DUE DILIGENCE FOR TRANSACTIONS WITH STARTUPS AND DIGITALLY TRANSFORMED ENTITIES WITH A LONG-TERM PERSPECTIVE

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Introduction

Information and communication technologies started transforming the global business ecosystem at an accelerated pace since 1956 when IBM first proclaimed availability random access storage system. After about forty years from then began the Industry 4.0 era. Advents of powerful digital technologies, their evolutions, and innovative applications by startups and technology giants created both transformational and foundational impacts on business operations with superior financial performance.

More and more corporate entities are transforming themselves with digital technologies for gaining first mover's and/or competitive advantages as well as remaining relevant in the present era. Digital transformations (DT) are also helping exploration of new business models with multiple revenue models. At the other end of the spectrum the world is witnessing emergence of unicorns from the embryos of startups. According to the Hurun Global Index, there are 1,058 unicorns in 2021, when India has become third largest home for 54 Unicorns leaving the UK behind. Indian entrepreneurs have set up 119 unicorns with 65 of them being in the USA[1]. Many more 'soonicorns' (soon to be unicorns) are waiting to join that elite club

All these have been possible due to staking of lifetime savings and boot strapping by 'Startupians'. High-net-worth individuals (HNIs), Angels, Venture Capital, and Private Equity Funds, herein after collectively referred as AIFs, have invested huge funds in technology sector. All these have helped startups designing innovative solutions and developing unique products with applications of digital technologies. All such investors while taking enormous risks in quest of very high returns, have participated in progression of Unicorns. Traditional industry players are continuing to organise hackathons for exacting unique, yet needful digital solutions for befitting their need for DT of operations. These have encouraged young talents and startups to participate in digital revolution,

The process of DT received further momentum through mergers and acquisitions transactions (M&A) by and between corporate entities, unicorns, and startups for inorganic growth with added strength for acceleration and sustainability. There are many instances of collaboration through strategic alliances (SA) and joint ventures (JV) between such entities. For example, FinTech startups collaborated with befittingly designed digital solutions to wrap up traditional banks with DT as a service (DTAS).

The Need for Due Diligence

The above process of DT kept on multiplying because many decisions for investments and collaborations were right, albeit many also were wrong. But the right ones brought fortune for risk taking investors nullifying the negative impacts from wrong investment decisions. Any such decisions can be right when entities follow the rightful process for knowing each other. While remaining invested, PE and VC firms also encourage startups for M&A transactions for attaining critical mass before existing with high returns. When AIFs want to exit though IPO and listing, again DD by underwriters and regulators is an essential process before permitting the entity to go to public for unlocking the value simultaneously with transfer of ownership.

The formal structured process for an investor to know the investee startup, a corporate entity, or a unicorn to know the target startup for M&A or entering into agreements for SA or JV is called Due Diligence (DD). The conventional processes for conducting DD, before any capital investments with one or more specific strategies in mind, e. g., participation in equity, M&A, JV and/or SA, as conducted by traditional business entities may not be applicable in toto to startups and unicorns dealing with digital technologies or digitally transformed corporates.

Objective

In this article the author will first revisit due diligence and bring out its critical importance as a process to be completed before taking decisions for investments and/or inking agreements for strategic alliance with a long-term strategic perspective. Thereafter the nuances for DD will be delineated to establish that traditional concepts and objectives behind conducing of DD is equally applicable to startups, organisations which are driven by digital technologies, and traditional entities which have transformed themselves by digitalisation in present Industry 4.0 era.

The next aim is to deal with DD activities for the specific business and operational aspects of such entities whose business and revenue models as well as deliverables to stakeholders are dependent on digital technologies. Importance of reverse due diligence by the investors for self-introspections would also be highlighted so at the 4Rs of DD, i. e., taking the right investment decision, at the right time, at the right price and for the right investee is achieved.

Due Diligence for Transactions in Industry 4.0 Era

At the outset it would be useful to revisit the fundamentals of due diligence as an imperative action precedent to any transaction with a long-term perspective involving huge stake of money. Such fundamental knowledge would help in strategizing action steps for conducting DD while dealing with startups engaged in applications of digital technologies or digitally transformed entities in traditional sectors.

Tasks for Two-step Due Diligence

Due diligence is a two-step process. Desktop or preliminary due diligence, which in cases of early-stage startups commence with the reverse process called pitching for inviting investments. This is because publicly available information either is not available, or many be sufficient to conduct desktop DD like in cases of established entities. The first step of desk top due diligence is like that of a litmus test enabling that enables the investor to get a first-hand idea of the target entity. The following is an illustrative list of topics/questions for enquiry surrounding the business of the target entity. Answers for these are generally obtained through pitching document/presentation, cold calling of stakeholders and industrial espionage:

1. What is the exact nature of business, product/service and unique/innovative features thereof?
2. Which is the industry sector, sub sector and what are the findings from PESTEL and Porter's Five Point analyses for the industry sector and SWOTC analysis of the entity?
3. What is the exact nature of problem being solved and who are the target customers and in which region?
4. What preliminary details are available regarding nature and stage of digital technology(ies) being used, the capabilities and relevant experience of the founder and team members in critical responsibilities?
5. How the product and/or solution is going to pose challenges for existing players in industry, e. g., by disruption, 'destructive disruption, i. e., 'destruption', and/or business process disruption i. e, 'bizruption'?
6. Is there any earlier instance of funding by an Angel, or VCs, etc., how many series funding has so far been provided and at what valuation of equity shares at respective points of time for funding?
7. Are applications pending for registration of IPR in the form of Patent(s) for products, trademark(s) and/or copyrights of taglines and at what stage those are?
8. What are the business and revenue models and what is the projected business plane in foreseeable future? Is there any Plan B in case the first one does not work?
9. What information could be collected from existing stakeholders of the entity including through cold calling and unanimous visits?
10. What is the present fund requirement?
11. What could be acceptable broad exit strategy to be offered by the investee?
12. What are the broad plans for present operations and future expansions?

Having understood the answers to the above illustrative questions members of the DD team, must first identify what all more questions can be raised befitting to the specificities of target entity for which answers can be obtained through desktop. One must keep in mind that detailed due diligence, as process is very expensive and time consuming.

It requires professional knowledge and experiential learning inputs. Therefore, it is better to put up all possible efforts for as much deep dive diligence as is possible in the first stage itself.

The second step is detailed due diligence post arriving at the conclusion to proceed ahead after the desktop DD and signing of non-disclosure agreement with the target entity. At this stage all tasks are to be performed with due exactitude and objectivity across length, breadth and depth of technology absorption/application, operational, financial, human capital and governance aspects of the target entity. The ultimate objective of this rigorous DD process is to determine whether the final decision for investment and/or collaboration for SA is to be taken in affirmative. The tasks in both the stages majorly involve the following:

- Asking and finding answers to a series of questions for evaluating all aspects of the entity and the opportunity that lie ahead of the done transaction,
- Meticulous review and scrutiny of all major legal documents, past period's financial statements and annual business plans vs. achievements,
- Industrial espionage and cold calling of vendors, customers, employees, bankers/financiers, and other stakeholders for extracting information qualitative information related to corporate and product brand image, as well as success factors in management environment, society and governance,
- Qualitative review of managerial personnel and leadership team with application of responsibility accounting techniques,
- Identifying misrepresentations in documents and other evidence provided by the prospective investee/alliance partner for detailed DD post signing of non-disclosure agreement,
- Articulating and grading critical findings from the DD process for setting assumptions while valuing of business and equity shares of the target entity and framing negotiation strategies based on findings about strengths and weaknesses of the target entity

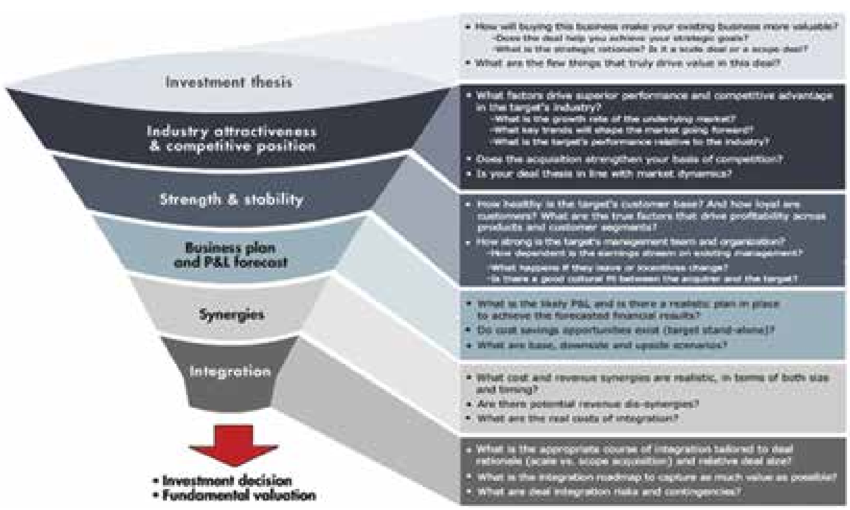
At the outset of commencing the very first process for DD it will be useful to remind oneself about the following four axioms that are prevalent in the commercial world:

- *"Deal Making is glamorous, due diligence is not."*
- *"Due Diligence is neither a pure science nor an art. It is a combination of both. It also demands lots of sixth sense and professional intellect."*
- *"Skeletons in the cupboard are decorated and perfumed with essence."*
- *"A deal is as good or as bad as the quality of due diligence activities performed before the deal."*

DD for Funnel Method of Decisions Making in Digital Era

No two transactions for investment and/or strategic collaboration can be the same. Like in cases of M&A deals certain business/revenue models, operating features, organisational culture of the two involved entities ought to be different from others in the same sector due to uniqueness of variants. This is more so when a transaction is being contemplated by and between two companies dealing with dynamic digital technologies which are evolving almost every day with powerful features and variants. Therefore, some of the probing points for DD also should be different. The DD process would also vary befitting the cognitive features, and not so prima facie perceivable tangible and intangible attributes of the investor and the target investee.

Keeping in view the critical importance of DD the following funnel method for analysing decision variables soaked in findings from DD is a useful process before arriving at any transactional decision. This is rather an imperative particularly when risks involved are high and objectives are to be realised over a longer period. Hence the process and agenda for exploratory DD should also be planned in a manner that ensures success to bring out all conceivable risks elements and impacts thereof. This would help in either initiating and monitoring actions for mitigating risks or appreciate those before taking any conscious decision for entering the transaction. The following graphic may help to appreciate the subject in a detailed way:



Source:
http://www.bain.com/bainweb/media/flash/popup_funnel_chart.asp and *https://www.pinterest.com/pin/239260602495289 8/*

The above graphical example and narratives for each category of information input are more suited for M&A related investment decisions. However, one can suitably modify the narratives while deciding to invest large funds for equity stakes in a startup for both initial and series funding. Unique features of products/solution design and superiority in applications of digital technologies should be one of the major groups of input items into this funnel while conducting DD for digitally transformed entities and/or startups dealing with digital technologies. Information requirements from DD regarding 'Integration' as a component should be identified with variations befitting the objectives to be achieved from the transaction, and integration/alignment with the vision and mission of the investing company and/or partners joining hands for strategic alliance. This method can also be useful for taking decisions for collaboration and strategic alliances amongst digitalised entities.

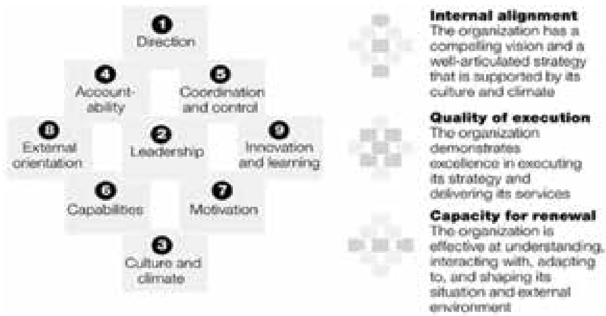
However, the most important yet common requirement for DD activities to ensure success in all types of transactions with long term perspectives are clarities on the following aspects of the deal and the process for DD:

- What objectives are to be achieved from the transactions being contemplated with a long- term perspective?
- How evolutionary developments in the adopted technology(ies) will be featured into the products and solution design in future?
- What are the hidden upside and/or down side effects of certain known and/or to be known features of the target/investee entity on the financial objectives to be achieved from the deal?
- Does the investing/acquiring entity have in-house capabilities for conducting DD or assistance from external professionals are required?
- Whether the tasks for tracking and monitoring of DD processes are being performed with total discipline at each stage of the deal value chain?
- Whether it would be possible to discover what is not known about the target with due transparency and commitment of the investee/target entity during detailed DD process?
- Is the process of DD fully relying on the investee/target for intelligence or the investor/acquirer has sufficient insights about the industry sector, technologies, products, and services?
- What is the possibility of success for sustainable growth and prosperity while dealing with the concerned digital product/solution and what would be the ESG score in the journey?
- What will be the effects on existing business which is intending to invest or sign a strategic alliance agreement with the target entity?

The process of DD is, therefore, a fact a finding mission which facilitates the process of taking the right decisions with a long-term perspective after being equipped with insights of and informed judgements on the target entity. All these in turn help predicting future performance of the entity with reduced range of error margin.

DD for Assessment of Leadership Quality

In the context of all types of long-term transactions assessment of leadership capabilities of the target organisation's officials at the helm of affairs is essential, irrespective of being a startup, a 'soonicorn' (soon to be a unicorn), a unicorn or an established entity.



Source: *https://www.linkedin.com/topic/m%26a-due-diligence*

The above graphics and narratives alongside are self-explanatory. Before commitment for funds and managerial support for acceleration, stabilisation, and/or lifting from distress, as appropriate and needed, AIFs rely more on the technical and leadership capabilities of founders and employees in critical positions. On them largely depend scalability and sustainability scores in future of operations and revenue earnings from goods and services developed with applications of digital technologies. Therefore, in the present digital era three qualitative attributes of the leadership team of digitally driven entities, viz., 'Internal alignment', 'Quality of execution', and 'Capacity for renewal' are equally important like for entities in traditional sectors.

Mapping of Findings from DD

Readers must have been convinced by now that due diligence is an essential requirement for taking right investment decisions at the right time and for the right value, tracking and monitoring of progress in return generation and realisation of the same at the appropriate time in future. However, at this stage it would be worthwhile to remember the famous quote of the Management Guru Michael Porter - "*Exclusive reliance on financial gains promotes short term behaviour that sacrifices long term value for short term performance*"

To make best use of findings from pre-investment DD activities one must adopt a structured and agile approach for conducting DD. One required step for that is mapping of findings from DD to their rightful domain and impacts. This will facilitate estimation of synergy benefits, action steps required for risk-enabled performance management and realisation of desired returns while remaining invested and/or at the time of exit by AIFs. The following is an illustration of such mapping of findings from DD

Domain → / Impacts ↓	Internal	External
Tangible	Product Readiness, Spare Capacities, Product Diversification, Scalability, IT Facilities, Supply Chain, C&CE	Present and Future Market Share, Export Potentials, Input Supply Contracts, Room for Loan, Govt. Grants
Intangible	IPR, R&D and Innovation, Culture, Technical and Managerial Competence, Employee Motivation,	Success Stories, Images of Brand, Promoters and Entity, Customer Loyalty, Service Reliability

Corporate and consulting experience of the author prompts him to write the following points in the context of the above mapping and investment management with a long term persptive:

- Internal tangibles are easy to integrate and derive benefits.
- External tangibles are difficult to integrate and time consuming.
- Internal intangibles are highly potential but need employee retention.
- External intangibles are highly potential but need due care.

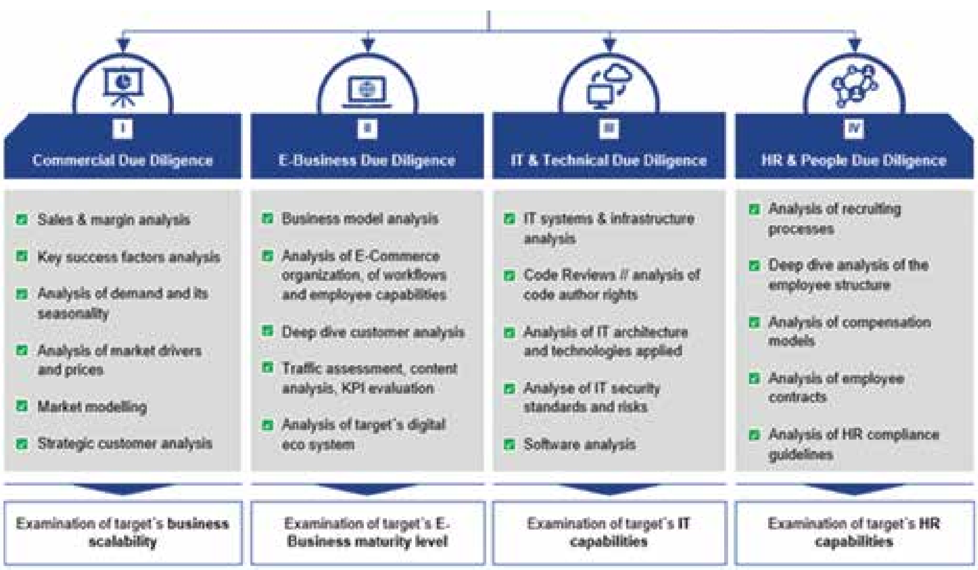
DD of Technology Driven Entities – Specific Aspects

Having understood the multidimensional nuances of due diligence it will be useful to deal with some of the specific aspects of conducting due diligence of business operations of technology driven entities like startups, unicorns, soonicorns, and digitally transformed established organisations. Operations of such business entities can be categorised into the following major groups:

- Online marketplace and eCommerce,
- Digital agencies for service deliveries,
- FinTech, CBDC, trade finance, retail banking, crowd funding, end to end management of financial instruments, wealth management and insurance,
- Physical and mental healthcare, and community services,
- EdTech and online training for skill building,
- Supply chain, with track and trace of products,
- Online content delivery,
- Online digital platform services, SAS and DTAS,
- Agriculture, crop surveillance, harvest management and crop insurance,
- RPA of manufacturing, maintenance, and surveillance of operations,
- Delivery of services by governmental and non-governmental organisations
- Information and data safety, security, and prevention of cybercrimes and so on.

The author is tempted to use the graphics created to delineate 'Portfolio of Due Diligence Services' by Fostec and Company GmbH[2], Germany . Their services range from raising initial 'Red Flag Report' to full scope due diligence reports in respect of one, more or all the above four types of DD activities. Readers may observe from the visual given below and narratives therein that they have divided DD services into the following four major groups related to the target entity's business:

- Scalability of Business - Commercial due diligence
- eBusines Maturity Level - eBusiness due diligence
- Information Technology Capabilities - IT and digital technology due diligence
- HR Capabilities – Human capital and people centric due diligence



The above model may be made more comprehensive by including the following illustrative, but not comprehensive, aspects of the target entity from a long-term perspective:

- Findings from SWOTC analysis assessed in the backdrop of understanding of the macro level PESTEL and VUCAFU analyses of emerging business ecosystem,
- Uniqueness and/or superiority of use cases and applications of digital technologies in solution designing and/or product

developments,

- Effectiveness score in compliance of Environment, Society and Governance (ESG),
- Assessment of differential competitive advantages of the target including first mover's advantages, if enjoyed, the estimated financial impacts and sustainability thereof,
- Risk-enabled performance management (REPM) system if there be any, else recommendation for REPM under the broad framework of COSO,
- Review reports on applications filed for grant of IPRs and status thereof after scrutiny of the claims filed, objections from competitors, and statement of defences submitted which are available from the website of the concerned national Register for IPRs.

Reverse Due Diligence

Due diligence, being a pre-investment activity, should not be considered having one-way traffic only. Biggest mistakes may be committed if DD is conducted only for the target or investee entity assuming that everything is hunky-dory for the investor entity or the larger of the two partners for strategic alliance. The author would recommend the following revers due diligence exercises:

- **Investee Entity**: The investor organisation, particularly the acquirer, before conducting M&A transactions, must also conduct similar DD for their existing business operations as a self-introspection exercise. This would help aligning the proposed investment transaction with its vision and mission. They would also be better equipped to diagnose gaps and maladies in their own organisation and identify the right target which would fill up those gaps and remove maladies by complementary strength and services. This in turn would ensure maximisation of synergy benefits.
- **VC and PE Fund Houses**: AIFs, in addition to meeting the fund-specific objective, should take a detailed look at their own areas of strength and capabilities before investing in targets. Findings from such an introspective DD would help setting appropriate terms and conditions for share purchase agreements and shareholders' agreements. This would also help identifying the need for micro-managing and monitoring performance of the investee entity by positioning their own management professionals.
- **Investee Entity:** Founders and leadership team of the investee/ target entity also would do well if they conduct due diligence to the extent needed to better know the entity which is going to be their investor, acquirer and/or controller. This will complete the exercise with a 360^0 approach for better infusion and realising equitable returns by both the groups. The founders of startups would be able to assess whether their passionate journey for actualisation of dreams will continue and/or be accelerated from the prospective association with the investor.

Investment bankers, and underwriters would also immensely be benefitted by conducting similar due diligence exercises before plunging into actions for arranging large funds from private/ overseas investors, or IPO and listing of their client's equity shares. This process would not only facilitate the earlier investors exiting the startup entity, but also presenting the client entity to retail and institutional investors from capital market with lots of confidence and with due compliance of regulatory provisions. DD is also an essential necessity in setting assumptions for valuation of shares for IPO and/or strategic selling of investee entity to future buyers.

Digital Tools for Due Diligence

Readers are aware that for conducting any due diligence activity the concerned team will have to deal with both structured and unstructured data and information. Many voluminous documents, physical evidence, news items, videos, static pictures are also to be scrutinised. The investee entity may or may not submit those in logical sequences and linked to each other on time. Some of those may not be of any relevance. Gone are the days when DD activities used to be physically conducted sitting with heaps of documents and data in excel sheets or physical statements. The practice of creating a library, with permissioned access, containing soft copies of all these have started several decades before. However, human efforts continued to be huge because support from IT software and digital tools were not sufficient. With the recent advents of digital tools powered by Artificial Intelligence, Big Data Analytics, Machine Learning, Augmented and Virtual Reality, Digital Libraries of Blockchain Platform and Drones with facilities for GPS mapping, the tasks of DD have become much easier. The author will look for some other opportunity to deal with this aspect in separate article.

Conclusion

The author in his thirty-four years of corporate experience have witnessed many failures of investment decisions and M&A transactions. News items are galore delineating bursting of startup entities even after series fundings. AIFs look for higher committed returns only because many investment decisions go wrong and result in losses. They neutralise those losses by asking for higher returns from investments which are successful. The 4Rs of due diligence are taking right investment decisions, at the right time, at the right price and for the right investee. The author would consider his efforts yielding rewards, if investors and investees commit lesser mistakes and derive higher benefits by taking cues from the contents of this article. The ultimate objective is to increase rate of success and lesser burning of precious cash. In the ultimate analysis all startups, waiting for money to actualise their dream, would get their rightful share to continue with the journey for inclusive growth and inclusive happiness with inclusive smile. MA

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All these websites have been accessed during December 2021.

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