Due Diligence Factsheet

Business

The following factsheet was drawn up by the trade body's Technical Committee, comprised of experts in financial, technical and legal aspects of angel investing. This factsheet on business issues has been produced by Martin Brassell at Inngot Ltd and Martin Avison at Pera.

Business due diligence

When you invest as an angel, you will be buying shares in a company, which you expect will appreciate in value over time to provide you with an appropriate return at exit. In addition to considering the market, the products and the people involved, it pays to investigate the company itself to ensure it is an appropriate investment vehicle and a sound place to put your money.

Top 10 Tips

1) **Review the shares already issued**. At an early stage, request a breakdown of the current ownership of the business by class of share (usually shown in a share capitalisation or 'caps' table). For tax reasons, you will probably be investing in ordinary shares; make sure other classes do not exist which have preferential rights that could dilute your value. Take this opportunity to understand who all the other shareholders are and whether all shares are paid up, particularly where the prospective investment round is the first one following "friends and family" involvement.

2) **Look at the amount of money being sought**. Does the company have a funding strategy explaining how it will find what it needs for this round? Is it asking for enough money – or asking for too much (and therefore reducing your upside)? It is common for businesses to need a number of rounds, if their initial plans do not work out as anticipated, or (conversely) because their potential markets are larger than expected; do the directors realise this and what are they saying about it?

3) **Assess the share price**. An investee business should have a clear idea of what they want to achieve, but you are not bound to accept it. Think about what the price means for the overall valuation of the company and question how it has been arrived at, particularly if there have been no prior 'arm's length' investments. Ultimately the value of a business is determined by what the market is prepared to pay – and in this instance, you *are* the market.

4) **Be clear what the valuation means**. Various terms can be used in business plans and prospectus documentation when describing the company valuation. 'Pre-money' means prior to the

prospective round; ‘post-money’ should be the pre-money price plus the anticipated investment. The price per share will be determined by the pre-money value, but the proportion you will end up owning is determined by the shares issued when all the money is in (which may be more or less than the company is aiming to secure).

5) **Pin down what the business owns**. It is normal for early stage customers to have very few tangible assets: this makes their intellectual property (IP) and other ‘intangibles’ particularly important, as these are the assets to which you will be attributing value. If there are registered IP rights, clarify their relationship with the company (sometimes these are owned by the proprietor not by the business) and assess what they may be worth, to increase (or reduce) your comfort levels in the overall company valuation. Also, do not overlook *unregistered* intangibles – contracts and letters of intent can be crucial for success.

6) **Consider overall ownership post-investment**. It is generally regarded as important to ensure that those with day-to-day responsibility for running the business have a sufficient stake in it, to incentivise them to bring about a profitable exit in due course, and balance the fact that their drawings should be limited at least until the business is sustainably profitable. Beware of situations where for some reason a management team has ended up with a very small stake, or where there is a myriad of small shareholders – it can make a business hard to manage and very challenging to re-finance.

7) **Form an opinion on the potential exit value**. Does what you know of the product and the market convince you that an exit value could be achieved in 3-5 years which would give you a worthwhile return on your investment? Statistically, only about 1 in 10 investments is a “star performer”, but there needs to be some potential for stardom in every deal you do.

8) **Establish the sources for advice received**. In particular, look at the professional advice that the company has obtained in respect of the fundraising (and its business generally) in key areas such as accounting, legal and IP advice. Has this been of good quality or could some business basics have been neglected? Have the directors got a good sense of the risks their particular company faces, and do they have appropriate measures in place to mitigate them?

9) **Validate everything you can**. You are likely to spend some time on warranties and disclosures as part of legal due diligence. These are important, but costs should be proportionate to the size of the deal – even if the investee is bearing them all, they reduce the amount available to spend on business growth. You can supplement your knowledge of the facts by using online services to verify information being presented to you. Companies House, for example, can provide information on directors and financial interests as well as statutory accounts (which often tell you very little).

10) **Make sure the company is EIS qualifying**. The Enterprise Investment Scheme provides valuable tax advantages, whether the venture is ultimately successful or not. Companies can obtain advance approval for the scheme from HMRC and will have done so if they are truly ‘investment ready’.