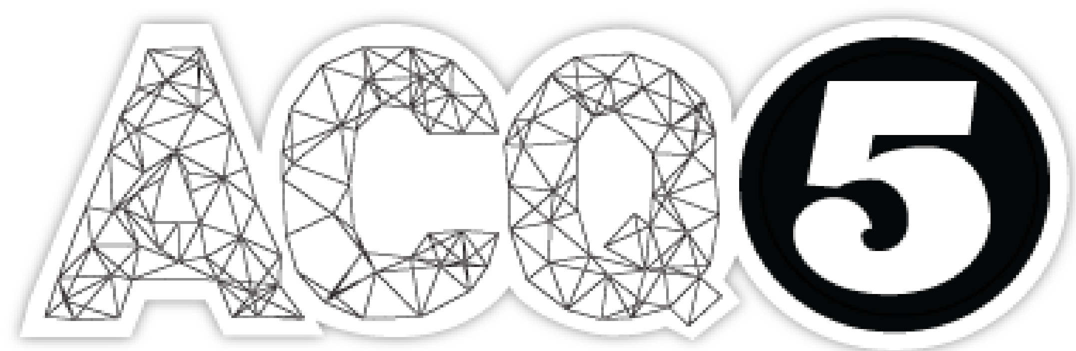

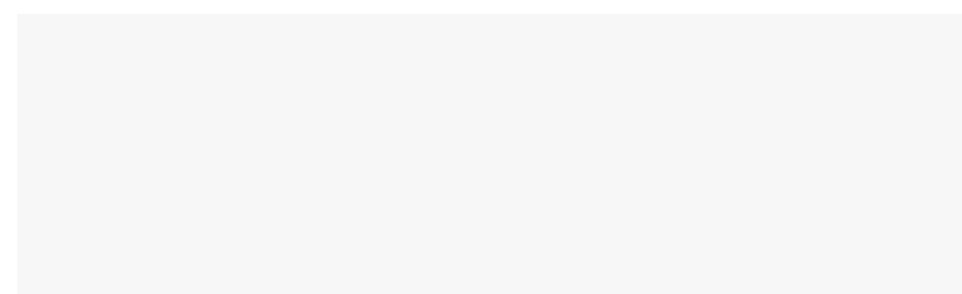



# Information Technology DD

More than ever before it is possible for technology to improve business performance. Developments in enterprise resource planning ("ERP"), customer relationship management ("CRM") and related enterprise software permit efficiencies within internal operations and across external supply chains that can impact top and bottom line performance. Moving to a software -as-a-service delivery model can lower the cost of IT ownership and reduce the time and effort required to implement new technologies. In today's weaker economic environment many businesses are turning to such investments for immediate, possibly essential increases in revenue growth and efficiency gains. The critical business benefits that technology can deliver have allowed many technology vendors to continue to achieve strong sales growth despite the generally weak economy.

The rapidly changing nature of the technology industry makes it possible for SMEs to quickly win leadership positions in a chosen niche. Relatively young technology companies that develop new, disruptive technologies are able to establish strong relationships with large, blue chip clients. The products they provide are often built on proprietary intellectual property, allowing them to sustain relationships over time and to resist the efforts of larger competitors to replace them. Such small businesses are highly attractive to financial investors and lenders. They combine established, defensible businesses with the potential for outsized growth and returns.

Private equity investors and corporate lending banks providing growth finance and development capital to technology companies will typically seek out intellectual property rich businesses in need of a capital injection. The capital should allow the business to reach a position of sustainable profitability and cash generation and to stimulate it onto an accelerated growth trajectory. This type of business might be branded the 'mature start -up' because 'on paper' the company should look to have passed the 'proof -of-concept' stage, ie established commercial traction from a sustainable customer base, in an operation with reasonable processes and controls, led by a stable management team.

The potential for outsized returns inevitably brings with it an increased level of risk. However the risks involved in a technology investment can be minimised, or at least better understood, through appropriate levels of due diligence. Many private equity investors and lending banks who choose to invest in SME technology businesses will try to minimise their risk by engaging independent due diligence experts to assist with, or lead investigations into target companies.

Carlton Strategy Advisors has a long track record of successful due diligence engagements. When engaged on a new project we look to identify and test a number of themes and characteristics that we would expect a successful technology firm to demonstrate, applying our consistent, proven methodologies.

*David McClelland, Director*

In the initial stages of any new project, we will map out the structure of the sector's supply chain as a precursor to further market characterisation, sizing and segmentation using a combination of primary and secondary market research ethods. At this stage in the process our aim is to define the nature of the investee company's addressable market and clarify the roles of the respective buyers, suppliers and middlemen, particularly the nature of their interwoven activities and relationships, cooperation and competition:

- ***For an own equipment manufacturer ("OEM") or hardware manufacturer the technology supply chain could include various component manufacturers, a contract manufacturer, an IT distributor, a VAR, a retailer and an IT services/implementation services provider;***

- ***For a software vendor this could include a value added reseller ("VAR"), a partner independent software vendor ("ISV") and an IT services/implementation services provider.***

After gaining a thorough understanding of the market landscape we will ask to interview the company's management team. With management's help we will drill down into the sales numbers and the methods used to prepare the business plan, including its revenue forecast and pipeline of customer prospects. We will seek to gain an understanding of the intellectual property and embedded knowledge within the company that might be hard to replicate, thereby creating protective barriers against competition. We will discuss and analyse additional sales opportunities within a given market vertical and review wider geographical territories and parallel verticals which the company might exploit. By blending together our analysis of the internal strengths and weaknesses of the company, together with the external opportunities and threats, we are able to develop an understanding of whether the company has a sufficiently strong position in its market to allow it to appeal to the financial community.

When analysing the investee company's trading a key area of focus is the nature of the sales cycle and the processes needed to initiate and finalise a sale. Key questions include:

- ***If market channels are a mix of both direct and indirect sales, are these uniformly executed across each territory and vertical, or patchy and in need of further planning and attention?***

- ***How long are lead times? These might be several months long, driven by potential customers' needs for assurance about issues such as the robustness of the company's products and technology and of its ability to deliver.***

- ***Are customer revenues one dimensional, or are they multi faceted involving an initial licence or service installation fee followed by product upgrades and version releases, i.e. lumpy fresh customer sales but with a pattern of predictable recurring revenues?***

In addition to analysing the revenue and sales cycle, our diligence scope often includes a review of the target company's intellectual property. Our methodology includes both quantitative and qualitative elements: are the target company's IP protected products capable of generating more than a minimum level of revenues? Is the company's pipeline of customer opportunities sufficiently robust to meet management's forecast?
Due diligence of any small, high growth business should include a review of whether the company is at risk from resource stretch through market over -reach and resource misalignment. If sales leads are not converted and the pace of the initial sale and client engagement is not followed through with adequate installation, support and maintenance, the company's reputation will suffer, leading to future revenue loss.
Overall, full and proper due diligence reporting should provide clear, evidenced opinion about the relative strengths and weaknesses of the business; whether or not competencies are appropriately aligned with areas of greatest market attractiveness and that the likelihood of commercial risk is favourably placed against the degree of severity of its possible outcome.



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