# Slow Money Due Diligence Primer

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## Introduction

For many, the phrase "due diligence" conjures up images of accountants, lawyers and investment bankers locked away in plush Manhattan offices for days on end, crunching numbers and analyzing corporate strategy and industry trends before finally going off to celebrate the deal with cigars and single malts. While due diligence for large corporate transactions is a daunting process, due diligence as a concept is nothing more than simply becoming familiar with the business, to get a better understanding of the risks and returns, financial or otherwise, that the potential investment offers. Obviously, the level of work required varies enormously depending on the size and type of the business in question and the investor's level of familiarity with the industry. The purpose of this document is to provide potential investors with some simple pointers that will hopefully aid them when they undertake their own due diligence on potential investments. It is also important to recognize that there is no right answer in the due diligence process. Individuals will have differing expectations for risks and returns, both social and financial, meaning that an investment that is perfect for you might be wholly unsuitable for your neighbor.

Some factors that you might want to consider during your own due diligence process might include the following: how much of your net worth are you intending to invest? How long do you intend to hold the investment? As a potential equity investor, do you want a say in how the company is managed? What financial return do you expect? What social and environmental impacts do you hope this investment will have and is this investment the best way of achieving those goals?

Each of the following sections outlines some of the main issues that potential investors should be looking to address when conducting their due diligence process. This is far from an exhaustive list, but more a guide as to some of the things that investors should be thinking about. A good business plan should cover all of these areas in more depth and will likely be a very useful source of information during the due diligence process.

## Financial health of the company

For new investors, understanding a company's financial position is one of the most important, and potentially daunting aspects of the due diligence process. The amount of financial information available will differ greatly between companies as will the quality of the information. Perhaps the single most important question relates to the amount of debt that the company has. A company which does not have the cash to meet its debt obligations will not stay in business very long. Other important questions include:

- How long has the company been in business?
- Is it currently profitable and if not, when does management expect the company to become profitable?
- How strong are the company's margins compared to its industry peers?

- How fast are sales growing and what level of investment is needed to support this increased sales level?

For a simple example let us look at Jim's Farm Fresh Sandwiches, a trendy café selling only a single type of sandwich. In its third year of business, the company is seeking capital from investors. The following outlines the history of Jim's Farm Fresh Sandwiches and provides investors with some information which can be used to build up a better understanding of the business. In its first year, Jim's sold 29,200 sandwiches for $5 each, a total revenue of $146,000. The ingredients cost $3 for each sandwich ($87,600 in total for the year) and Jim paid himself $1 for each sandwich that was sold. Rent, insurance and utility bills totaled another $29,200 for the year meaning that Jim's Farm Fresh Sandwiches' broke even, meaning that Jim's revenues were exactly offset by expenses. (**Exhibit 1** shows the financial results from the first three years that Jim was in business.)

Jim believed that his main problem was that he could not keep up with all his customers and estimated he could actually sell 50 percent more sandwiches if he had the time to serve everyone. The next year, Jim hired a part-time employee to help at the shop and sales of sandwiches rose by 50 percent as Jim expected. Well done Jim. He paid his assistant $10,000 during the year or around $0.23 per sandwich. Ingredient costs remain the same at $3 per sandwich. Rent, insurance and utility bills were the same as the prior year at $29,200. In year 2, Jim actually made a profit! Even though he paid out $10,000 to his employee, the increase in sales as a result of productivity improvements was enough to generate a profit of $14,600. As Jim is the sole proprietor of the business, the $14,600 belongs to him and he can choose to distribute this money as a dividend or reinvest it in the business.

Feeling flush after the success of his second year, Jim decided to treat himself and used the $14,600 retained profit as a down payment on a Tesla Roadster sportscar. However shortly thereafter, he became aware of a new machine that could help increase his productivity and enable him to make more sandwiches while lowering his ingredient costs. The SARNIE3000 is an integrated bread baking & sandwich preparation machine, which Jim believed could lower his ingredients costs by 10 percent. Unfortunately, such a machine does not come cheap, and Jim did not have the $25,000 needed to purchase it. Jim had a few different financing options available to him and his position is one faced by many small business owners every day. Jim could ask his bank for a loan, he could borrow money from investors or he could sell a stake in the business to an outsider. (These different options are outlined in more detail in the section on "Loan versus Equity" and each one has different effects on the financial condition and profitability of Jim's Farm Fresh Sandwiches.)

In its third year of operation, sales grow by a further 25 percent. Jim decided to purchase the SARNIE3000 using a loan from Slow Money investors. The loan pays annual interest of 4 percent, or $1,000. Additionally, he increases his employee's wages by 20 percent.

Now consider the Slow Money investment(s) that you are analyzing: what funding do they require and what are the funds going to be used for? How long has the company been in business? Is it generating a profit? Is the company capable of paying all its debt obligations, not just the loan that you might be considering making?

**Exhibit 1**: Jim's Farm Fresh Sandwiches Summary Profit and Loss Statement

| | Year 1 | Year 2 | Year 3 |
|---|---|---|---|
| Annual Sandwich sales (units) | 29,200 | 43,800 | 54,750 |
| Annual Sandwich sales ($) | $146,000 | $219,000 | $273,750 |
| Ingredients costs | $ 87,600 | $131,400 | $147,825 |
| Jim's wages | $ 29,200 | $ 43,800 | $ 54,750 |
| Employee salaries | $ - | $ 10,000 | $ 12,000 |
| Overhead (rent, electricity, insurance) | $ 29,200 | $ 29,200 | $ 29,200 |
| Interest on $25,000 loan | $ - | $ - | $ 1,000 |
| Net profit | $ - | $ 14,600 | $ 28,975 |
| | | | |
| **Unit costs** | | | |
| | | | |
| Sales price | $ 5.00 | $ 5.00 | $ 5.00 |
| Ingredients | $ 3.00 | $ 3.00 | $ 2.70 |
| Jims wages | $ 1.00 | $ 1.00 | $ 1.00 |
| Employee salaries | $ - | $ 0.23 | $ 0.22 |
| Overheads | $ 1.00 | $ 0.67 | $ 0.53 |
| Interest on $25,000 loan | $ - | $ - | $ 0.02 |
| Net profit per sandwich | $ - | $ 0.33 | $ 0.53 |

## Investment Potential

Beyond the financial health of the company, there are many other aspects of the business which need to be understood before investing. The following section looks at some of the other important parts of the business.

### Management team

For many investors, the most important element is the people. Do they have a track record of success in similar projects, and do they have the relevant backgrounds for this business?

After you invest, many of the core aspects of the business, such as regulations and customers demands, may change and the management will need to respond. Will they be able to identify new opportunities and solve problems as they arise?

In the case of Jim's Farm Fresh Sandwiches, Jim never set out to be in the sandwich business. He spent 10 years working in information technology before realizing that his true calling was serving fresh food to happy customers. While Jim has got his business off the ground, he will readily admit that the learning curve was steep and he made lots of mistakes.

Jim's early success is perhaps the start of a track record of success in this industry. However, a more experienced restaurateur might have anticipated the capital needs of scaling up the business and might not have spent the retained earnings on the Tesla.

Finally, for new businesses the management team may still be coming together. This is often not a deal breaker. However, it is important to look into whether the management has connections and resources to get the talent and resources it needs.

### Industry

A business' ability to make a profit depends on the economic climate. It also depends on the industry climate. Each industry has its opportunities and challenges. For instance, Jim competes in the food service industry. This industry is characterized by high competition and low barriers to entry. Very little might prevent a competitor from setting up a taco truck right in front of Jim's Farm Fresh Sandwiches.

Things to look at for an industry include: competition, suppliers, buyers, and regulations. Restaurants have many vendors to choose from for buying their ingredients. So they can benefit from low supplier power. On other hand, customers have many places to choose from.

### Product or Service

What problem is the product solving for the customer and does the product address an actual need? Some products will flounder in the marketplace because there is already too much competition. Other products will struggle because they have not identified their customers and fine-tuned their product to meet that group's needs.

For Jim's, the product fits a need for nearby office workers who are tired of the mostly fast food options in the neighborhood. Jim's is in walking distance of many businesses, so his customers easily come to him. However, for Jim to change his business and sell his sandwiches at supermarket delis, he may find out that getting items into a national grocery chain is very difficult. It is important to ask 'has the business solved how their product or service will reach its customers?'

How can this product adapt to changing markets and can it scale up quickly? A software company can easily go from producing 10 copies to 100,000 copies. Jim cannot scale up his sandwich business without finding new space, equipment, and staff.

Finally, what prevents others from copying this product? Does the company have patents, key people or relationships that prevent this? Right now, Jim has an exclusive long term contract with a popular local meat farmer for his sandwich meat. But he uses a traditional sandwich recipe that he could never patent.

### Business Model

How does the company generate money? Business plans will often have sunny forecasts that show growing profits. What is more important is how the company understands the forces and conditions that affect its ability to generate profits.

Jim's business model is pretty established. There are examples of profitable sandwich shops. And Jim seems on a path for growing profits. Yet if his ingredients costs increase by 20%, Jim will not make a profit without increasing his prices to customers. To evaluate Jim's business model, one would have to look at how susceptible the profits are to changes in key variables and the likelihood of these changes.

## Slow Money Impact

Jim's Farm Fresh Sandwiches is generating a number of important social benefits. Despite the pressures of running his own business, Jim loves the sandwich business and is glad that he has finally managed to break free from the daily grind of the corporate world. He enjoys taking an active part in his local community and now provides excess sandwiches to the local homeless shelter. Jim's commitment to buying from local farmers has the added benefit of creating secure employment at the farms where he buys ingredients.

Slow Money is a strategy for investing in small food enterprises, organic farms, and local food systems. What are the returns related to this and how efficient is the organization at achieving them? One approach is to quantify the Slow Money related returns and look at how much investment and inputs are required to achieve them. At the same time, many social returns cannot be quantified, and these returns should not be disregarded because of that.

Like financial returns, Slow Money returns will vary in their potential and depend on certain factors and conditions. Are you comfortable with the Slow Money potential impact and its likelihood? For example, businesses that sell compost to farmers may be more likely to improve soil fertility than an organization that invested a portion of its profits in researching soil fertility. However, improvements in our understanding of soil fertility could have global reach.

## Risk Assessment

When conducting your due diligence, it is vital to remember that things can and do go wrong. Looking back to Jim's Farm Fresh Sandwiches, what would have happened if Jim had been ill and unable to work for three months? Or perhaps the secret ingredient in Jim's sandwiches doubled in price due to a crop failure? Or even worse, new legislation is introduced that outlaws the use of integrated bread baking & sandwich preparation machines? Asking a business owner what keeps them awake at night will likely lead to some interesting insights into the condition of the business. Again, there is no right answer but it always inspires confidence when an owner has a solid understanding of the risks facing the business.

## Deal Terms

The deal or the terms of investment should be simple, should be fair to both sides, durable in the face of surprises and should reward the right behavior.

### Loan versus equity

#### *Loans*

Loans can be a simpler and sometimes less risky way to invest in a business. The three main questions for loans are:

- What is the collateral guaranteeing the loan?
- What other loans does the business have?
- What is the appropriate interest rate given the risk associated with the loan?

What is the loan secured against and can that asset be sold quickly for close to its value? Highly specialized machinery, such as Jim's SARNIE3000, often cannot be both sold quickly and near its purchase price.

Can the business generate enough cash through its operations to pay the interest or payments on all of its loan payments? It is important to examine not just the terms of your loan but also the other loans the company has.

Does the interest rate match the risk and returns of the loan? For instance, if you aimed for a 5% return overall from your lending and made 10 one year loans, and you expected one of them to be a complete loss, to get your targeted return you would have had to charge a 16.7% interest rate on all the loans.[1] While the numbers in this example may or may not look similar to a potential Slow Money investment, the point remains important. That is, investors should look to make a reasonable return on their investments given the level of risk associated with the investment.

#### *Equity*

Equity investments give an entrepreneur more flexibility but they are more difficult to evaluate for investors. For equity investments, two main questions are:

- Exit strategy – when and how do you realize a return on your investment?
- Valuation – how should the business be valued?

An equity investment can only be paid back through certain events. Often this is when the company is sold and sometimes when the owners generate enough cash to buy out the

[1] If you make 10 investments of $1k each, and you want to make 5% total return ($500), and you expect one to be a complete loss (-$1k), you would have to charge each of them 16.7% interest just to generate a 5% rate of return ($1,500 / 9 remaining investments). Note that the interest rate quickly goes down as you increase the number of investments and reduce losses/risk of loss. (Craig Wichner)

investors. Until then, the investors may not see a penny from their investments, regardless of how profitable the company is.

By doing an equity investment you are buying a percentage of the company and are therefore entitled to a share of any profits. Equity investments are often valued on a multiple of sales or a number times the earnings. How much does the company think it is worth and what have similar companies recently been valued at?

Finally, if the company has to sell more shares at a later point your percentage ownership can be lowered.

### *Loan Equity Hybrids*

Other types of financing include equities that pay dividends or loans that convert into equity.

### *Summary*

As previously highlighted, the due diligence process is subjective and individuals will have to draw their own conclusions about the suitability of the investment. It is also important to remember that the business is likely to change and (hopefully) grow over time. While Jim has started out selling directly to consumers, the focus of the business might shift if he sees better opportunities using grocery stores to distribute his product. Or he might even find that there is a better market making and selling his secret sauce, which is the key selling point for his sandwiches. Such changes in strategic direction are not uncommon for firms, both large and small. WPP, one of the largest advertising agencies in the world started out manufacturing shopping carts. Nokia, the Finnish telecommunications giant, can trace its roots back to paper mills and rubber production. Patagonia’s original business was climbing equipment before it diversified into clothing. It is vital for investors to continue to monitor the performance and strategic direction of the company once an initial investment has been made. Obviously these changes in course can have a substantial impact of the social and financial returns that the business generates.