

Knowledge Series

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Conducting business, financial and legal due diligence



Introduction

Due diligence is a fundamental process for investors, particularly within angel networks, to assess the viability and potential of startup investments. Angel investors rely on a meticulous due diligence process to identify risks, validate business claims, and make informed investment decisions.

This process typically includes three key types of diligence: business, financial, and legal. While business diligence is conducted by internal member experts of the angel network, financial diligence is outsourced to Chartered Accountant (CA) firms, and legal diligence and deal documentation are handled by specialized legal firms.

This article delves into the specifics of each type of diligence, outlining the steps involved and the critical aspects to consider.

Business Diligence

Business diligence involves an in-depth evaluation of the startup's market potential, product viability, competitive landscape, and operational capabilities. Conducted by internal member experts within the angel network, this diligence focuses on understanding the fundamental aspects of the startup's business model and growth prospects.

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Market Analysis

Market Size and Growth: Assess the total addressable market (TAM), serviceable available market (SAM), and the growth rate of the industry.

Customer Needs: Identify the core customer problems the startup aims to solve and the demand for its solution.

Competitive Landscape: Evaluate the key competitors, their market share, and competitive advantages.

Product Evaluation

Unique Selling Proposition (USP): Understand what differentiates the startup's product from others in the market.

Development Stage: Review the current stage of product development, including prototypes, MVPs, and versions in the pipeline.

Technical Feasibility: For tech-intensive products, conduct a technical assessment to ensure the feasibility and scalability of the technology.

Management Team

Founders' Backgrounds: Evaluate the experience, expertise, and track record of the founding team and key management.

Team Dynamics: Assess the team's ability to work together and their complementary skills.

Business Model

Revenue Streams: Analyze the startup's revenue model, pricing strategy, and monetization plans.

Scalability: Evaluate how scalable the business model is and the potential for future growth.

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Operational Capabilities

Processes and Infrastructure: Review the startup's operational processes, supply chain logistics, and infrastructure.

Execution Risks: Identify potential operational risks and the startup's plans to mitigate them.

Financial Diligence

Financial diligence ensures that the startup's financial health is sound and free from hidden liabilities. This is typically outsourced to CA firms that have the expertise to conduct a thorough financial review.

Historical Financials

Financial Statements: Review audited financial statements, including balance sheets, income statements, and cash flow statements for the past 3-5 years.

Revenue Verification: Verify reported revenues against contracts, invoices, and receipts.

Financial Projections

Forecast Analysis: Evaluate the startup's financial projections, including revenue forecasts, expense budgets, and profitability estimates.

Assumption Validation: Scrutinize the assumptions underlying these projections to ensure they are realistic and achievable.

Capital Structure

Equity and Debt: Review the startup's equity structure, including shares issued, ownership percentages, and any outstanding debt or convertible securities.

Valuation: Assess the valuation of the startup and the fairness of the proposed investment terms.

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Cash Flow Analysis

Liquidity Assessment: Analyze the startup's cash flow statements to understand liquidity, cash reserves, and cash burn rate.

Working Capital: Evaluate the working capital requirements and the startup's ability to meet short-term obligations.

Risk Identification

Contingent Liabilities: Identify any potential contingent liabilities, such as pending lawsuits or tax disputes.

Mitigation Plans: Assess the startup's plans to address and mitigate these financial risks.

Legal Diligence

Legal diligence ensures that the startup complies with all legal and regulatory requirements. This process, managed by specialized legal firms, involves a thorough review of the startup's legal framework and documentation.

Corporate Structure

Incorporation Documents: Review the startup's incorporation documents, organizational structure, and governance policies.

Shareholder Agreements: Examine existing shareholder agreements, including any rights and obligations of current shareholders.

Contracts and Agreements

Key Contracts: Review all key contracts, including those with customers, suppliers, partners, and employees.

Terms and Obligations: Assess the terms, obligations, and potential liabilities arising from these contracts.

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Intellectual Property

IP Portfolio: Verify the startup's intellectual property assets, including patents, trademarks, copyrights, and trade secrets.

IP Protection: Ensure that appropriate measures are in place to protect these assets and that there are no pending IP disputes.

Compliance and Regulatory

Legal Compliance: Confirm compliance with applicable laws and regulations, including labor laws, environmental regulations, and industry-specific rules.

Regulatory Risks: Identify any regulatory risks that could impact the startup's operations or market entry.

Litigation

Ongoing Litigation: Investigate any ongoing or potential litigation involving the startup.

Legal Risks: Assess the potential impact of these legal issues on the startup's business and financial position.

Conclusion

Conducting thorough business, financial, and legal diligence is crucial for angel investors to make informed investment decisions and mitigate risks. By leveraging the expertise of internal members for business diligence and outsourcing financial and legal diligence to professional firms, angel networks can ensure a comprehensive evaluation of potential investments. This diligent approach helps identify red flags, validate the startup's claims, and ultimately secure successful and profitable investment opportunities. Understanding and executing these diligence processes effectively is essential for the long-term success of both investors and startups in the dynamic startup ecosystem.