



Due Diligence Checklist for Business Buyers and Investors

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You've decided you want to either invest in or buy a privately held company. You've researched the company, the market, the management team, and their products. You've decided to make an offer.

Are you sure?

Here is a brief list of areas that every business buyer and investor should investigate before signing a deal.

Your Financial Situation

Before you sign a deal, review your financial situation carefully. If the total investment requires more than 5% of your current net worth, or you have limited income potential from a job, spouse, or other sources, or you do not have enough liquid assets to cover all your expenses if the investment fails, then you may want to hold off for now.

Your Risk Tolerance

Nobody invests in a business expecting to lose all their money. But it happens all the time. If this business does poorly, will you be able to sleep at night? Will your spouse? Note that this really has nothing to do with your net worth or your long term earning potential --- it is really more a matter of personality. If you stay up late at night worrying about your mutual fund portfolio, you should probably avoid private equity investments altogether.

Business Model

Do you understand the company's business model? Be sure you really understand how the company makes money. If not, or something seems askew, then you should dig deeper. If the answers still don't make sense, just walk away. It may be a house of cards.

Market Size and Trends

How large is the potential market for this business? Have you verified this using third party data? Do some research on the Internet or in the library to get a handle on the size of the potential market. Generally, the bigger, the better.

What are the market trends? Are there regulatory, demographic, economic, or other trends that affect this business? Do the positive factors outweigh the negative ones? Most venture capitalists invest in businesses where the market is growing rapidly due to outside influences



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(population is getting older, etc.). This way, even if their investments do not become market leaders, at least they aren't swimming against the tide.

If the market is small, or large but shrinking, or the company doesn't have a plan for gaining market share, take a pass on this one.

Competition

How does the company rank among competitors in terms of quality, pricing, growth rate, cost structure, and market share?

Who are the top competitors? List them (if just a few) or categorize them (if there are many).

If there isn't much competition now, try to imagine what the landscape will look like in a few years. Competitors come from almost anywhere. Remember Sears and Home Depot ten years ago? Schwinn and Cannondale?

Are there any "800 pound gorillas" (market leaders with strong brands and large amounts of cash)? If so, how will your company compete against these giants? If management cannot supply a convincing answer to this question, run, don't walk, away.

Management Team

Weak management teams lead to weak results. Be sure to interview the top management people at the company. Look for signs of indecisiveness, bitterness, in-fighting, grudges, etc. If you see potential problems, dig a little deeper. If you don't see any sensible solutions, walk away.

Financials

Hire a finance expert to review the company's financials for at least the past 5 years (or from the beginning if the company is less than 5 years old). These include the balance sheet, profit and loss (income) statement, and cash-flow statement. Don't be fooled by a strong balance sheet or paper profits: remember many "profitable" companies go bankrupt.

Does the company have any outstanding short- or long-term debt? Find out when these debts were incurred, for what purpose, and what the terms are. Does the company have enough cash, liquid assets, and positive cash-flow to pay off the short term debts? Will future cash-flow be sufficient to pay off the long term debt?

Internal Processes

Investigate key internal processes to see how efficient, or inefficient, they are. Ask to see procedure manuals.. If the company is more than 5 years old and does not have any, this is a red flag. If the company is less than 5 years old, this could just be a sign of youth, but in any case, it is worth investigating.



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Customer Satisfaction

Are customers happy, less than happy, or just plain disgusted? Go beyond customer satisfaction surveys and word of mouth: the key here is customer retention. If customers keep coming back, this is a clear signal the company is doing something right. On the other hand, if most people are one-time buyers, or there is a consistent long term pattern of complaints about the company's products or services, this is a major red flag.

Start with the company's own internal reports and word of mouth. Supplement this with checks to the local Better Business Bureau, the Secretary of State's office, Internet blogs, third party reviews (Consumer Reports for example). It also never hurts to speak directly with some actual customers.

Sales and Marketing

How much does the company spend on sales and marketing each year? Divide this by the number of customers gained during the year to obtain an average customer acquisition cost. Calculate the ratio of marketing plus sales costs divided by total revenue. Compare these numbers to others in the industry to see if they are high or low. If they are high, you need to find out what the problem is.

Legal Issues

Ask to see the most important legal documents for the company (articles of incorporation, operating agreement, etc.) Check the Secretary of State's office, and any other relevant certification or compliance agencies to make sure the company follows state rules and regulations.

Are there any outstanding lawsuits, liens, or judgments against the company or its officers? Have there been any in the past? If so, were these legitimate and do they reveal major problems with the organization?

Cash Management

How is cash managed on a day to day basis? Is there --- literally or figuratively --- a cookie jar bursting with cash and available to anyone with an arbitrary "need"? Or are there reasonable policies and procedures in place to make sure cash is handled properly?

Human Resources

Does the company take employee issues seriously? Are they an Equal Opportunity employer? What are their policies on hiring, firing, compensation, and promotions? Even if the company just has a few employees, they should have some sort of policies regarding these issues. Find out what they are, and dig a little to see if the policies and procedures are actually followed.

Risks and Insurance

If a company has salaried employees, or annual revenues of at least a million dollars, they



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should have some insurance. Investigate the liability issues for this company and their industry. Find out what insurance and other risk mitigation procedures they have in place, and decide whether they are adequately protected.

Pricing

How do the company's product and service prices rank in the marketplace? Are they a "low cost provider", a "premium provider", or somewhere in between? Does the pricing fit the company's marketing and sales messages, or is there a mismatch?

Technology

Technology can be a huge differentiator between market leaders and losers. Leaders use technology to grow the business in ways their competitors never imagined. Losers spend too much --- usually on ill-conceived internal projects that ultimately fail, or too little --- resulting in slow or inefficient processes. Compare the company's technology spending per person and per dollar of revenue with others in the industry. If they are very different from the norm, then ask why.

Strategic Planning

Does the company have a strategic plan? If so, get a copy. Read it carefully and decide if it makes sense. If the company does not have one, or the plan is lacking in critical areas, you should address this in the negotiation stage. Consider engaging a professional consulting firm to help you develop and execute a winning strategy once a deal is finalized.

Exit Strategy

At some point, you will want to get your original investment back, plus hopefully a significant positive return. How and when will this happen? Be sure you have at least one viable potential exit strategy before you make an investment.

Valuation

Hire an expert to conduct a valuation of the company. A professional valuation ranges in cost from \$5,000 to \$100,000. Generally the higher the price, the better the quality, but you might not need to pay top dollar for your particular case. A \$100,000 price tag is only warranted if the deal is huge.

Although many people have made fortunes by investing in private companies, there are significant risks. Most entrepreneurs are honest, but a small percentage will intentionally hide problems from business buyers or investors. More often, the entrepreneurs are simply blind to potential problems because they are so focused on growing the business as quickly as possible. Smart investors protect themselves by asking good questions. The issues listed here barely scratch the surface, but they are a start. If you are considering purchasing or investing in a private business, be sure you do your homework before you sign a deal. Your wallet will thank you for it.



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