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Scoping commercial due diligence for the SME private placing

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ENTREPRENEUR-LED SMEs WITH A SUSTAINABLE POSITION IN A DEFENSIBLE MARKET 'NICHE' CAN BE ATTRACTIVE TO PRIVATE EQUITY

Owner/manager-led SMEs, which have been able to demonstrate sustainable earnings from a defensible position in an identified market segment or protected niche, can be attractive to the private equity community. The injection of development capital into such stable business platforms, priming logical business extension and growth, may take the investment onward to an attractive point of exit.

SETTING COMMERCIAL DUE DILIGENCE SCOPE FOR THE SME PRIVATE PLACING

SMEs are often led and controlled by one or two key senior managers and/or principal shareholders: individuals who, as entrepreneurs, have driven business direction according to their sector experience, business intuition, contacts and personality – often as 'free rangers' with little management challenge from second tier reports and lesser shareholders.

A problem which can arise from this classic situation is when the previously successful, but autonomous, owner/manager suddenly finds him or herself facing the considerably sterner strictures of the private equity investment model - an experience most frequently brought to bear on these individuals by exposure in the first instance to the process of pre-transaction due diligence, requested by the potential equity investor.

Traditional commercial due diligence carried out by the reporting consultant can encompass business strategy review, customer revenue analysis and marketplace characterisation, with conclusions drawn about business competitive positioning and sustainable advantage. As a process, CDD tends towards the empirical and is evidenced by the track record and tacit capability of the company, bridged to future expectations for the company.

It is the quest for consistent, quantitative information at a granular level of analysis which can be hard to realise in the more strongly owner/manager-led SME: the situation in which the personal character and dominance of a senior manager leads to incomplete or poorly committed-to-paper business planning and reporting; a practicality that has immediate ramifications on the way CDD should be scoped to accommodate these circumstances.

CDD scope should recognise that there may be a variance in the way an SME's historical trading statement and forward business forecast are individually segmented and presented. Actual, historical revenues will almost certainly be segmented by customer and product type in addition to, possibly, geographical region and product application or sector end-use. But these then may be bridged to more opaque and weakly defined sales targets that allude, for example, only to fields of general industry application and/or product function and with little reference to indentified and prioritised customer targets, either grouped or as individual companies or organisations.

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Examples of this less visible forecasting can be found in circumstances where markets are volatile and customer activity generally more ad hoc. However, poorly defined forecasting can also be symptomatic of a weak commercial function and management planning or overreliance on a 'top-down' forecasting process delivered by the MD, CEO or Chairman (with an eye for the transaction at hand). Here, forecasting will be less easy to reconcile with the historical situation than if it had contained the more 'grass roots' customer detail.

This latter point can be important. CDD scope that sets out by means of market research to validate market growth in a sector targeted by the business, as a means of judging transaction potential, is only so relevant if the company's business plan is also able to articulate the necessary business development milestones and selling steps to get it there.

Secondly, a bucketful of ideas from management about future customer acquisition, product range extension or supply chain repositioning is great but immediately becomes less believable if not prioritised by relative timescale, business importance or technology/resource requirement, for example.

ALLOWING FOR IMPERFECT INFORMATION

In circumstances where the commercial numbers supporting the SME business plan are weakly presented, the CDD can be scoped to provide some greater emphasis on the analysis of the company's balance of internal strengths vs weaknesses and external opportunities vs threats.

The process by which due diligence obtains the supporting evidence for such qualitative 'SWOT' analysis is relatively straight forward; a matter of engaging in some close dialogue with the management team from which information can be cross-referenced with what customers may say about market prospects, vendor threshold criteria and supplier strengths relative to alternative providers.

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

Although less quantitative in their analysis, the basic attraction of all three assessment models lies in their ability to tease out and distinguish SME information that will help to make the PE comfortable and understanding - as opposed to nervous - and therefore a knowing and knowledgeable likely investor.

FORWARD PIPELINE ANALYSIS

More quantitative analysis, and perhaps more central to the private equity case, is the scope that spells out the probability of a particular commercial activity being undertaken by the SME falling within the timeframe dictated by the PE's parallel window of investment thinking.

By allocating a measure of weighted probability towards the sources of the company's anticipated revenue streams, it becomes possible for the reporting consultant to work with the management team and discuss, on a line by line basis, what grass roots build-up of revenues can be allocated to customers, products, or territorial regions over a timespan relevant to the SME in its particular market.

The criteria that can be modelled include knowledge of customer contract work started, won but not started, tendered not won and identified not tendered, for example.

Supporting this type of review would be knowledge of the service level agreements and other less formal arrangements running between company and customer that can further determine if there is any established propensity of repeat work, say, in the form of a rolling programme of order fulfilment vs. more ad hoc supply arrangements.

By systematically running a rule over the opportunities open to the SME, the reporting consultant can effectively recast management's vision of top line growth by providing a picture of revenue build-up according to the business and market scenarios identified by commercial due diligence.

However, it is the combination of both the qualitative and quantitative commercial analysis that enables the CDD scope to bring greatest value to the SME transaction: the ability of the analysis to distil the SME's business plan and forecast down to a core of most sustainable, recurring revenues that serve to underpin second phase developments, as can be reasonably contemplated by management backed with fresh equity.

Not only can such breadth of scope help determine, with some degree of confidence, what minimum level of business is most secure, it also helps the post transaction board of directors to 'set out its stall', in terms of any new order of priorities for the business taken forward, including the upside from growth and performance improvement, prior to a natural exit point for the equity investors.

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