EVENTUS ADVISORY GROUP

RIMÔN

Preparing *for* Due Diligence

A Practical Guide for Founders

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Don't Blow Your Only Chance to Make a First Impression.

Introduction

You have decided to raise funds for your company or to sell your company. For the investor or acquirer this transaction represents opportunities, but also poses risks. In negotiating a deal with you, they have made certain assumptions about the prospects of your business, its profit potential and the risks that your company faces. The officers, directors and managers of your investor or acquirer typically have a fiduciary duty to undertake due diligence to verify the soundness of their assumptions and to discover all potential material risks that the company confronts.

The linchpin of the due diligence process is a due diligence questionnaire sent out by the investors or acquirer and the data room set up by the company to respond. This article discusses the negotiation and diligence process, details the information that will be requested and provides practical advice on how to disclose information in a manner that will be most helpful to the due diligence team.

The Due Diligence Process when looking for an investor is slightly different than when you are looking for an acquirer, however, most of the differences are in degree rather than content. To simplify this article, we have focused on investor diligence. Also, this overview focuses on US-based companies and investors.   Transactions with foreign companies or with foreign investors will be similar but often have material differences.

Overview: Investment Process

Before we go further, let's talk about the actual due diligence process. It's made up of a lot of parts, so we'll go through each one.

Fundraising (Debt or Equity)

Fundraising (or "pitching") is likely to involve a large number of meetings with potential sources of funds. In some cases this process might be assisted by investment bankers who can help identify funders, although, especially in the early stage, this is uncommon.   A critical early question is whether the fundraise will be funded by one entity or will be "syndicated" among several. If the financing will be syndicated, typically one funder will be identified as a "lead" and will handle most of the negotiations and diligence.

Initial Disclosure

Initially you will present some high-level information about your business, its product/service, its market and the management team. On the financials side, it's usually standard financial statements (income statement and balance sheet), a three-year projection, and at least a short pitch deck presented to investors. Very often, venture capital firms will not sign non-disclosure agreements at this stage, so sensitive company information is generally not shared. This presentation will also include the "ask" – the amount the company is looking to raise and if equity, in what form will it be raised (SAFE/Convertible Note/Priced Equity).

Pro-Tip: Keep updating your pitch deck to match your current projections. If not, you could have a case where your pitch deck to the previous set of investors shows a significantly different future than you are at now and are projecting in the future. Usually, your projections reflect your optimism but reality may be quite different. You don't want potential new investors seeing how far off base you were in your last projection or they could lose confidence in your current projections.

Negotiation

At this stage, negotiations will largely center on critical economic terms, primarily valuation and funding amount. In the context of debt, it will typically include interest rate, maturity, secured/unsecured and covenanted/non-covenanted.

Pro-Tip: Know what you want, what you are willing to bend on and your "walk away points" before you go down this process or the odds of you getting an offer you are happy with will be much lower.

Term Sheet

The investor will generally issue a term sheet. For priced equity investments, the term sheet usually follows an industry standard template maintained by the National Venture Capital Association (NVCA). Term sheets for debt and convertible debt are more varied. All term sheets will address the main economic terms and a handful of other key terms. Terms sheets are generally non-binding except for confidentiality and exclusivity.

Pro-Tip: This will be the initial structure of the deal, so make sure everything significant you want is in the term sheet. Odds are the deal will get less favorable for you post-term sheet, so if it's not in the term sheet, it's not going to happen.

Exclusivity

Many term sheets provide the investor with an exclusivity period in which to complete diligence and the negotiations of definitive documents. Essentially the company agrees to be "taken off the market" for a limited period of time and in consideration, the investor/acquirer agrees to devote substantial resources to diligence. If the parties are close to the deadline, but making good progress, it is fairly common for the exclusivity to be extended for short periods of time. Exclusivity periods will typically range from 30 to 90 days depending on the size of the company and the complexity of its business.

Deep Dive Diligence

At this point, the company will provide the investor with access to a data room. See the diligence discussion below.

Pro-Tip: You need to ensure you have an efficient process as well as decide how much data you will show a potential investor – especially if the investor is a strategic investor and as a result, a potential competitor. There is always a risk the investor walks away and now has a blueprint to how to compete against you. Balancing what and how much you show is all part of the process.

Draft, Negotiate and Execute Definitive Documents

There is some variability as to who drafts the definitive documents. For lending activities, usually lender's counsel creates the initial draft. For equity investments and convertible instruments, company counsel will often create the first drafts, although in particular on the East Coast in the US, investor counsel may create the initial draft. For priced equity investments, most US investments utilize documents based on models maintained by the NVCA – the typical financing will include an amendment Certificate of Incorporation, Share Purchase Agreement, Voting Agreement, Co-Sale/Right of First Refusal Agreement and Investor Rights Agreement.

See https://nvca.org/model-legal-documents/

Funding

Often a funding will have an initial close at which time a majority of the anticipated funds will be raised and then one or more additional closings where additional investors can invest on the same terms. Usually, the investment documents limit how long the funding round will remain open and the maximum amount that can be raised.

Legal Costs

In both debt and equity transactions, it is fairly common that in addition to its own legal costs, the company will reimburse the legal expenses of the investor/lender. If there is a syndicate, reimbursement is generally limited to the lead.