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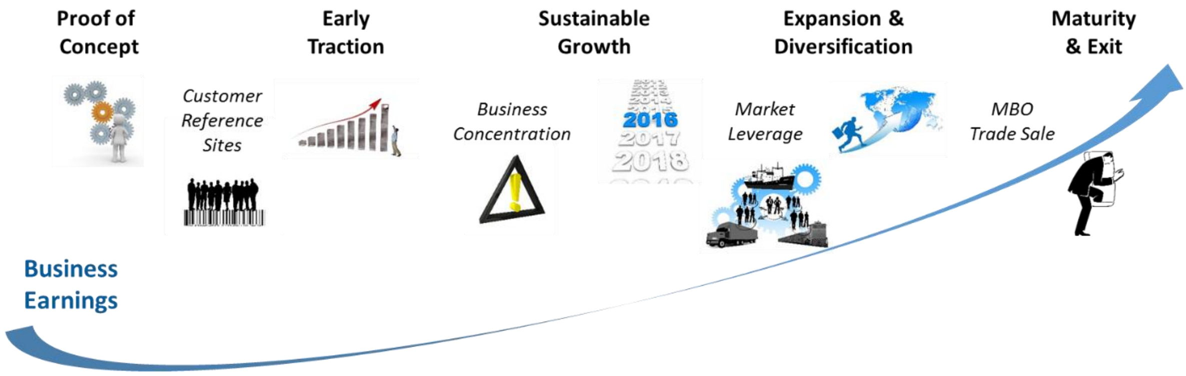
Scoping commercial due diligence for cashflow finance in the entrepreneur-led SME

David McClelland, Director of Carlton Strategy Advisors, outlines his thoughts on the subject of scoping due diligence for cashflow finance in the entrepreneur-led SME:

The owner/manager-led SME which can demonstrate sustainable earnings from a defensible position in an identified market segment or protected niche represents a potentially highly attractive investment opportunity for private equity investors and bank lenders. At face value, the injection of development or growth capital can prime logical and rapid business expansion, carrying the portfolio investment to a point of fruitful settlement and exit at maturity.



However, equity investors and debt lenders sometimes struggle to accommodate the often imperfect flow of management information reported within the business when they are considering an SME investment. Weak and incomplete management accounts, sales data and other performance indicators can hinder an open understanding of the business model and plan. In the absence of 'bricks and mortar' assets traditionally used as security for conventional debt lending, this can bring the strength and accuracy of the trading forecast into question on which cashflow finance may be dependent.

A clearly scoped due diligence assessment which:

- understands the practicalities of SME business planning
- accommodates imperfect information
- acknowledges the strengths and weaknesses of management operations
- develops an analysis of the forward pipeline, and
- recognises the competitive dynamics of the industry supply chain

can provide the investor with the specific business and market information they will need to have at their disposal if they are to reach a position of comfort that a deal with the SME can be struck.

UNDERSTANDING THE PRACTICALITIES OF SME BUSINESS PLANNING

SMEs are often led and controlled by one or two senior managers and/or principal shareholders; key individuals in the business who have driven direction and strategy according to their personal experience and intuition as 'free rangers' often with little challenge from second tier management and lesser shareholders.

Problems can arise from this situation, when a successful, but relatively autonomous, entrepreneur is introduced to the sterner strictures of the corporate finance transaction process - and no more so than during due diligence.

Commercial due diligence is normally mandated by a debt provider or equity investor and carried out by an independent reporting consultant. It can encompass a review of the target-company's strategy, trading analysis and marketplace characterisation from which conclusions will be drawn about the competitive positioning and sustainable advantage of the target-co. However, the quest for detailed, or even broadly consistent, business information which allows for granularity of analysis can be hard to obtain in situations, for example, where the business has no full-time FD or the dominance of a critical senior manager has led to poorly committed-to-paper reporting, planning and forecasting. These are 'real-life' practicalities, typical of many SMEs, which need to be recognised and accommodated within the terms of the scope of the work agreed between the reporting due diligence consultant and client sponsor.

ACCOMODATING IMPERFECT INFORMATION

A business plan that claims given rates of market growth and opportunity in a particular sector of SME trading activity is only relevant if the plan is also able to articulate the necessary development steps, processes and milestones to get there. A bucketful of ideas from top-management about customer acquisition, product range extension and supply chain repositioning is great; but not obviously believable unless reasoned by relative resource and timescales in line with the term of a bank's loan or PE window of investment thinking.

In CSA's experience, due diligence project work may need to recognise at the outset that there may be several variances and inconsistencies in the way the SME's trading statements are prepared and presented for examination.

Historical trading records will almost certainly segment the financial numbers by (main) customer and product category. Additionally, there could be some regional or sector segmentation. But this cut of the numbers may then have been linked with altogether more opaque customer and market penetration targets, depending on the sophistication of the business's internal planning, available sales and marketing resource and the specific nature of the marketplace.

Low forecast visibility can, of course, be a characteristic of markets prone to certain levels of volatility, such as the high street fashion clothing sector and where the pattern of a customer's demand is more ad hoc, for example in jobbing contract engineering services. However, poorly defined forecasting is also symptomatic of weak commercial functionality and overreliance on 'top-down' management forecasting.

In circumstances where a business forecast is difficult to reconcile with its historical situation, the scope of the diligence can be structured to address 'probability and sensitivity' within the business, especially across IP or other tacit capabilities which may drive customer acquisition and underpin future business performance.

RECOGNISING STRENGTH AND WEAKNESS IN SME BUSINESS FORECASTING

Should a commercial forecast prove weakly defined, the approach of the diligence can be modified to place greater analytical focus on the balance of the business's internal strengths vs weaknesses and external opportunities vs threats.

The process behind a basic 'SWOT' analysis is qualitative and relatively straightforward; a matter of engaging in some close dialogue with the management team before going on to cross-reference that information and detail with what customers (lost customers, agents etc) have to say about the inter-relationship. This level of analysis should also seek to capture the interviewee's own perspectives about market prospects, threshold vendor selection criteria satisfied by suppliers and the presence in the market of substitutes as possible threats to trade continuity.

Taken to a next phase of analytical assessment, the SME's strategic positioning can be modelled by examining commercial risk vs likelihood of occurrence and industry attractiveness vs competitive strength.

Although less quantitative in their analysis, the basic attraction of both of these assessment tools is in their ability to tease out the necessary information giving comfort, or otherwise, to the corporate financier that a deal with the SME is worth proceeding with on the basis of the SME's strategic standing, customer references and indicative prospects.

FORWARD PIPELINE ANALYSIS

Further, more quantitative, modelling of the SME's order book and customer pipeline will clarify the results of particular business development activities adopted by the business together with the pattern of this trade in volume and value terms across a timeline relevant to the investment consideration.

By attaching certain measures of weighted probability to the levels of business that the company would anticipate receiving from its customer base, it becomes possible for the reporting consultant to work with the management team in order to prepare a more definitive, line by line build-up of 'sensitised' revenues and volumes over the forecast period. Key criteria that can be most usefully modelled along these lines include knowledge of customer service contracts started, won not started, tendered not won and identified not tendered.

By systematically running a rule over the collective customer opportunities that are potentially open to the SME, the reporting consultant can effectively recast management's vision of its top line business growth. This delivers a picture of most probable volume and value build-up for a given timeline, based on various trading scenarios identified by the due diligence process. It also serves to re-adjust the more obvious 'hockey stick' growth curve often very typical in the more aggressive SME business growth plan.

CREATING TRANSACTION VALUE

Ultimately, the foundation of strong due diligence and its value to the client's investment case rests in the combination and balance of several qualitative and quantitative business analytical techniques.

"SMEs active in a sustainable and defensible market 'niche' are highly attractive to financiers"

It is the ability of this reporting analysis to distil a business forecast down to its core of the most sustainable revenue and profit streams which will underpin overall business performance and provide comfort that a) the SME can adequately service the repayment of its debt or b) act as a platform in support of further business scale and financial leverage.

Of possible equal importance and certainly not to be overlooked, strong diligence can also further empower the SME's management team to more accurately and confidently 'set out its stall' by making clear the optimal order of strategic priorities in the business in any post deal environment.

Carlton Strategy Advisors is a commercial due diligence and business strategy services consultancy with clients across the Private Equity and Corporate Banking sectors. For information about how CSA can help you to assess business and market attractiveness please contact: carlton-advisors.co.uk