



DUE DILIGENCE

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Due Diligence

- **Be Prepared**

- How you answer DD questions, your willingness to answer, and the time it takes you to answer is just as important as the facts at hand.

- **Be Organized**

- Style points count. An investor will assume you treat your business in the same manner that you treat the DD process.

- **Non Disclosure Agreements**

- Useful in some circumstances, but not likely as necessary as you may initially think.
- You are special...just like everyone else.



Due Diligence

I. Corporate Records and Organization

- Corporate / Organization Design
 - Articles, Bylaws, Operating Agreement, etc.
 - Standard provisions – shareholder meetings, board seats, voting, etc
 - Protective provisions – unique voting rights, major decisions, negative covenants, etc
 - Org Chart and Board composition (IMPORTANT)
 - Quality of Documentation (minutes, resolutions, etc)
- Complexity?
 - Does the existing structure allow for investment?
 - Where does new money fit in the capital stack? Smooth operations of business?
- Evidence of effective governance: Now, or are you prepared for it?
 - Annual S/H meetings, regular BOD meetings, policies (compensation, incentives, conflicts of interest, appropriate disclosures, etc)



Due Diligence

II. Sales and Marketing

- Do you know your market?
 - Who is your customer? Value proposition? Need to have or nice to have? Competition? Real time trends?
- Distribution: Direct, channel, license?
- Technology doesn't sell, people do
- Experience – track record of selling similar product, to similar customers via similar channel?
- Rational forecast:
 - Explicitly articulated assumptions
 - Range of expectations
 - Cash flow break-even? Margin for error?





Due Diligence

III. Financial Data – Past and Future

- Income, Assets, and Cash Flow
- How does cash move through your business?
 - Recurring vs. Non-Recurring Revenues (impacts valuation)
 - Expenses: Fixed or Variable (do margins scale?)
 - Cash Management: AR vs. AP, bad debt expense, etc.
 - Revenue Recognition – applies to subscription sales models
 - Sustainability, Risk, and Cash Reserves
- Reporting – How you report is how you govern.
 - What are the key metrics that drive revenue and profitability
 - Do you know them cold
 - Does this feed back into management and operations
 - Who prepares your financial information



Due Diligence

IV. Financing

- How is the business capitalized? Is there fundraising flexibility?
- Instruments
 - Debt: Seniority / Secured / Convertible / Equity Participation
 - Equity: Rights / Liquidation Preferences / Multiple Rounds
- Liabilities and liquidity
 - Amounts / maturities of debt / are they secured
 - Operating lines – available or drawn down
- Who are the owners?
 - How complicated is the cap table? Is there investor fatigue?
 - Rights and preferences for new capital – Is there room?
- ***The Big Question: What is the Exit?***
 - When? Who? Why them? Why you?
 - What are you doing to position for an exit now? (operationally, strategically, tactically)
 - Opportunity for you to demonstrate you know the market and where you fit in it





Due Diligence

V. Tax Matters & Auditors

- Is the company structured in a tax advantaged manner both for operations, investment and exit?
- Auditor selection as a component of governance and preparation for an exit.

VI. Material Agreements

- Are your crucial agreements formalized?
 - Employment, invention, option plans, strategic relationships, channel, license
 - Can 3rd parties impact your business (i.e. license agreements, distribution agreement)
- Do you engage in related party transactions? Disclosure is key!



Due Diligence

VII. Intellectual Property

- Protected? (Corollary, does it make sense to?)
 - Patents, copyright, trademarks (get a lawyer)
 - Trade secrets
- Is all IP properly assigned to the corporate entity?
- How credible is your IP asset? Do you have the ability to defend or enforce a Patent through litigation?
- IP can be important for defensibility, *however, capturing and controlling market share is even more important*





Due Diligence

VIII. Other Matters

- VIII. Employee Deferred Comp, & Benefits
- IX. Insurance & Risk Management
- X. Litigation, Environmental, Government & Regulatory
- XI. Miscellaneous
 - Anything else material. Remember lies of omission are still lies.
 - Third party information – analyst reports, expert research
 - Outside information is particularly important in rapidly changing industries

