepare for due diligence is to construct a simple data room ordered in a way that allows investors to easily find what they are looking for. Google Docs, Dropbox or Box etc are fine to use - there is no need for anything expensive or fancy. I've seen founders try to use specific data room products, but in my opinion, this is an overkill and experienced people will often require you to provide a downloadable version of the whole data room – defeating all the tracking and other features.

Hopefully your company records are already centrally stored and organised, so this is just a subset of that information.