

Founder Focus: FAQs for Start-Up Success

Due Diligence - what are investors looking for?

Summary

Getting that first investment is a hugely important and exciting time for founders. Understanding what investors look for during due diligence can help you make a strong first impression and ensure a smooth investment process. This short guide explains what to expect and how to prepare.

What is due diligence?

Due diligence is the process investors undertake to understand your business before making an investment. They will review key areas such as your company's legal structure, finances, tax compliance, and commercial position. The aim is to confirm the value of your business, identify any risks, and decide how best to structure the investment.

Key areas investors will review include:

- **Legal:** company structure, key contracts, employment matters, litigation, and property.
- **Commercial:** carrying out analysis on the market, competitors, industry issues, and key customers or suppliers.
- **Tax:** compliance with tax laws and any historic tax issues.
- **Financial:** annual accounts, management accounts, and financial projections.

Depending on the nature of the business an investor may also carry out further due diligence, for example, IT, insurance, or environmental diligence may be deemed necessary depending on the sector in which the business operates.

Why do investors carry out due diligence?

The fundamental reason investors carry out due diligence is to gain a greater understanding of the business they are proposing to invest in. An investor will be seeking to confirm there is sufficient information about a company to:

1. **Valuation:** support its valuation of the business or establish if there are issues which may require a renegotiation of pricing and/or investment amount;
2. **Risk:** consider whether there are material risks which may impact the capital they are proposing to invest; and
3. **Advice:** obtain appropriate advice on how to mitigate any risks identified and to address them ahead of the investment documentation being signed.

The findings of the due diligence exercise(s) are often a crucial bargaining tool in the negotiation of the legal documents.

How does due diligence affect the investment documents?

Diligence informs what protections appear in the investment documents. In particular, it affects:

- **Warranties:** These are statements of fact given by the company and typically the founders or executive team at signing. They are designed to uncover issues before completion and to protect the investor if unknown risks later crystallise.
- **Disclosure:** If a warranty is not strictly true, you can set out the relevant facts in a disclosure letter. Proper disclosure will generally prevent the investor from being able to bring a claim for breach of warranty in respect of disclosed matters.
- **Protections and conditions:** Specific findings may lead to targeted protections (for example, specific indemnities), adjustments to warranty provisions or materiality thresholds, financial protections (such as caps, baskets or escrows), or conditions to be satisfied before completion (such as obtaining third-party consents, completing IP assignments or cleaning up company books).

Where does the information for legal due diligence come from?

The key component of any legal due diligence exercise is the information request list (legal due diligence questionnaire (**LDDQ**)) which sets out the areas for investigation and the key questions to be put to the company and the founders about the business. The questionnaire will typically be supplemented by additional questions as the investor learns more about the business throughout the diligence review process. It is important, when preparing responses to an LDDQ, that time is taken to answer the questions fully and accurately: this limits the number of supplemental questions and allows the due diligence process to be completed timeously.

Investors will be looking for the process to be run as smoothly and efficiently as possible. This usually means setting up an online data room to allow relevant information to be made available to the investor for the purposes of carrying out its due diligence, ideally with one person at the company having overall responsibility for populating it and keeping it up-to-date.

Do your own investor due diligence!

Choosing the right partner matters. Speak to portfolio companies about investment behaviour through both good and tough times, follow-on support, decision-making speed and involvement. Align on milestones, reporting, strategy and board governance. You will be working together for years—fit and shared expectations are critical.

Final thoughts

Taking part in an investment round is an incredibly exciting time for a business and for founders.

A well-prepared diligence process reduces friction, protects valuation and builds investor confidence. Align early on scope and timing, invest in an organised data room and use disclosure thoughtfully. Above all, choose partners who bring capital plus alignment. Follow our top tips to help your business meet these objectives.

Any questions?

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Here are our final top tips:

1. **Data room preparation:** have a well-prepared data room with folders and subfolders numbered to correspond with the question numbering in the LDDQ. Having a well organised data room will enable a smooth due diligence and disclosure process.
2. **Communication:** have a discussion with an investor at the outset regarding the scope and nature of the due diligence exercise – this helps to manage expectations on both sides.
3. **Understand the key issues that commonly arise in due diligence:** consistently the key issues that come up are:
 - *Share buybacks* - were these lawfully financed? Was the relevant shareholder authority received?
 - *Dividends* - did the company have sufficient distributable reserves to make any payment? Is there a clear paper trail to evidence that the company's financial position was considered prior to any dividend being made?
 - *Company books* - have these been properly maintained, and are they accurate and up to date?
4. **Investment Documents:** agree a detailed term sheet before getting into negotiations on the long-form investment documents. This will ensure key points are negotiated early in the process and key items agreed before management time and professional fees are incurred on the investment process.