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Ask the Expert: Commercial due diligence

David McClelland, director of Carlton Strategy Advisors, discusses what is involved in due diligence in transactions between private equity and SMEs.

Q: What is the value of commercial due diligence applied to the SME private placing?

Small and medium sized enterprises with sustainable earnings from within a defensible market niche can be attractive to the private equity community. The injection of development capital can prime logical business extension and accelerate growth with the potential to take the investment onwards to a point of equity exit.

Growth and risk are often close bedfellows within the SME space. As a consequence, investors may seek to mitigate transaction risk through an appropriate level of due diligence carried out on the prospective portfolio company by an independent firm of reporting consultants. But what is involved - and what is its value?

Commercial due diligence sits alongside financial and other DD. Arguably, it is the former that is most relevant to the fast growth business where analysis of internalised, historical numbers as carried out by the FDD may be only so useful. CDD tends towards the empirical and whilst this may be evidenced in part by the track record of the investee company it is the ability to understand the nature of the company's trading prospects in the external marketplace that is of greater importance to the private equity investment case.

A typical programme of CDD might consist of four interwoven stages or key steps, which seek to answer the following types of questions:

1. Business strategy review
    - Is the business planning process logical and coherent? Who wrote the numbers?
    - Are ambitions realistic, and with a strategy and resources that match vision?
    - Can plans be reasonably implemented in a meaningful timeframe?
2. The trading projection
    - What confidence underpins customer acquisition and retention?
    - What comfort can be derived from additional customer/supplier referencing?
3. Market fundamentals characterisation
    - How is the addressable market defined - are growth drivers attractive?
    - What is the balance of power between buyers, suppliers and middlemen?
    - What market barriers work against new market entrants and product substitutes?
4. Investment value creation

- What are the unrealised opportunities and actions to improve performance
- What is the likely end-game, including scope for further bolt-ons or sell-offs

In conclusion, due diligence reporting should provide clear, evidenced opinion about the relative strengths of the business and whether or not competencies are aligned with markets of greatest opportunity in a scenario in which the likelihood of commercial risk is favourably placed against the severity of its outcome.

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