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SPOTLIGHT ON... COMMERCIAL DUE DILIGENCE

David McClelland, Director at Carlton Strategy Advisors Ltd

The business investment cycle tends to respond to macro economic growth, not lead it. Constrained of economic pull, we see the successful UK business in 2013 being the one that can best build its commercial proposition around a differentiated core competence and is able to command a leadership position within a chosen trade sector, offering sustainable revenue flows through customer loyalties and effective market barriers against rivals.

These are the goals to which all businesses aspire, of course, but no more so at the present time in financial markets than for the small and medium-sized enterprise on the very cusp of true business momentum and scale as a growth play, subject to the injection of some further 'still difficult to find' growth capital from a bank, VC or private equity investor who in themselves remain cautious and risk sensitive by the nature of their own exposure to today's politicised funding environment.

In this economic and financial situation, the SME's prospective funding partner, be it a corporate lending bank or PE investor, will likely seek to mitigate its potential transaction risk in connection with the SME through an appropriate level of pre-lending or investment due diligence, carried out by an independent reporting advisor commissioned by the bank or PE. Due diligence of this nature and particularly commercial due diligence, will examine the business affairs of the SME in order to assess, most specifically, the sources of business value creation opportunity and trading risk within the SME for the bank or PE to then determine its level of foreseen debt settlement exposure or equity investment risk.

The scope of the commercial diligence agreed between the bank or PE and the reporting advisor will depend on each party's early understanding of the main 'deal issues' likely to be involved in the making of any deal with the SME, following initial analysis of the SME's business plan or financial memorandum. Thereafter, the approach of the commercial diligence will set out to understand the positioning of the SME within its overall sector supply chain and the thinking and rational of the SME's senior management team having already taken the business down one, or more, paths to market set against plans stated for the future.

As a reporting consultant, CSA will initiate the commercial diligence process by submitting a request for information to the SME, following this upon review by meeting company management for a one-on-one interview before going on to verify aspects of this level of internal detail against externally sourced business and market information.

An internal business review may examine company developments to date, such as new product introductions and customer acquisition, for example. It will most certainly include an assessment of the experience of the management team in setting and meeting key business objectives and the metrics used within the business to monitor performance outputs. In this context, particular granularity will be given to an analysis of revenue and margin growth across product, customer and geographical business categories in a comparison of the historical situation against forecasts contained within the business plan in the light of the assumptions made by Management about core business competences, pricing and market share amongst other business drivers.

External market information is gathered by means of secondary and primary analytical market research methods as will determine market volumes, values and their rates of growth. Most importantly, this will also include customer/lost customer references in addition to an assessment of the impact of competition on pricing and market share.

In short, commercial diligence will assess and form an opinion about the wisdom, benefit and risk involved when a company's trading activity is aligned by its Management to certain customer groupings in competition to current or foreseen market rivals or product/service substitutes – not forgetting the influence of any short or long-term sector cyclicality on prospects. Of course one bank or PE's risk is another's opportunity; the trick for the commercial diligence consultant is to view the transaction through the eyes of the prospective debt lender or equity investor, alert about what will make either party 'comfortable' or 'nervous'.

To conclude, the economic environment increases the pressure on companies, particularly SME's, to perform, increasing the risks associated with business refinancing and especially financing for growth. Commercial due diligence can bring greater transparency and perspective to bank lending and PE investment decisions, thereby improving transaction value and aiding deal success.

About the Author

David McClelland is a Director at Carlton Strategy Advisors Ltd. CSA is a commercial due diligence and business strategy consultancy, with clients across the Private Equity, Bank and Corporate sectors.

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