



THE DUE DILIGENCE FOR INVESTORS **GUIDE**

Compiled by Rob Murray Brown MBA

ROB MURRAY BROWN

Rob Murray Brown has spent most of his working life in the SME sector. At the age of 25 he started trading rice and coal from Asia and after a lifetime in startups, has along the way had plenty of good and bad experiences.

His career has straddled the pre- and post-internet age, and he believes that the business fundamentals that he started with have not changed.

After selling his retail business, he spent a year at Cranfield completing an MBA. His involvement in equity crowdfunding was born out of a wish to see it succeed and a conviction that retail platforms had it all wrong. Rob's blog, fantasyequitycrowdfunding.blogspot.com, is read and quoted by the FCA and over 1,000 readers per week.

His latest project is ECF Solutions Ltd, which advises companies on using equity crowdfunding and consults for selected platforms.

You can contact Rob at rob@ecfsolutions.co.uk



Equity crowdfunding (ECF) offers investors the chance to back new private companies by buying their shares online and thereby funding them. These shares are illiquid, as there is no marketplace for them until the companies are purchased or go public. So, it is important to do your research before you invest. This guide will help you cover due diligence checks; what to look for and what to avoid.

companies house

market analysis

directors and the team

business model

analysing balances sheets

conclusion

8

14

18

22

28

31

CAVEAT EMPTOR

To be able to engage in helpful due diligence, investors should start from what might be perceived as a rather negative position. They must check all the claims made and are therefore automatically appearing to make assumptions about the entrepreneurs' trustworthiness. In reality, this is not the case. Clearly, it would be pointless believing everything you are told at face value.

As an investor, it is in your own interests to help the company in which you are investing and by covering off a thorough due diligence process, you may well unearth things that the company has not even considered. That the company can then address this issue is a positive outcome, not a negative one. Sure, you will come across things that don't turn out to be true if you do a thorough job, but this in turn is also helping the new company – if they are not ready or fit and able to run a company, then funding them is pointless and can in some instances be harmful – i.e. when on the company closes, creditors are left hung out to dry.

THE FIVE COMMANDMENTS

- 1.** Never ever take anything you are told at face value
- 2.** Always do your own research – never rely on a third party
- 3.** If one aspect is being heavily promoted then it is usually masking something else
- 4.** Always cross check facts and claims from as many different sources as you can
- 5.** Where possible meet up with the founders face to face – ECF platforms usually arrange investor evenings

KNOWLEDGE IS POWER

Investors need to understand the numerous ways that they can check the facts presented to them, as well as understand the limitations of some of this checking. By reading this guide, you will be better informed and better prepared to sift through the information presented and make secure judgements about what is fact and what is fiction. This will give you a much better position from which to view your investment decision.

Due diligence covers all aspects of business – past, present and future; it is not simply about reviewing accounts filed at Companies House. It considers:

- Company details as filed
- Team members, their backgrounds and their claims
- Business trading record
- Financial projections and their credibility
- Credibility of future revenue streams
- Exit projections and sector credibility
- Macro market analysis
- News stories and PR
- Filed accounts, returns and other documents at Companies House

Failure to cover all these aspects leaves you, the investor, missing some vital information at best and losing your investment at worst.

Caveat emptor is fine, but it only works if the information presented is accurate. Basing investment decisions on either false or exaggerated claims will not help your ROI.

I have spent the last five years researching the phenomenon that is equity crowdfunding. My background is in startups and growing small- and medium-sized enterprises (SMEs), and I have 30 years' experience in both. My consulting company, ECF Solutions Ltd, offers companies wanting to use equity crowdfunding a bespoke end-to-end service for their campaign. I know the way the market operates, and I know the pitfalls that await investors who have not carried out their own due diligence. It always surprises me when they don't.

What you are looking for in due diligence is assurance that the information you have about the company is complete and accurate. By making multiple checks, using varying information sources, you get ever closer to building a clearer picture.

// case study

// EVERYONE FOR THEMSELVES

I was interested some years ago in investing in a company that had developed a new medical service. The company had excellent partnerships with relevant, nationally acclaimed universities and teaching hospitals, where they had presented their case in filmed national conferences, which the institutions then posted on YouTube. It had received at least two government enterprise grants, won a national enterprise competition, and had some excellent PR on the internet in the form of newspaper and magazine articles.

After doing some initial investigations, I got a feeling something was off. This started when I did some background on the CEO and the guy behind the campaign, and found that some of their previous businesses and associated claims did not add up. It turned out that the man behind the business was in fact a disqualified company director who was still serving part of his seven-year ban.

The idea was just that – an idea, and he had hoodwinked a number of renowned institutions along with the government. He changed his name slightly so that traces of his ban were very hard to find at Companies House – something we will look at later. The man in question has now appeared in court under fraud charges. The company has expired.

THE TAKEAWAY

DON'T RELY ON ANYONE ELSE TO DO THE RESEARCH FOR YOU.

COMPANY STATUS AND HOW TO USE FILINGS AT COMPANIES HOUSE

Company accounts in the UK are filed at Companies House. Until recently you had to pay to access these files and the time lag made doing any due diligence a tedious job. Now HMRC has opened a new site – <https://beta.companieshouse.gov.uk> – which allows instant free access. However, the problems with our accounting system do not end there.

For the purpose of this guide, I have assumed that you are comfortable reading and understanding company accounts, so a guide on how to do this is not included.

The first problem you will encounter is that accounts for a trading period (normally 12 months) do not have to be filed at Companies House until nine months after the period has ended. For a new company that started trading, say, on 1st January 2016, their first set of accounts for year end (YE) December 2016 will not be due until the end of September 2017. There have been instances on some equity crowdfunding platforms where startups have been funded only to go bust 16 months later having never filed any accounts.

It is also possible – and I have seen this done frequently – to move your filing date. If a company does this around the time of fundraising, you need to know why. Is it a genuine reason, or an attempt to hide some unwelcome results? Since the company will have to have filed through Companies House to move this date, you are able to trace this.

In 2015 the UK government implemented measures set out on the EU Accounting Directive. Of course, with Brexit it is entirely possible that some of these measures will be changed when we leave. The current situation in the UK with regards to Small Company Status is:

Companies which comply with at least two of the following three criteria need only file annual unaudited accounts in the form of a balance sheet. Anyone familiar with these balance sheets will know that they can vary considerably with the information and layout.

Criteria

- Turnover less than £10.2m
- Balance sheet total not more than £5.1m
- Average number of employees not more than 50

They can choose to file full accounts.

As anyone who has studied multiple company accounts will know, it is not easy to gauge a company's current condition from its filed balance sheet. We'll go into the intricacies of reading a balance sheet later – suffice it to say that if you are intending to invest in a company, you would be well advised to obtain their full accounts for the past few years and check these against the versions filed.

It might surprise you to find that I have come across numerous examples where the filed accounts did not tally up with the company's full accounts or the information presented on the pitch site. By cross checking and asking questions, it is nearly always possible to clarify the discrepancies. If it isn't, then don't invest.

ANNUAL RETURN OR CONFIRMATION STATEMENT

The Annual Return (AR) – now renamed the Confirmation Statement – is the filing at Companies House that confirms the amount of equity finance a company has raised and the types of shares issued, as well as listing its shareholders at the stated date. It is unaudited and, in my experience, often incorrectly filed.

As with the accounts, it is worth checking the details with the company. You can see if a company has issued (sold) equity as they are obliged to file an Allotment of Shares. This explains what type of shares have been issued and at what price but as with the AR, it is quite often filed incorrectly and it is important again that you check the information with the company.

Check the list of shareholders. You may recognise some of the names or the company might be backed by some famous people. You need to be a little wary of fame – at least two failures in the last three years have been backed by major sports stars. But it's still good to know who you'll be investing alongside. So, for example, if a company is claiming that a famous businessman is a backer, then you should find their name in the list of shareholders and by reviewing their shareholding, you can ascertain what size of investment they have in the company. Clearly a small investment will mean they aren't in reality involved in any meaningful sense, whereas a larger investment indicates a higher level of trust in the company's future.

You should also check that the people running the company have a founder's stack in the business. If they don't, you need to know why. A recently failed ECF campaign from a profit-making company failed

because the two guys running it had little skin in the game and the main backers were mysteries. If you invest in this type of business, you have even less control as the people you're dealing with (the directors who have no shares) will not be making the vital decisions about the future of the business.

FILINGS

Looking at the Companies House filings can give you clues as to the structure and solidity of the company, though for a new startup this will be less relevant. If, for example, the company started trading a year ago and was founded by three directors, one or two of which have since left, it will be worth asking the company why. Changes in directors' details are not relevant; you are looking for a termination filing and/or new appointments. The filings will give you the dates the director was appointed and resigned.

It is often worth checking when a pitch deck states that so and so was a founding member, that they were a director when the company was formed. It is surprising how often this turns out not to be the case. Likewise, when someone tells you they have successfully sold a company in the past, you need to check whether they were actually involved at management level when this success occurred. It is not uncommon for these types of claims to be made only to be found wanting in the truth department. Joining a company the year it sold for £30m does not mean you can lay claim to having been the instigator of this success.

CHARGES

Charges present an alternative way to raise business finance and are listed at Companies House. But remember that the information you get from filed accounts, where a loan will be listed under 'long-term debt', refers only to the period up to the accounting date. More recent loans, which can include a charge over the assets of the company, are listed under the 'charges' tab for the company. It is worth checking to see how many the company has and whether any are overdue for repayment. Borrowing from P2P lenders and banks will be included here. Again, if in doubt, ask the company to clarify.

It is also worthwhile checking with them to see if they are in current negotiations with new lenders – something that might not have mentioned in the pitch deck. I have certainly come across instances where companies have tried to gain a loan from a P2P lender and at

the same time as launching an ECF campaign, but somehow failed to mention this.

COMPANY DIRECTORS

Checking company directors is not easy. As mentioned above, the main problem comes in the name. For example, someone called 'Richard John Ernest Brown' might appear in the Company Register under any combination of these names or initials – that means he could have multiple entries using different variations of his forenames and/or their initials. There is nothing illegal in this, it is just the way the system has been set up.

Of course, it is possible for unscrupulous people to use this illegally, as has happened on at least one occasion. I came across a director who had six versions of himself listed at Companies House, in one in which he had misspelled his surname. Two of the versions had run companies that had been liquidated, but this was not evident when you searched the name he gave in his pitch (see case study opposite).

There is a way to check this information. Each version of the same person may have different addresses, but the one thing that unites them is their date of birth. Since signing a false date of birth would be illegal, chances are it will be genuine on the register (month and year only). To check thoroughly, you need to put in all the different variations and check the names against their dates of birth. You can also cross check the names and any associated companies against a simple Google/Google News search.

Along with online PR, LinkedIn is a good source for checking on company directors and their past and current activities. You must also ask them directly, especially if you find some discrepancies. In the world of startups and so-called entrepreneurs, ego plays a major part and chances are the people you are dealing with will have been issuing their own PR for some time, which all sits on the internet waiting to be accessed. You should not necessarily rely on a single or even two of three disparate sources, but by cross referencing several you will begin to uncover a better picture.

The main thing is to be aware of the veracity of these sources – we'll go into this later.

// case study

// BY ANY OTHER NAME

I once came across a company that managed to raise £1m on one of the UK's leading ECF platforms. It appeared to be a well-run company with an innovative new technology in a sector most would agree landed it firmly in the 'sexy' quadrant. The ECF pitch flew; the company promised the world.

In the pitch, the founder made certain claims about past successes, which were hard to verify as they took place before information at Companies House was digitised and before the internet. His given name was checkable at Companies House and there were no bad reports. The platform had carried out its usual checks and found nothing untoward.

A year after the company successfully funded, it went into liquidation, owing creditors over £600,000. The money had all gone, and so had the founder. Clearly something was not right.

On rechecking the founder's history, using his date of birth, it turned out that he had multiple entries at Companies House. All but one of them was legitimate as he had simply used his forenames in a different order. In one instance, he had changed the spelling of his surname.

This mattered because Companies House had data on him which none of the investors knew about – because a search using his given name didn't clock up these other variations. He'd had at least two bankruptcies and a string of companies go into liquidation in circumstances pertinent to anyone considering investing in one of his ventures. One of his current 'successes', highlighted in the pitch, was in fact a shell company based overseas that did nothing and was co-founded by a struck-off solicitor.

It's a fair guess that had this information been known at the time of the round, the company would not have raised the £1m. The platform also played a crucial part in this fraud as it failed to check the founder's real background and published false historic accounts – a fact revealed by the liquidation.

THE TAKEAWAY

CHECK NAME VARIATIONS AT COMPANIES HOUSE AND USE INTERNET NEWS SEARCHES AND SITES LIKE LINKEDIN TO VERIFY.

market analysis

SECTOR ANALYSIS: TAKE NOTHING FOR GRANTED

Businesses do not function in a vacuum. When looking at a pitch deck or business plan, it's important to drill down into the numbers – do not take anything for granted. I have found that quite often, plans put forward in the ECF sector are poor – especially so for market analysis.

The key here is to get the right market, segmented so that it is specific to the offer. Take as a simple example the UK car market. This is a complex and highly segmented market, so figures showing the growth in new car sales, per se, across the UK are useless for a new launch electric car targeted at first-time, city-dwelling buyers.

You get the point – lift the bonnet and have good look around for the segment that matters.

SPECIFIC ANALYSIS OF COMPETITION

Check online for all competitors – you may find that the pitching company has forgotten a few. You should also be careful to consider what constitutes a competitor. It may not always be companies carrying out the exact same function. Consider substitutes as competitors also.

GROWTH PROSPECTS

As you know, most startups fail. Those that go on to succeed normally take five to ten years to get there, so look at the pitch's financials and see how this company intends to get from A to B. What is the marketing budget, compared to the sector norm? Look for similar companies that have succeeded and compare the paths.

SCALABILITY

We all want this. Most of the businesses pitching on ECF platforms will claim to have it. But the crucial thing here is, have they stress-tested how they will deliver it?

// case studies

// PIPE DREAMS

A recent business I looked at had first-year sales of £34,000 from three tiny pods in London. The business was, in principle, scalable. But by year two of the projections, it had leapt to a turnover of £3m with overall London coverage, and the following year was UK-wide with revenues of £5m.

Logistics were completely untested, but were crucial and highly time critical. It just didn't make any sense. The pitch failed, although I suspect the business may go on to succeed over a longer time frame.

THE TAKEAWAY

CAPITAL INVESTED NEEDS TO BE COMMENSURATE WITH THE COMPANY'S PLANS, OR THE WHOLE THING WILL FALL APART.

// TEMPORAL AWARENESS

A company I helped raise £500,000 for is at the leading edge of consumer payments technology, or it was in 2016. Now, new developments in South Korea, where they are trialling a palm reader that allows you to pay by simply presenting your hand to a reader, is proving a threat that simply didn't exist 12 months ago. The window has got smaller.

It's not all bad news as the palm reader requires specialist equipment, which would mean changing the world's point-of-sale equipment, but it illustrates the speed of change. New players in the sector with stronger financial backing have now emerged, and could take over the space and wipe this company out.

THE TAKEAWAY

THE TECHNOLOGY DARLINGS OF TODAY ARE OLD HAT TOMORROW. CONDUCT SOME THOROUGH BACKGROUND RESEARCH INTO THE SECTOR. DOES THIS COMPANY HAVE THE FUNDING TO MOVE QUICKLY THROUGH THE STAGES?

M&A ACTIVITY

It's important that the sector the business you are looking at has a track record of M&A (mergers and acquisitions) activity. This may be the only way you will get any ROI. You can check this out using a Google search for the sector and adding 'M&A' – usually there will be a report compiled by someone out there. Double check the findings and take care to read up on the companies that have been successful.

REGULATION, FUTURE CHANGES AND TECHNOLOGICAL DEVELOPMENTS

This is particularly pertinent now with developments in the EU and changes to trading patterns with the USA. Again, online searches will provide volumes of information – not all of it will be correct, but it will be useful upon employing a bit of common sense and some graft. A good example is the change to alternative energy subsidies – could you have seen this coming?

In a world where today's leading-edge technology is tomorrow's rubbish, you need to take a view on the lifespan of the technology in which you plan to invest. Will the window you have be long enough to develop and take this product to market successfully before the technology is overtaken?

SOCIAL MEDIA

Social media allows you to check the real activity of a company. The number of Twitter followers and the Facebook activity both give clues as to the traction the company has created. Of course, one can buy Twitter followers, so caution is required. Compare other successful businesses in the same sector and see how this company stands up.



BUSINESS BACKGROUND

Most founders and directors will have a LinkedIn page. Most LinkedIn pages are grossly exaggerated. In fact, there are plenty of examples of people outright lying on theirs. It is easy enough to check. Just use the claim and the person's name and Google it. As a general rule, if one claim is over the top, then they all will be. Then you ask yourself, is this someone I can do business with?

EXPERIENCE: SUCCESSES AND FAILURES

What you are looking for is experience of starting, building and selling a business – preferably in a sector with similarities to their current offer. Failures are fine; in fact, you tend to learn far more from them than from successes. Pretending a failure was a success, on the other hand, is not fine.

I can think of numerous examples where founders have been tempted to dress up failures instead of admitting to them and the lessons learned. In one instance, the founders went on to make the exact same mistakes again in their next business.

// case studies

// GOOGLE IS YOUR FRIEND

A pitch states the company has two company directors, both of whom are successful entrepreneurs with two exits, one of which was of a well-known brand to an internationally acclaimed company for a large multiple. Impressive stuff. However, closer inspection revealed that only one of the two was ever involved in these two exits.

It also showed that while he was indeed a director of the well-known brand, he did not start that company nor grow it. He joined it the year it was sold. So, claiming he had experience of growing a successful exit using this example was stretching the truth. He was a shareholder and did see a multiple return, but not on the back of his genius.

THE TAKEAWAY

USE INTERNET SEARCHES AND NEWS STORIES TO VERIFY ANY CLAIMS.

// STAY ON TARGET

A small startup brewer in London raised funding on an ECF platform. Within 12 months, he had decided that this was not the life he wanted. So he packed his bags and went back to the US without closing the company or contacting the shareholders. A few months later, from his new job in accountancy, he posted a closing notice on his website. Companies House later closed the company for failing to file any accounts.

In another case in the same sector, a craft brewer raised a small amount via ECF. In this case, however, they had planned to use this first tranche to explore the market. Things were tough, but the founders stuck it out and found their winning formula.

Once this cash was gone and they had a proven sales record, they came back for more funding and were successful. The business is now forging ahead and exceeding projections.

THE TAKEAWAY

IT IS ESSENTIAL TO KNOW YOUR ENTREPRENEURS WILL STICK AT IT THROUGH THICK AND THIN.

LIFESTYLE

This may sound a little insane, but it really is worth considering the lifestyle of the founders/directors. They are, after all, what you are investing in. Age, marital status and family all play a part in what they are likely to do over next five years when they have your investment.

There are many examples of ECF-funded companies where the founders have packed it in at the first obstacle citing ‘family reasons’. On the other hand, you will come across hundreds of founders who’ll tell you the reason they are able to keep going is because of the unwavering support they have at home.

Starting and growing a business is a high-stress occupation; make sure your founders are up to it.

NON-EXEC DIRECTORS

A non-exec with relevant experience is very useful; the very fact of their involvement suggests that they believe this business has legs.

Check the non-exec’s experience – it should be in some way related to the project. Check how many other companies they are involved in – they shouldn’t spread themselves too thinly, since for a startup, time is critical. If you know people who know them, ask what they are like as a person.

You will often come across the idea that a business with a turnover of, say, £100,000 can be pushed to realise a revenue of £2m in 18 months if the market is there. Well, it might. But what you as an investor want to be sure of is that the systems in place at the £100,000 level are robust enough to manage £2m.

It's always worth being wary of companies that stress growth in turnover or customers. Sure you want growth, but in profits. Companies often quote revenue growth figures but fail to tell you how they achieved them. This has become a real problem with online businesses, which often grow exponentially by offering starter discounts. This can be highly misleading. By using promotional programmes like Groupon or Wowcher, companies can show fantastic growth in customer numbers over a very short period – often around Christmas.

// case studies

// STRESS TESTING

A classic example of stress testing occurred when a company, funded by ECF and producing a new fast-moving consumer goods product, needed to make that jump, but found that its raw material was subject to some very unhelpful seasonal changes. This set the company back two years and meant it had to raise extra funding, diluting the existing shareholders. They simply hadn't tried processing the raw product in volume in the winter. It sounds obvious, but no one asked them.

Similarly, another company successful in raising cash via ECF had plans to open up businesses overseas. But they had not factored in all the logistics this would involve. Failure and closure ensued. When it comes to startups, confidence is a must, but arrogance is a disaster.

THE TAKEAWAY

ALWAYS ASK YOURSELF, HAS THE BUSINESS MODEL BEEN STRESS TESTED?

// LOOK A LITTLE CLOSER

One example was a snack box company which gained tens of thousands of new customers by offering massive starter discounts via Groupon – so much so that they couldn't cope with the numbers and wound up with thousands of angry complaints.

They used these figures a couple of months later (minus the complaints) to raise money via ECF. Very few of these bargain hunters became real customers and the company has now closed – due to a lack of traction. Investors hadn't bothered to check where these new customers had come from or asked if they were still active.

THE TAKEAWAY

DOUBLE CHECK THE NUMBERS WHEN IT COMES TO ACTIVE CUSTOMERS.

MARKETING BUDGETS

How much will a company need in its marketing budget to achieve its stated revenues? It's an impossible question to answer, so you'll have to use some common sense, aligned with looking at the sector norm.

Similarly, look for surges in revenue – they need to come from somewhere, perhaps an increased marketing spend. Check the figures – does the marketing spend appear to show a lagged increase in sales? You would be surprised how often the answer is no.

The rise of social media has allowed more promotion to be free – or so the claim goes. But running an effective, sustained social media campaign takes time and effort – neither of which come for nothing. A cheap social media setup simply will not work.

And relying on social media is not enough, even in this day and age. I have lost count of the number of successful ECF pitches that have had to return for more cash because the promotions budget was inadequate.

Assume budgets are always too low and work from there.

GROSS PROFIT MARGIN

Gross Profit Margin, or GPM, is a key driver. It is impossible to be sure whether or not a new company pitching for funding via ECF has its future GPM right, but there are ways of checking it's in the right ball park. Different sectors will have their norms, you just need to find them.

If the company's GPM is wildly out of kilter with these, you need to know why. Likewise, GPM shifts over time need to be explained. Often they are influenced by economies of scale, but then you have to dig down and find out whether the company can really take advantage of these.

NET PROFIT MARGIN

The net profit margin (NPM) will vary by sector. So, for instance, a restaurant or chain of restaurants will have a sector norm for NPM. If the company you are looking at exceeds the norm or undershoots it by a noticeable margin, you need to know why. Unless they have reinvented the wheel, chances are their figures are wrong.

STAFF AVAILABILITY AND COSTINGS

It is astounding the number of times that financials ignore the requirements for staff. If you see increases in turnover of the order of millions of pounds over a short period, then chances are the company will have to employ more people. You need to understand the workings of the company to get a good idea of how this will pan out.

OVERTRADING

This is a classic small business bear trap. Your company has a world-beating widget, you raise the funding to start the process of launching it. After a few months, you need to restock raw materials but your cash flow is poor. Your sales are stratospheric, but invoiced receipts are slow. This slowness is exacerbated by two of your multiple listings refusing to pay their bills until their demand for new stock is met – they have angry customers to placate. You can't solve this because you can't buy the raw materials. Worst case – you run out of cash and go into administration. All investors lose their money. Yet the product was a massive hit.

There are a few solutions. Trade financing is one, a friendly bank is another. As an investor, you need to be sure that the problem has been considered. Look at the cash flow on a monthly basis for periods where sales are high. Allowing for the production time lag, is there enough slack stock to easily cover this surge, and is there enough free cash coming back in to allow the bills to be paid? Again, I see so many instances where this simply hasn't been tested.

// case study

// FAILURE TO SCALE

A recent company I was involved with had plans to produce a revolutionary financial tool – for everyday use. Everything on the plans stacked up, except for one thing: the plans to actually produce the item, in large numbers, had not been tested. When tested, the plan fell to bits.

To be more specific, the manufacture of the tool had not been carefully costed or tried and tested to scale. When it was, the system didn't work as expected and as the people involved had never made anything similar, they didn't have answers to the queries the initial production run highlighted. This led to a six-month delay, the loss of several hundred thousand pounds and, most importantly, the chance of the company losing its vital first-mover advantage.

THE TAKEAWAY

IF THERE'S CERTAIN EVIDENCE YOU NEED TO SEE BEFORE YOU INVEST, DON'T LET OTHERS CONVINCE YOU OTHERWISE.

The situation in the UK, as mentioned earlier, is that most businesses you come across in the ECF funding sector will be classified as 'small' in terms of their accounts. This means that they do not have to file full accounts. In fact, it means they can file a one-page balance sheet. So, in order to get a picture of how this company is doing, you need to be able to analyse a balance sheet.

A balance sheet is a snapshot of a business's assets at a given moment in time – a day in a year.

The top section is given over to fixed assets – tangible and intangible. You ignore this at your peril. For SMEs and startups, tangible assets are not that important. Intangibles are. IP and all that goes with it comes under this section.

So, for example, if a company claims to own some IP, you might expect to see this on the balance sheet under intangible assets. You do need to be cautious here, as any accountant worth his salt will have advised the company to write off the IP costs on the P&L and claim the R&D tax credits. If the IP is capitalised, then the claim is void, so be sure to ask the CEO.

GAUGING ACTIVITY LEVELS

You cannot ascertain a company's revenue from its balance sheet, but you can gauge its activity levels. For example, comparing the debtors' figures for this and last year will indicate whether the company has seen an increase in sales and if it has efficient debt collection routines in place. Similarly, the one-year creditor figure will provide clues.

The longer-term debt figure will reflect the borrowings. These are often directors' loans for SMEs and startups, so check the terms of the loan. You do not want your investment paying it back.

LOOKING AT FINANCING

The balancing figures in the bottom section show how the top section has been financed. If read correctly, it will give you an idea as to the company's profitability.

Issued share capital and the share premium accounts added together will give you the total that has been invested in the company so far – worth checking out how this is made up via the Confirmation Statement

so you can see what money the founders have placed into the company.

If they have put little money into the business themselves but have large loans outstanding, then you should request these loans are transferred into share capital so their money is locked in as well as yours.

The paid-up share capital plus or minus the profit and loss (P&L) account will be the balancing figure from the top sections, i.e. the assets. The P&L can give you an annual account of the losses made by a company when you take the difference from one year to the next. However, if the company is making profits, it becomes a little more complicated.

Dividends can be issued (often in lieu of directors' salaries) only if a company has excess cash, i.e. profits. But these dividends are not always revealed in the balance sheet and will have been deducted off the P&L account before it is completed. So the figure given for a profit for any year is not necessarily the actual profit. To be sure, you need to get sight of the P&L.

KNOWLEDGE IS POWER

Due diligence is not some boring lawyer speak for ticking a series of boxes. It may have been in the past, but with modern technologies, all of us have access to levels of information that should make it a key part of the investment mix.

Partly creative, partly factual and wholly thorough, due diligence enables investors to look at the investment offer in the round. In carrying out the process, readers will find that one discovery will often lead to others, both positive and negative.

It's a bit like peeling an onion, but hopefully without the tears.

The more you do, the more you learn about business and people. If ultimately you invest and it goes well, you will have done the company and the founders a great service. UK plc needs its SMEs to be successful. If, however, you choose simply to invest without bothering to carry out these checks, the outcome will be far less rewarding for all involved.

As Sir Francis Bacon wrote at the end of the 1500s, 'Ipsa scientia potestas est' – a sentiment these days more commonly echoed as 'knowledge is power'.

These materials are written and provided for general information purposes only. The content is solely the opinion of SyndicateRoom and/or other contributors and research from third parties. It should not therefore be relied upon in making any investment decisions.

You should not invest in any investment product unless you understand the nature of it, along with the extent of your exposure to risk. You should be satisfied that any product or service is suitable for you given your financial position and investment objectives. Where appropriate, you should seek advice from a financial advisor in advance of making investment decisions.

SyndicateRoom is authorised and regulated by the Financial Conduct Authority (No.613021) registered in England and Wales (No. 07696935).



The Pitt Building
Trumpington Street
Cambridge
CB2 1RP

01223 478558
www.syndicatoroom.com

© Copyright Rob Murray Brown 2017