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On the Nature of Due Diligence in a Search Fund Acquisition

A primer exploring the action steps necessary for a successful due diligence program

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When an aspiring search fund entrepreneur successfully identifies an actionable acquisition target, they must cross one of the final bridges prior to ascending to the CEO role – due diligence. Due diligence is the process of evaluating the target company in granular detail to ascertain whether the business the search entrepreneur thinks they are purchasing is actually the business they are buying. It is a multi-pronged and multi-month process that thoroughly explores many facets of the target company to give the entrepreneur, creditors, and investors a deep and meaningful understanding of the business.

Due diligence is a bespoke process since every target company is unique and will require examination of the appropriate items for that specific company. Of course, many core diligence components are common to all companies. This case note is a primer on due diligence intended to provide a simplified, general overview of the action steps necessary to execute a successful diligence program. For searchers pursuing diligence on an active target, we encourage them to customize this guidance further with the databases, third-party advisors, and other services recommended in this case note. Investors or industry advisors may also be able to provide more detailed diligence checklists.

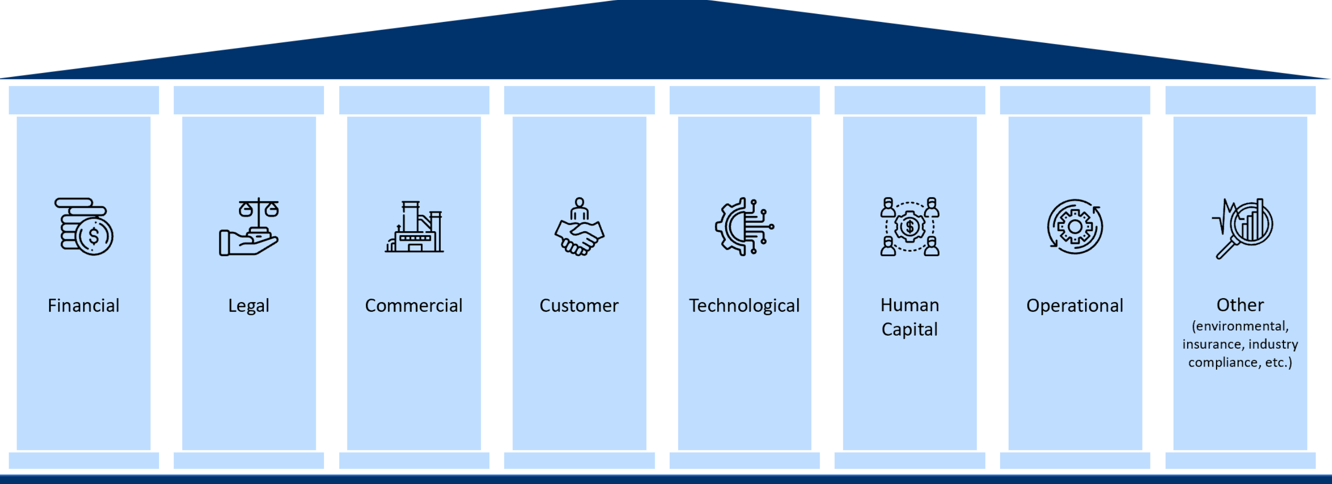
Specifically, this case note will explore the following:

- How due diligence in the search fund world is different from due diligence in larger companies
- The two forms of diligence a search entrepreneur will engage in: preliminary diligence prior to issuing a letter of intent (LOI) and confirmatory diligence after an LOI has been signed by the seller and search fund buyer
- The eight pillars of confirmatory due diligence in a search fund acquisition that are depicted in **Figure 1:**
    - **Financial**: ascertains the accuracy of the seller's historical financial statements and makes adjustments to arrive at pro forma and go-forward EBITDA[*] figures for the searcher's model.
    - **Legal:** evaluates the legitimacy of the owner's identity and ability to transact and reviews the company's past promises and agreements to transfer ownership and build transaction terms.

[*] Earnings before interest, taxes, depreciation, and amortization

- **Commercial:** uses public resources and paid databases for quantitative and qualitative information to evaluate the health of the company's industry and the stability of the firm's competitive position.
- **Customer:** analyzes customer data and customer perspectives to understand the extent to which current services meet customer needs and the likelihood customers will stay and create value after acquisition.
- **Technological:** develops key beliefs related to the company's exposure to technology and assesses technology tools, the people administering them, and security concerns.
- **Human capital:** tests owners' intentions to sell, explores issues of employee retention or incentives, identifies top people contributors, and examines the company's culture through surveys or interviews.
- **Operational:** looks at a typical customer order to understand the step-by-step process required for the business to work and evaluates the speed, accuracy, and cost-effectiveness of serving customers.
- **Other:** employs industry experts to answer questions in niche areas that are crucial for running the business, such as environmental and insurance issues.

Figure 1: The eight pillars of confirmatory due diligence in a search fund acquisition



When pursuing entrepreneurship through acquisition (ETA), the diligence step is possibly the most exciting. Entrepreneurs typically have spent months or years looking for a business to acquire, and now they get to explore their potential new business in an unfettered and unvarnished way. Much like getting a feel for a shiny new car, diligence is, essentially, taking the business off the lot for a test drive. Through diligence, a searcher can thoroughly research the company and reflect on the opportunity.

However, the diligence step is also likely the most dangerous. It follows a long and exhausting search process, and by this point, searchers often have placed all their chips on a single bet. Therefore, searchers

have every motivation to fall prey to confirmation bias, potentially minimizing unfortunate news. Because of this, we encourage searchers to approach diligence with as much healthy skepticism (but not cynicism) as possible. Eschew a posture of "I am trying to confirm what I already believe" and embrace a tone of "How can I prove what I believe is inaccurate?" After all, diligence is the final step in what will be a multi-million-dollar investment for investors and a personal bet for searchers that can be a decade long or more.

An entrepreneur should keep several goals in mind to maximize both fun and success. First, they should achieve a cut-and-dried "yes" or "no" decision on whether to acquire the business. This requires challenging assumptions and identifying risks before moving forward or jettisoning the opportunity. Like in a game of chess, a searcher inspects the entire board for hidden threats they may not have seen at first. Finding these problems is a great way to help the searcher decide whether to wipe the board clean and move on to a new deal or develop potential mitigation strategies and a post-acquisition checklist. Next, diligence is a crucial period of exclusivity to build and deepen rapport with and win over the seller, a uniquely enjoyable opportunity that, as we will discuss, defines the search fund diligence experience. Finally, in the case of a "yes" decision on acquiring the business, diligence also helps the parties develop final purchase terms and key in on important considerations for the concluding negotiations that will help secure the deal.[3]

Search fund due diligence is not the same as other diligence venues

Due diligence is a staple in private equity, venture capital, and large-scale corporate contexts when a company evaluates whether to consummate a merger or acquisition. Currently, much of the outstanding literature on diligence is produced by large, third-party advisors such as major accounting and consulting firms and targeted towards the clientele they serve, such as senior managers of Fortune 1000 companies or private equity (PE) funds looking to acquire billion-dollar assets.

However, this content and approach do not serve search fund entrepreneurs well since search fund assets are substantially smaller and the projects tend to have limited time and financial budgets, coupled with inexperienced sellers – and inexperienced buyers in the search fund entrepreneurs. It is akin to using a tractor-trailer for a family's trip to the grocery store. This case note will detail a more accurate portrayal of due diligence in search funds, which face a variety of constraints and tradeoffs unseen in traditional, large-scale merger and acquisition settings. We believe there are three significant distinguishing factors in search fund diligence: low budgets, low-quality information, first-time sellers, and inexperienced buyers.

***Low budgets*:** While most large corporate and private equity settings are defined by large budgets, comprehensive checklists, and extensive materials to review, search fund diligence is characterized by a scarcity of resources, which instead requires entrepreneurs to make distinctions between need-to-know and want-to-know aspects of the business. Instead of throwing money at every potential solution, search fund entrepreneurs will face a constant battle to prioritize questions and then find clever, fast, and affordable ways to answer them. On the upside, however, this norm informs the entire search fund ecosystem, which has a lot of experts willing to offer pro bono advice, enabling entrepreneurs to obtain help if they are resourceful enough to use their networks to find it.

***Low-quality information*:** Large corporations and large or middle-market private equity diligence is a comprehensive, resource-intensive process featuring intermediary bankers, experienced lawyers, strict project management deadlines, and hordes of professionals on both sides aggregating financial, legal, and business documents in easily accessible data rooms. The sheer number and expertise of professionals analyzing the materials creates high-quality information and confidence about the target company. This process is composed of people who know the ground rules and have deep experience in playing the game. Even search fund entrepreneurs with this type of professional background will not be prepared for the information gaps defined by ETA diligence. For example, most search fund acquisition targets are using QuickBooks (a small business accounting solution) – sometimes even Microsoft Excel – for their

accounting in cash-basis standards. Additionally, the information is often disorganized or missing altogether, with a limited repository of customer contracts, for example. Compounding information quality issues, searchers have their own limitations, often spearheading this type of diligence for the first time, with no experienced intermediaries representing buyers or sellers. This is clunky compared to the well-oiled process of larger diligence projects.

***First-time sellers*:** Search fund entrepreneurs will often encounter owners who are selling a business for the first time. As a result, sellers will not expect the high levels of time, information, effort, and negotiation required in the diligence and sale processes. They will likely be prone to discomfort around persnickety questions about their business and increasing levels of deal fatigue as each day of diligence passes. Searchers, therefore, face a huge responsibility in setting sellers' expectations, communicating with them frequently and transparently, and cultivating seller trust through extensive relationship management. The goal of diligence with respect to the seller is not simply pitching a fair deal and convincing them to close on it but rather to ensure a smooth transfer of "sweat equity," the business's intellectual property and secret sauce that generates value. A strong relationship between buyer and seller is the greatest enabler of confidence that these assets will transfer smoothly and that searchers will encounter success post-acquisition.

***Inexperienced buyers*:** Despite their pedigreed resumes and educational backgrounds, search fund entrepreneurs are rookie buyers of businesses. We think this is more profound than the seller's inexperience—the seller tends to respond to requests, but the searcher is driving the process. The fact that searchers have never done this before, and make many mistakes, as a result, has a significant impact on the process. Furthermore, the searcher's inexperience coupled with a first-time seller creates a very emotional process for both sides. The seller's life is changing for good — thoughts of mortality, identity, and fear — are all present. The searcher has trepidation about running out of money, buying a poor-performing business, and imposter syndrome. The best searchers pay as much attention to the emotions at play (including their own) as the mechanics of diligence.

Preliminary and confirmatory due diligence

Diligence in search fund deals has two major steps: *preliminary* and *confirmatory diligence*.[4] Preliminary diligence encompasses all research and testing done *before* an offer to purchase, submitted as a letter of intent (LOI), is shared with a business owner, whereas confirmatory diligence includes all diligence undertaken during the 90-day (or longer) exclusivity period the LOI provides. Therefore, the searcher's mindset and goals differ between the two steps.

Preliminary diligence

Preliminary diligence is performed towards the later stages of the deal-sourcing process, when the entrepreneur has identified a target company that fits their criteria, has contacted the seller, and is crafting an LOI. The outstanding decision points are whether to submit an LOI, and, if so, what non-binding price to offer. During the sourcing process, in which some time is devoted to preliminary diligence, we encourage searchers to swing early and swing often because submitting an LOI comes with little cost or reputational risk.

However, LOIs still require time – they should demonstrate knowledge about the business and be written with good intentions; otherwise, sellers might not consider them. While little money is usually spent during this period, searchers may consult with attorneys for some directional guidance. Generally, in preliminary diligence and early confirmatory diligence, there is little need for legal advice because efforts are focused elsewhere, such as the financial and commercial pillars. However, there are exceptions for ad hoc questions that would truly influence an LOI decision (e.g., intellectual property, worker categorization, immigration

compliance, technology privacy, regulatory issues, and government intervention, etc.), and searchers should work in tandem with lawyers to address these outstanding issues.

LOIs have implicit opportunity costs and future ramifications; a searcher would not want to end up squandering future time and money on confirmatory diligence by moving forward with a target that would otherwise have failed preliminary diligence tests. Making a wise decision here draws heavily on the accuracy of the searcher's search criteria and deal-scoring rubric (see **Exhibit 1** as an example). If searchers have built strong pipelines and filtered businesses to identify those with positive industry dynamics, large and unpenetrated markets, and light external competition (to name just a few important criteria), they should expect to easily validate these characteristics through this stage's research, and moving to the LOI should be relatively straightforward. For more information on the general criteria that lend to selecting strong target companies, see On the Nature of Economic Characteristics.

If moving forward with an LOI submission, searchers will need to determine a fair offer price. Here again, we encourage searchers to approach the topic of a non-binding price with a swing early, swing often mentality. For example, a seller's response to a valuation yields helpful insights into the basic viability of a potential deal. To make a simple valuation model, searchers make use of primary sources in the form of financial information directly from the seller. They also use secondary databases and tools, such as S&P Capital IQ, Yahoo! Finance, and Pitchbook, to compare the target's specific information with performance averages and trading multiples of comparable businesses. Investors, peers, and brokers may also be engaged for their insights and opinions on valuation and frequently have rubrics to price different types of revenue. Searchers may feel either pressured to take their time and set the perfect price or rushed to reach a number and move on. Neither approach will be most helpful for the diligence and transaction processes. Many deals see prices changing on the margins later, but keeping the price relatively stable is a good tool in managing a seller's trust and expectations. Therefore, searchers should be meticulous in setting a price but not so hesitant that they risk losing an interested seller's attention.

More importantly, searchers use preliminary diligence to test seller character and motivation, looking for clues that they are selling primarily for non-economic reasons and that they have taken actions that commit them to sell. Searchers should use preliminary diligence to begin building the seller relationship and to understand how the sellers have prepared themselves to sell, such as confirming that they have hired a lawyer or started organizing their financials. For an in-depth exploration of seller readiness to sell, see On the Nature of Seller Selection in a Search Fund Project.

In some ways, preliminary due diligence may be the most difficult of the two major stages. Without an exclusivity period, sellers often will not yet hand over complete business information to verify major search criteria. Thus, searchers are often left with some inchoate data and deciphered signals from conversations with the owner. More amorphous information also means there are fewer guardrails in the form of investor or advisor feedback. Furthermore, third-party advisors rarely participate in this step, leaving the searcher to handle much of the analysis on their own. Finally, preliminary diligence is not bound to the clock of a 90-day exclusivity period, creating high, intangible stakes in the form of opportunity costs: searchers might feel that preliminary diligence diverts attention from sourcing and pipeline management.

Tarra Sharp (The Kellogg School of Management at Northwestern University 2013) spent several years in consulting, marketing, and startups following business school before raising a traditional search fund, JHMacon Capital, at the end of 2020. In late November of 2021, a business broker connected her to a clinical trials company, which she identified as a great acquisition target, catalyzing her preliminary diligence. After evaluating the new industry and flying to California to meet the owner, she spent a couple months negotiating with the owner on a sale price for the LOI, but the two ultimately parted ways when they could not agree on price or terms. Regardless, Sharp enjoyed the learning experience and developed some great insights for the next steps in her search.

> My preliminary diligence began with researching this industry, one which I had never before considered. I was doing calls with industry experts. I didn't have a background here and wanted to understand what really differentiates these companies and what I should be looking for in a target. It was quickly clear that I would love to acquire a business in this space and that I could have an impact here. It's weird; it was never on my radar before the
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> broker brought it to me, but I sensed a lot of opportunity once I started to dig around. A lot of these companies need better operational management, especially in marketing and sales, which I have a background in. So, I felt that I would be a good operational fit as well.
>
> The next steps of preliminary diligence – and where I ran into trouble – were verifying early assumptions about the business and identifying a non-binding price for the LOI. I faced obstacles in getting this done because the owner was preoccupied with running the business. They didn't have a middle management team, and they were doing everything from sales to running the day-to-day operations. It was hard to track them down, so I went out to California to visit them, get their focus, and request some data. This included talking about a valuation multiple to get a sense of how much they were expecting for the sale price.
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> They kind of gave me some high-level guidance, which helped direct what I was thinking about for the price in the LOI. But two things happened that killed the deal. First, the owner was looking at a public company trading multiple in this industry, and their expectations were set at those numbers. I spent a lot of diligence time trying to educate them on why values differ between public and private companies. The second conflict was the earnout, which was intended to get the business back to pre-COVID numbers and cover my risk of buying the business in its current state. They ultimately didn't agree and wanted full cash at close. This impasse continued to drain my time, so, after several grueling weeks, I suggested we should part amicably.
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> The preliminary diligence impacted my focus on the rest of my fund. I spent two whole months concentrating on this deal, running the model, trying to put together growth assumptions, talking to experts, and reading up on the industry. I spent a lot of time on it – too much time. My interns helped me continue to source deals, but it was difficult for me to focus on the sourcing. In the future, I think I would try to get to the LOI more quickly. Cutting the time by two weeks and fully focusing on the deal for a short period of time to get the LOI right would have been better than dividing my focus over the longer term because dividing my attention wasn't productive. It's a tough balance, but I would have forced myself to put the deal in front of the seller earlier. If we had an upfront draft and conversation about the objections to the earnout, the process wouldn't have dragged on so long, and I could have insulated the rest of the fund operations from these negative shocks.

Confirmatory diligence

After a seller signs the LOI, confirmatory diligence begins. Whereas preliminary diligence often focuses on broader questions pertaining to the industry or business operations, confirmatory due diligence allows searchers to go deep in specific content areas – the eight pillars identified earlier in **Figure 1**. The main decision point of confirmatory diligence is a clear conclusion on whether to close the deal or not. To run a tight confirmatory diligence that reliably informs this determination, work in each pillar will be significantly more robust than during preliminary diligence research, challenging existing assumptions, reframing perspectives, and attempting to uncover any red flags, all while building and assessing a rapport with the seller.

Additionally, the searcher will start to engage functional experts and incur expenses with financial, legal, and other third-party advisors. This does not mean the searcher will have to take a back seat. In fact, quite the opposite happens. They will always take the first steps within each pillar of analysis, selecting and engaging the advisor, making sense of advisor reports, managing the seller relationship, communicating between parties, and ultimately making unilateral decisions about moving forward with a deal.

The tasks that are involved in preliminary and confirmatory diligence are not mutually exclusive. Some of the eight pillars of confirmatory diligence described below, such as commercial and financial, also appear in the preliminary process. The major distinction between preliminary and confirmatory diligence is the research depth required for the relative stakes of the decision (i.e., submitting a non-binding LOI versus closing a deal).

Eight pillars of confirmatory diligence

After an LOI is signed, there is little roadmap for getting to a decision on closing the deal. The exact journey depends on the searcher's skills and the idiosyncrasies of the specific target company. But the searcher has many tools at their disposal: experienced advisors, resourceful investors, a generous ETA community, and their own personal networks. With this toolkit set, we highlight eight pillars, followed by general strategies and tips, as a rough guide that should help searchers navigate this leg of the journey. Note that the pillars are *not* mutually exclusive; our categorization is meant to simply illustrate the wide scope of potential research during diligence.

Financial

Financial diligence is one of the most important places for search fund entrepreneurs to focus their time and attention. It informs projections of the company's earning power, determines whether the entrepreneur should complete a deal, and influences the final purchase price and deal terms. It is also one of the most rewarding aspects of diligence, giving the searcher a peek at the value they may be able to generate with the new company. Over the course of only a few weeks, aspiring entrepreneurs will cover the following:

- Understand a company's accounting methods and deviations from GAAP[†]
- Identify adjustments that need to be made to existing financial documents
- Translate qualitative hypotheses about business growth into quantitative forecasts

Searchers should never undertake these efforts alone. Investors expect independent accounting firms to be heavily involved, and the search fund ecosystem is well stocked with advisors, such as Minnesota-based Boulay Group and Chicago-based Mowery & Schoenfeld, who know the search fund ecosystem and its

[†] Generally accepted accounting principles

capital providers well and know how to expertly conduct financial diligence.[‡] While accountants play a big part in financial diligence, they bear no liability and will not provide an overall recommendation on whether to acquire the business – that decision ultimately still rests with the searcher. The entrepreneur will need to play an engaged, key role, being primarily responsible for crafting the financial narrative, mediating information and concerns between parties, and making confident, informed choices influenced by the accountants' findings.

Two first steps of financial diligence are ***proof of cash*** and ***quality of earnings*** (QofE). Proof of cash is a retrospective comparison between a business's financial documents and its official bank statements to make sure all deposits, expenses, and disbursements are running through the bank account. The investigation adds credibility to the business and confirms money is being exchanged. For example, if a business claims to have $5 million in revenue, the proof of cash analysis would expect to see and verify $5 million of cash deposits in the bank account. Furthermore, if expenses tally $4 million, the expectation is that $4 million of disbursements will also be reflected. Accountants typically target getting the firm's financial data to within 1% of the formal bank account statements.

Meanwhile, quality of earnings looks both forward and backward, normalizing past earnings and using them to forecast future ones. Using historic documents (it is helpful to look at historical data when building trends on a monthly basis to prevent annual data from obfuscating problems), accountants and searchers will first adjust the line items to get ***normalized EBITDA***. Reasons for these normalizing adjustments could include the following: converting cash accounting to accrual accounting, removing or evenly spreading unique expenses or revenues, fixing out-of-period items, adjusting for non-cash compensation, and resolving depreciation and amortization methods. Accountants and searchers can then use these normalized numbers to create or confirm a financial thesis about what the business will look like going forward.[5] These forecasts, called ***pro forma normalized EBITDA***, include the historical adjustment and easily achieved expected synergies and operational changes. When making adjustments, there are inevitably addbacks for expenses the prior owner incurred (personal car leases, as an example) that the buyer will not have. Searchers should be cautious about murky addbacks and consider whether addbacks in total represent too large a percentage of pro forma normalized EBITDA. A good sanity check is to compare EBITDA to the tax return net income.

After proof of cash and quality of earnings, searchers should make sure they address ***taxes***. While most small firms are flow-through entities (like an LLC[§]), meaning tax obligations in a certain year normally flow to an owner in that year, classifications like a C-corporation might leave liability with the new owner regardless of who the owner was at the time of the tax event.[6] Furthermore, a new owner may be responsible for underpayment of payroll and sales taxes even under a flow-through entity. This is particularly relevant for sales tax on software products that are bought all over the country and potentially worldwide, with tax nexus issues that can create potential liabilities. Accountants will help uncover any of these liabilities and forecast tax obligations for the future more accurately.

The ***working capital peg*** is the final step in financial diligence. It is a mutually agreed-upon benchmark of net working capital for the business and a guide for how much the seller is refunded or pays in, based on actual business performance up to the closing date.[7] It is one of the most complex areas of the negotiation process. (For more information, see the case note On the Nature of Working Capital: Understanding its Mysteries and Complexities.) To avoid overpaying for a business, a searcher and their team must have an incredibly granular understanding of items on the balance sheet that have an impact on the economic valuation of the deal – categories such as accounts receivable, accounts payable, and inventory – up to the

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[‡] We include service providers to help search fund entrepreneurs. Inclusion should not be interpreted or misconstrued as an endorsement or a recommendation.

[§] Limited liability corporation

exact expected date of the deal closing. For example, an inaccurate working capital peg might mean the searcher pays for inventory that is gone by 12:01 AM on the day they take over as CEO. Searchers will review the definitions, key metrics, tracking methods, seasonality, and trends of these balance sheet items to work towards the peg. The complexity of the working capital peg creates a high risk of conflict between the seller and the searcher. To avoid this, we recommend setting a goal of creating zero surprises for the seller. Searchers should work with financial advisors to transparently walk sellers and their advisors through the assumptions, logic, and math used to arrive at a certain peg.[8]

There are a few risk areas searchers should specifically be aware of in financial diligence. First, searchers need to be on the lookout for invoices from friends of the target company's owner; these may not be bona fide transactions and may exist only to amplify revenue and earnings as part of a window-dressing scheme in anticipation of a sale. Second, searchers should closely examine bad debt reserves and expenses to ensure reasonable accounting assumptions are in place. Under-accounting for bad debt results in overstating earnings. Third, searchers should attempt to ferret out if any customers are about to terminate their relationship with the target company. While this might be difficult to discover, searchers should ask as many people within the company as possible if they are aware of any pending customer separations. Finally, the searcher should confirm that the seller has not made any deathbed promises regarding employee compensation for future periods. Unreasonable future compensation is effectively an unrecorded contingent liability that falls to the buyer financially.

Searchers should not hesitate to use their financial advisors as a resource to comb through any other financial concerns, including customer and sales mix analyses, evaluations of accounting procedures around specific fixed assets, and advice for post-close financial management.

We recommend searchers get an early start on financial due diligence. The whole process, including compiling official financial projections and a narrative deck for investors and capital providers, can last up to 4–5 weeks, eating up a large chunk of the 90-day exclusivity period. It also requires time – potentially a few weeks – for sellers to collect the relevant financial documents. As we mentioned earlier, managing the seller and their potential deal burnout during the process is a defining feature of search fund due diligence. Complicated requests that demand the seller's time could become a major obstacle in these relationship maintenance efforts. Samples of a financial diligence narrative overview, quality of earnings report, and working capital peg summary are available in **Exhibits 2**, **3**, and **4**, respectively.

Legal

The goal of legal diligence is to fully understand a business's past promises and agreements and the legitimacy of the entity and its principals. Depending on the information uncovered here, the buyer's or the seller's attorneys may be required to create legal documents to clarify any unclear ownership, title, and transfer issues. Legal diligence informs and bleeds into other legal services, such as purchase agreements and deal closing, but we encourage searchers to see these two steps as being distinct. These other legal services are not covered in the scope of this diligence case note.

When done correctly, this diligence pillar assuages the concerns of investors, protects the entrepreneur against legal action from third parties, generates information that provides legal recourse in the purchase documents created later, and enables smooth, continuous operation of the business. These objectives will undoubtedly require the advice and expertise of a legal advisor. There are a handful of attorneys who are

well experienced and fluent in the ways of search fund transactions. Three of the most prominent are Raam Jani at BakerHostetler, Kevin Christmas at Holland & Knight, and Jon Herzog at Goodwin.[**]

When legal diligence begins in earnest after an LOI is signed, legal advisors will provide the entrepreneur with general checklists of contracts and documents that should be reviewed. First-time searchers could turn to their legal advisors for light assistance, but the lawyers will not be able to review all contracts as comprehensively as those in middle-market PE or corporate diligence. Instead, they can provide guidance on a handful of documents and allow searchers to own the rest. An example of a checklist is available here.

To prioritize the document review, searchers must take control with an offensive approach, focusing on their prominent legal assumptions for operating the business and generating value. That is, what assets, people, customers, suppliers, and so on does the searcher need to retain to continue to sustain confidence in the deal? An obvious first step for all deals is the target's ownership structure, verifying that they are in good standing with the state in which they operate or confirming their identity and capability to engage in a transaction of the business at the current time and location. Lawyers can often accomplish this through proof of compliance with business regulations (often a Certificate of Good Standing) and paid background checks.

The next steps depend on the target company itself. For example, real estate leases might hold little importance for a software company that can operate anywhere, whereas ensuring continued operation in the same location is crucial for a data center business that houses bulky servers. Furthermore, if certain employees bring talents or experience that are vital to a searcher's success, the searcher should prioritize their employment contracts and look for any potential basis for resignations. Here again, searchers get to reflect on why they fell in love with a target to guide them on action items.

When reviewing past legal documents, searchers will commonly face questions of consent and authorization. Searchers may be surprised that third parties may need to consent to ***change of control*** for a commercial relationship to remain in place (customers cannot block a transaction from occurring, but their contract might require change of control approval to remain valid). Customers could have this right baked into their contracts, regulatory bodies may require this if the business holds any license to operate, and landlords likely ask for it in their leases. If authorization is required, lawyers can prepare the right documents for the consenting third parties, while searchers can work with the current owner to manage the existing relationships and notify third parties of the upcoming transition. Searchers should also look for liens or tax obligations to confirm that the target company's assets are not encumbered or are encumbered only to the extent disclosed. Lawyers often have access to databases that can shed further light on those questions for the searcher.

After taking an offensive approach, searchers should go on the defense, using their well-maintained relationship with the seller to ask important legal questions and uncover any red flags such as past or present lawsuits, outstanding claims, or problems with clients, suppliers, or employees.

The most strategic and budget-friendly of searchers will bring in lawyers only when necessary and towards the end of the exclusivity period once financial due diligence is complete and they are certain about moving forward with the deal. This is because legal advisors provide the most expensive services and rarely reveal deal-killing information that searchers cannot find themselves. In these late stages of confirmatory diligence, lawyers will be instrumental in using the work and information uncovered in legal diligence to prepare documents like non-competes and, most importantly, the purchase agreement.

[**] We include service providers to help search fund entrepreneurs. Inclusion should not be interpreted or misconstrued as an endorsement or a recommendation.

As a final note about this pillar, searchers should not view their lawyers as free insurance. While these advisors can help searchers build a pathway for indemnification if sellers dishonestly proceed with a transaction, simply working with lawyers does not give searchers a scapegoat if performance goes awry during operation. Instead, entrepreneurs are in partnership with lawyers to deliver value to their investors in the form of assurance that legal matters have been explored, purchase agreements are up to standard, and transaction risks are minimized through traditional legal pathways.

Commercial

Commercial diligence covers the business's prospects in two categories: industry dynamics and competitive position.[9] Searchers focus a great deal on this pillar during preliminary diligence, since the confirmation of a healthy, growing, and fragmented industry is often a pre-existing requirement for search funds. While diving deep into commercial diligence before an LOI is signed may save time later in the confirmatory stage and seem attractive, searchers will find the commercial pillar often extends well into confirmatory diligence, especially if the company operates in a niche space within a larger industry. Given the earlier guidance to swing early and often when it comes to deciding to move from preliminary to confirmatory diligence, searchers should not be worried if they lack an incredibly detailed understanding of the industry and the target company's competitors before beginning an exclusivity period. So long as the searcher can confirm early on that major industry conditions are favorable to the risks of ETA (see On the Nature of Economic Characteristics), they should feel flexible to save deeper commercial diligence for the first few weeks after an LOI is signed.

When thinking about commercial diligence, searchers should channel Professor Irving Grousbeck's image of a search fund entrepreneur as a jockey on a horse on a track.[10] Grousbeck, the MBA Class of 1980 Adjunct Professor of Management at Stanford University's Graduate School of Business, conceived of the search fund model in the mid-1980s. His model of the search fund entrepreneur's journey comprises three elements: the track is the industry in which the entrepreneur chooses to play, the horse is the specific business or asset the entrepreneur acquires in that industry, and the entrepreneur is the jockey (the CEO) who rides the horse (the acquired business) on the track (the industry). Searchers should look for a smooth and obstacle-free track, or, in real terms, an industry where lots of companies are succeeding: attractive industries fundamentally lower execution risk. In addition to industry, we also want to investigate the target company's competitive position to confirm that many industry participants are doing well and that pathways for organic and inorganic growth exist.

Through both a quantitative and qualitative analysis, the searcher will measure the depth of the moat that protects the business and minimizes operational risk. These are insights that backward-facing financial metrics, for all their concreteness, cannot necessarily predict. First, searchers should put on their mathematical hats to confirm the existence of favorable quantitative signals, such as market sizes, market shares, margins, and growth rates. Next, these numbers can be cut and analyzed by factors such as geographies and subindustries to obtain a more detailed view of the specific competitive space of the target company. Then, searchers can take a qualitative perspective via Michael Porter's Five Forces[11] analysis of the industry, investigating the pressure that competitor rivalry, customers, suppliers, substitutes, and new entrants place on the target's potential profit generation. Searchers should understand themes such as the full scope of products and services the industry both provides and depends on, where the industry fits in a complex value chain to end customers, the target's major competitors, what customers look like and how they are segmented by different players, and pricing norms and strategies.

Searchers can take a first step in tackling commercial diligence through free secondary sources: Glassdoor, Yahoo! Finance, investment bank analyst reports, and basic Google searches. Searchers should also consider purchasing access to major industry databases such as IBISWorld, which are also accessible through membership on ETA community websites such as Searchfunder.com. Finally, for specific questions and the

deepest level of understanding, entrepreneurs can consider finding industry river guides either through their professional or MBA networks or by accessing paid expert networks like GLG and Alphasites.

Customer

Customers are the company's lifeblood and a central theme to examine in diligence. Their stickiness and relationships with the target company are one of the most essential dynamics for an entrepreneur to understand if they are going to be able to grow the company organically and increase multiples at exit successfully. Conversely, concerns about customers and sales put the business model and deal in jeopardy. In this pillar, searchers should aim to understand current customers' needs and the value the firm provides in response, how customers view the company in relation to competitors, customer attrition rates, and the size of customer switching costs.[12]

These factors influence the severity of several risks that may be uncovered. Take customer concentration for example. On the one hand, it signals that current leadership has a strong value proposition for their product or service, but on the other hand, searchers may lack the same political capital or make operational mistakes to disrupt the relationship. Once a major customer is lost, it becomes incredibly hard to maintain forecasted EBITDA margins and generate returns. Therefore, a detailed assessment of the criteria listed above will illustrate the level of protection a searcher faces with respect to customers. The notion of customer concentration can be amplified to revenue concentration. It is worthwhile for searchers to analyze revenue concentration on multiple dimensions such as customer logo, geographic area, product or service, and sales representative. All concentrations present risk, and entrepreneurs should endeavor to unpack revenue data to understand if and where concentrations are lurking.

A searcher will pursue two adventures to get this complete picture: retrieving information from both the company's and the customers' perspectives. First, the company has existing documents, though likely rudimentary, about customer data. Searchers can request anonymized customer lists detailing their revenue share (i.e., concentration), analyses of attrition rates, terms and conditions baked into customer contracts, and samples of advertising and marketing plans.[13] They also should pursue time with the seller and a sales and marketing team lead, who can answer objective qualitative questions on customer histories and sales processes. For example, searchers should seek to understand whether price levels or structures have changed recently and how the company attracts and retains new customers (i.e., its sales pipeline).

A key part of customer diligence and analysis should include attrition. Searchers should evaluate the rate at which customers terminate purchases. Of course, businesses with high attrition rates are riskier than businesses with low attrition rates. Attrition should be examined granularly at the customer level. Furthermore, we caution searchers from falsely claiming low attrition rates when revenue from some customers is actually dropping. Logo attrition and revenue attrition are distinct concepts. Customers who remain customers but have significantly lower sales volumes have experienced revenue attrition without churning. Ultimately, the goal of attrition analysis is to discover patterns and reasons for customer defection. For a detailed examination of customer attrition analysis, please see On the Nature of Customer Attrition and Revenue Analysis.

Second, searchers get to hear directly from customers. Regardless of method or strategy, this project will include some form of customer interviews or surveys. These conversations are incredibly important because they transcend information from the target and help searchers thoroughly understand a product or service's stickiness with clients, any pain points within the current relationship, and opportunities to earn more of their business in the future. Unfortunately, unless searchers have developed a very strong relationship with the seller, the seller will often heavily guard access to customers. Fortunately, there are ways for entrepreneurs to work around these restrictions. They can find similar customers in a different geography to interview personally[14] or develop a survey that the seller can disseminate under the pretext of a marketing

and sales project. Furthermore, they should strongly consider paying a third party to conduct face-to-face, live customer diligence.

Customer diligence services, such as those offered by Strategex and WHIZDOM, Inc.,[††] are increasingly available to the ETA ecosystem. Under a similar guise of customer satisfaction surveys, sellers are often more amenable to introducing their customers to an independent consultant and use the opportunity to unlock customer perspectives – all at the searcher's expense, of course. These service providers can develop customized guides to use for these interviews, and after carrying them out, the providers can also create detailed and objective reports that summarize the interviews, identify patterns, reveal areas for improvement, and create roadmaps for realistic value creation post-acquisition. The entrepreneur and their investors can then use these reports to make a fully informed decision on whether to close the deal. Many investors in the ETA community increasingly view outsourced customer diligence as essential in de-risking their investment. For a process map of outsourced customer diligence, see **Exhibit 5**.

Even if search fund entrepreneurs gain access to customers themselves or have the seller's approval to send out a customer survey they created, they should consider the value outsourced providers add to customer diligence. Customer interviews are an art and require a skill set searchers may lack. Searchers may find themselves ill-equipped to quickly find the most knowledgeable person within each organization or craft questions that effectively tease out non-obvious information. They may also find it difficult, wrapped up in the emotions of searching and diligence, to remain objective or unbiased in the face of concerning information from a target company's customers.

Technological

Technology diligence is becoming increasingly important as businesses become more digital. Searchers acquiring any type of company will need to take stock of the technological landscape, whether proprietary technology or third-party email systems and accounting databases are used. The capabilities, scalability, and constraints of any technology will partially define the business's likelihood of success. The searcher may inherit substantial investment responsibilities if technological infrastructure is inadequate (this is sometimes referred to as a technology debt). Searchers often do not have the skills to tackle this pillar alone and will likely need to find and pay a specialized firm to partner with them on the endeavor. Firms such as Spellbound specialize in technological diligence in the ETA ecosystem.[‡‡]

There is no mandate for exactly when to begin technology diligence, but we recommend getting started once financial and commercial diligence have kicked off and seem manageable. The first step for a searcher is to help their advisor thoroughly understand the technology-related items that will be essential to grow the business and making the investment successful. This could be anything from expanding into an adjacent market without changing the features of the product for a software-as-a-service (SaaS) company to having a high insulation from ransomware attacks without any further significant investment. Then, advisors can use these items to design a targeted survey for the seller and their team to complete.

Searchers looking to acquire a SaaS company or similar target with a proprietary offering will want deep insights into the technological product and process in any survey or interview. These include but are not limited to the following: the components of the tech stack (a list of technology services that run each application); places in the stack where tech debt or underinvestment may exist; the third-party products, application programming interfaces (API), or integrations on which the solution subsists; how new

[††] We include service providers to help search fund entrepreneurs. Inclusion should not be interpreted or misconstrued as an endorsement or a recommendation.

[‡‡] We include service providers to help search fund entrepreneurs. Inclusion should not be interpreted or misconstrued as an endorsement or a recommendation.

features are ideated, sourced, and deployed; how data are recorded, managed, and backed up; and how customers are onboarded and oriented with the product.

To some extent, even searchers acquiring non-SaaS targets should review the company's use of third-party technology vendors for services like enterprise resource planning (ERP) and accounting solutions to understand whether they sufficiently address employee and customer needs or if underinvestment may need to be rectified. Moreover, if an entrepreneur is betting on shifting a non-SaaS business towards providing technology solutions, tech advisors can help in developing surveys and interviews that can validate or inform these transition strategies.

Whether a searcher is acquiring a SaaS or non-SaaS target, surveys or interviews can also shed light on two crucial tech diligence categories: talent and security. The talent category includes identifying who has the most knowledge of and responsibility for the company's technology; their qualifications, workstreams, tenure, and relationship to the target's owner; and how staff are generally onboarded and trained in using or developing any technology. Finally, a searcher will investigate security vulnerabilities. Think of a company's security as a museum trying to protect a collection of valuable gems and crystals. Searchers can use surveys and interviews to understand where and how the doors lock, whether an alarm system exists, whether the valuables are locked up, whether guards know how to respond when an intruder arrives, and whether the camera footage has recorded someone inside the museum already.

Following the data collection, tech advisors will compile insights and findings into a narrative like those provided by financial and customer diligence providers. Normally, these experts can help summarize where the firm falls on a bell curve of technological development. The entire process, on average, takes about three weeks. Like many of the pillars we have discussed so far, the searcher retains responsibility for communicating findings to investors or capital providers and deciding whether they are comfortable with the information discovered.

Human Capital

This pillar includes three major elements to screen: ***owner***, ***employees***, and ***culture.***

Since the politics of post-sale transition and integration will prove challenging for a young, inexperienced, and first-time CEO, goodwill must exist in relationships throughout the company and will tangibly impact post-acquisition operational success and the long-term value of the company. Moreover, this is an area the searcher can explore mostly independently without reliance on a third party.

First and foremost, searchers must evaluate an owner's integrity, motivations, and commitment to passing off the business. Seller mistrust or conflict can sabotage operations in many ways. Inquiries about owners' prior attempts to sell, questions about past succession plans, and seller responses to document requests throughout the diligence process are critical tools for this evaluation. Searchers may also hire a background check firm to vet the owner. We will explore other seller management strategies later in this case note. Evaluating the character of the seller is crucial. No amount of legal documentation can insulate a buyer from a malevolent seller. Despite documents like non-compete agreements and a purchase and sale agreement, buying a business is primarily a character bet on the seller. For more thoughts on seller selection, please see On the Nature of Seller Selection in a Search Fund Project.

Second, the business's employees will be essential to carry over institutional knowledge and lead value creation. Therefore, it is critical to identify the key contributors and what motivates them to perform. Searchers should first start at a high and qualitative level by examining an organizational map to understand departments' roles, relationships, responsibilities, and specific employees. They should also look at documents like employee contracts and employee handbooks.[15] Then, searchers should digest the employee

experience quantitatively, requesting human resource data on salaries, benefits, churn, and demographics. These data should be analyzed by department, salary level, or tenure level to unlock the best insights. These numbers will help aspiring entrepreneurs understand early on if there are issues of retention, homogenization, or incentives. Searchers should also keep in mind that some benefits may be undisclosed, and they should ask the seller whether and how they offer casual incentives to members of their team, such as lending a summer house to an employee. If possible, searchers should consider doing an anonymous employee survey to assess whether employees are happy or disgruntled.

Finally, searchers should endeavor to assess the company's culture. What do the offices and company facilities look like? Are vehicles maintained and clean? Does the owner gloat about customer service or speak derisively about nettlesome customers? Assessing culture is trying to get a feel for the vibe and tone of the organization – whether it is uplifting and positive or corrosive and debilitating. Of course, cultures are malleable, but it is far better to acquire a company with a desirable culture than a noxious one.

Direct contact is the best and most entertaining way to study employees and culture. Sellers are often protective of access to employees and usually want to keep news of a potential sale confidential. However, if the seller allows, interviews with employees are the best way to identify the highest performers, begin building relationships with the brains and brawn of the business, and understand if they will stick around. If searchers obtain access, they should seek to understand compensation and promotion histories by employee, each employee's perception of the company culture, recommendations for company improvements, outstanding technological or training needs, and existing norms around how challenges get solved or escalated.[16]

Operations

In this pillar, a searcher gets to take a journey through all the nooks and crannies of a business and will develop a detailed understanding of how a customer order moves through the company. Sometimes this is called a value chain or an operations cycle. The process includes material, labor, and technological elements, and it will touch every department in an organization. The goal is to evaluate the speed, accuracy, scalability, and cost-effectiveness of delivering products or services to customers and the risks a target may face if any of these criteria are subpar.[17]

The ETA community does not have a robust selection of third-party operations diligence providers to choose and hire from. Instead, searchers face the responsibility of building out this diligence pillar for themselves and then pulling in members of their personal or investor network or paying for expert networks like GLG and Alphasites if pressing concerns arise that require consultation.

First, we recommend that searchers work with the seller to chronologically document the target's operations cycle if such documentation does not exist. This necessitates that the searcher take the classic perspective of following the flow of a customer order by putting themselves in a product or service's shoes and apply it to the specific target company. This will help the searcher relentlessly note every single operational step and how long each one takes. Harvard Business School's Professor Ben Shapiro's article "Staple Yourself to an Order"[18] offers some basic frameworks, but in general terms, this cycle may include actions such as purchasing inventory, receiving order requests from potential customers, disseminating invoices, delivering solutions to clients, and recording completed orders in the company's accounting system.[19] Since searchers are looking to capture the view of the *cycle*, they should also pinpoint the moment where the end of an order informs future operations. For example, fulfillment or financial data from prior periods may catalyze decisions on inventory purchasing, which impact future orders, and so on. Next, in addition to capturing the plain sequence and length of events, searchers should also note the specific people and departments involved, to what extent they participate in a specific step, and their associated workstreams. For example, *who* purchases the inventory, and *how* do they go about doing it? The searcher may be able to pinpoint

conflicting incentives, redundancies, uncaptured synergies, or bottlenecks, all of which could compromise speed, accuracy, and cost-effectiveness of operations.

Moreover, after documenting a chronological understanding of the operations cycle, a searcher should take a magnifying glass to look *between* the steps that connect them: the systems and processes that hold and transport data, information, and materials between people in the organization. For example, this could include how an account manager gets notified of a paid invoice by their client. This will entail reviews of meetings and communications between departments and overviews of e-commerce, ERP, accounting, or fleet management systems and how they are used to manage the cycle. While this investigation may overlap significantly with the tech diligence work described above, the searcher should look at these systems from the perspective of how they inform the speed, accuracy, and cost criteria of the operations we identified earlier in this section.

Finally, it is inevitable that the processes or systems above will not all be airtight. Thus, products or services may arrive late or be defective. Worker safety may also be at risk in manufacturing or industrial services businesses. Therefore, the operations pillar also means investigating quality and safety controls and what happens when the cycle goes wrong. These controls could exist in the form of a standing body like a quality committee, a single role like VP of Safety, federal documents like OSHA[§§] records, or weekly root cause corrective action meetings between departments. No matter the form, searchers should understand where orders may fall through the cracks, face hold-ups, or get corrupted, followed by how the company addresses these problems.

Other

The diligence pillars we have examined are not exhaustive. Some industries or businesses are so specific that even the areas and tools we have covered will not address all the outstanding diligence challenges. For example, environmental diligence may apply to industrial businesses or those with large real estate holdings since health and safety of materials and manufacturing could directly impact business value, reputation, and legal risk exposure. As another example, searchers may need to hire an insurance expert if the business frequently requires a lot of coverage or contracts with insurance providers in the value chain. Expert calls are an excellent tool for niche diligence challenges and the process more broadly. The cost is often nominal and delivers a huge return on investment in difficult areas for a searcher to navigate. Furthermore, entrepreneurs can use their own networks, their investors' networks, or even free websites like LinkedIn to connect with expert opinions.

Finally, searchers may fear that, despite covering all the pillars above as well as some of the strategies below, there still may be unknown unknowns that will surface after acquisition. That is always the case, and we encourage searchers not to let these fears keep them up at night. It is impossible to overturn every stone in a company, let alone in 90 days. Entrepreneurship through acquisition is not a risk-free endeavor, and searchers and investors must accept an inherent level of risk. Aspiring entrepreneurs, however, can adopt strategies and perspectives for risk mitigation. Entrepreneurs can resist the urge to accept their findings and conclusions (as well as those made by advisors and interns) at face value. Questioning initial information and resolutions and taking validations one step further while adhering to time constraints will ensure tighter diligence and less risky acquisition.

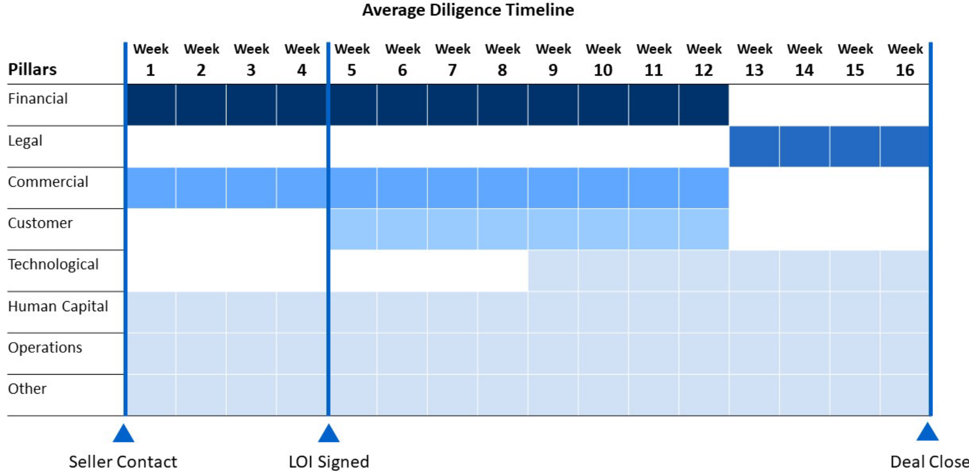
[§§]The Occupational Safety and Health Administration is a large regulatory agency of the United States Department of Labor.

Marcus Rush (Stanford Graduate School of Business 2020) worked in investment banking before his MBA and quickly launched his search fund, Black River Growth Partners, upon graduation. He had an early interest in the transportation industry and ultimately acquired AQC Traffic Control, a traffic control organization that provides work zone safety services for utility contractors. However, his diligence experience took a long six months to close, with quite a few financial and labor surprises along the way.

> Once I got AQC under LOI, I started diving into the information with a preliminary review. I saw a very strong and healthy company: three full years of business, 40%+ growth year over year, growing during the pandemic, and EBITDA margins close to 30%.
>
> So, I got really pulled into the opportunity. Once we got comfortable, we started moving into paid diligence. One of the first red flags I uncovered was that there was significant customer concentration in this business. Then, during the quality of earnings, the accountants found duplicate revenue of $150,000, so EBITDA was lower than we had thought. We were looking at a $1.8 million EBITDA business, and $150,000 was a material chunk of value lost. Some investors suggested we should re-trade on the purchase price, but I also had other investors who had seen this a thousand times before and encouraged me to build goodwill by not re-trading and instead using it as a leverage point. And that's the path I took towards the end of the deal; I used this as leverage to get a better outcome on the working capital peg.
>
> Another thing went south a few weeks before we initially planned to close and delayed the deal by more than a month. We engaged with a third party to do insurance diligence, and we discovered the company recently started coverage with a new company with the premium increased significantly by $170,000 per year. So, where we had already come down $150,000 in EBITDA, now it came down another $170,000. The firm's value lowered significantly, and I thought the deal would die. So, we recut things a little bit differently: we split the cost of insurance evenly with the seller and figured we could take action to lower the premium over time by embracing a culture of safety. It led to questions of trust and honesty, but we ultimately decided to close the deal since we needed insurance to get trucks on the road.
>
> Now that I've operated for a while, there's a final diligence item I realize I missed and wish we had done. The seller was sensitive about us talking to employees, and we didn't get access to them before we closed. A few days after the deal closed, two management team members – who I later learned had previously approached the owner to buy the business – tried to start a competing business while still working for us. I had to fire both of them during the first month as CEO. It was incredibly stressful and not something you want to do as you start operations.
>
> Something I could have done better was express to the seller all along that I wanted to be kept informed of major items like this during the exclusivity period. Despite all the challenges, I became even more excited about the opportunity. I believe we have a real chance to win here. This will be a really fun business to run, and we've already identified areas to drive tremendous value.

For an illustrative timeline of how the eight pillars intersect, see **Figure 2**.

Figure 2: Illustrative diligence timeline program



Suggested diligence strategies and tips

Memorizing the eight pillars and checking off tasks will not alone ensure that a searcher will successfully navigate the due diligence process. As in cooking or baking, a recipe will only take you so far. True success relies on artistry and craftsmanship. In diligence, we sort these capabilities into three areas: *key bets*, *relationship management*, and *time management*.

Key Bets

Key bets are the underpinnings or core hypotheses of the investment thesis. They can serve as a compass during the entire diligence process to help searchers sequence and prioritize action items. We recommend searchers enter an exclusivity period with 8–12 overall key bets on driving value for the current company. The key bets should satisfy two requirements: they should be must-haves, and they should be actionable.

Key bets are must-haves rather than want-to-haves, features of the business that currently exist, and whose sustainability or growth is required to generate economic returns. As one way to recognize these, we encourage searchers to reflect on why they fell in love with the business in the first place.[20] Searchers could also borrow tools from the private equity diligence approach to identify their must-haves. These types of companies often analyze acquisition targets' data on stock-keeping units (SKUs), customers, market segments, channels, people, and so on by profit contribution to locate areas of greatest opportunity and loss.[21] Seeking this type of information from the seller in any qualitative or quantitative form during preliminary diligence could be incredibly powerful in developing key bets later.

The key bets should also be actionable or reasonable, with no risk of breaking the business. A searcher must be able to deploy them in the immediate future without a traumatic intervention. Any value-creating change a searcher plans to introduce – like expanding geographically or outsourcing a business operation – will probably create complexity for the business and consume time and money.[22] We therefore encourage the entrepreneur to consider the ramifications of their key bets and de-prioritize riskier options.

Once key bets are formed, they can directly prioritize diligence tasks. For example, a SaaS company with competitive and proprietary technology built by the owner would implicate a key bet such as making sure the recently hired CTO has the knowledge, skills, and team to manage the product without the owner's continued involvement in day-to-day operations. This key bet would require a closer investigation of the

CTO and their team (within the human capital pillar) as well as a detailed approach to understanding how the company's processes and people develop upgrades and troubleshoot issues pertaining to the SaaS tool (within the technological pillar).

Relationship Management

Diligence requires excellent relationship management of three distinct constituencies: ***the seller***, ***capital providers***, and ***advisor networks***.

When it comes to ***sellers***, we urge entrepreneurs to protect the deal from seller burnout. Often, owners in the lower-middle-market range are selling their business for the first time and come with uninformed expectations of the diligence process. In working with sellers, searchers are managing not only a relationship but also a *fuse*. Sellers can get defensive and exhausted when searchers overburden them with questions and document requests or when motives, future steps, and timelines are not explicitly communicated. For example, sellers may bristle at inquiries into EBITDA adjustments during quality of earnings, which they may interpret as doubts about their management or professionalism. However, explaining that it helps the entrepreneur get a better idea of the business's normal cash flows in the future may mitigate these misunderstandings. In all instances of seller requests, we encourage searchers to be straightforward in their asks and transparent about their motives. We also suggest that searchers ask their advisors about time-commitment estimates ahead of asking the seller to complete surveys or compile documents so they can relay the expectations to the seller appropriately.

Searchers should spend pleasant face-to-face time with the owner. Engaging with them in a positive manner is a tried-and-true way of developing comfort and trust, which will color all interactions during diligence and beyond. The goal is to encourage sellers to embrace you into their lives; invitations to holiday parties and dinners indicate this going well. Experienced search fund investors have seen relationships managed so well that sellers have given searchers operating experience even before the deal closes, essentially stepping aside and handing over the keys before the business is sold.

When it comes to managing relationships with ***capital providers***, including both equity investors and debt providers, quality and frequency of communication are important. Searchers should disseminate regular communications via email on diligence milestones and progress and gauge capital providers' preferences on frequency. Additionally, searchers should consider hosting an investor day. This event, led and organized by the searcher, convenes all capital providers and the seller in one physical or digital space for networking and free exchanges of questions and ideas. If a searcher holds an investor day, it is essential for the searcher to command the meeting. A seller who overruns and takes control of the meeting could hurt capital providers' perception of the searcher, the owner, and the business opportunity.

Entrepreneurs should also hone their skills in the art of responding to capital providers' engagement during diligence. When capital providers share follow-up inquiries and offer second guesses about aspects of the business, we highly recommend that entrepreneurs use this as a cue to act. Going the extra mile in diligence and responding with zeal to nudges from capital providers will ensure a tighter diligence (they often have a better sense of potential red flags or issues) and work as a good relationship management skill that reflects well on the searcher's talents.

Finally, searchers must be strategic in deploying ***advisor networks***. Using experienced third-party service providers costs money, but it also offers a slew of benefits: speeding up tasks to curb the seller getting cold feet, picking up on red flags, deploying toolkits searchers often don't have on their own, and serving as a stamp of approval that can manage capital providers' expectations and concerns about the business.

While it is ultimately up to the searcher whether to acquire a company – and they should therefore seek to fully understand all areas of the business on their own – the expertise of third parties informs this decision and, therefore, requires a searcher to be strategic about whom to recruit. Searchers must always hire financial and legal advisors, and we highly encourage them to hire customer and technological diligence providers as well, but beyond these common players, there are many different combinations of experts that could step in to help. In choosing where and how to bring in other advisors, the first step for searchers is to be realistic about their own strengths and weaknesses at the start of an exclusivity period. They may find it helpful to create lists of content areas they are capable of analyzing alone, incapable of analyzing alone, and unable to prove to capital providers they can analyze alone.

When a searcher decides they require expertise in a particular area, they should prioritize free or pro bono help first, looking into their own personal network, undergraduate or MBA school networks, or their investors' networks. If searchers cannot find the level of expertise they are looking for within their networks for free, we urge entrepreneurs to shake off concerns about rising costs and not attempt to cut corners. In niche or high-stakes content areas, investors in traditionally funded searches will not mind the additional expenses required to bring experts in. Furthermore, the insights of these advisors will yield important information that will influence decisions on closing the deal or post-acquisition operations.

When any advisor comes on board, we encourage entrepreneurs to build a warm relationship, leaning into their expertise rather than using them as a means of outsourcing work. Advisors will not ultimately recommend whether to acquire a company but instead provide a narrative on their findings. Entrepreneurs who avoid digging into an area they do not understand and instead view diligence as delegating tasks to third parties will be confused and unable to close when the final reports come in. Therefore, searchers should view advisors as tutors and mentors and not fear that their attempts to learn will come at a cost. The search community is incredibly supportive and understanding, and established advisors look to establish long-term, educational relationships with searchers.

Time Management

Moving with a sense of urgency is crucial for all stages of diligence. This is distinct from rushing. Public safety professionals like firefighters move with a sense of urgency: they are familiar with their protective gear and tools and have the know-how to prepare them methodically. They are trained in procedures to identify and neutralize the biggest safety threats. Searchers should view themselves in the same way, thoroughly understanding their specific diligence goals and workstreams and the order in which they are staged. Then, when they identify aspects of the business that require further questioning and attention, they can stay calm and carefully leverage their advisors, networks, and their own skill set to gather the information required to act.

Urgency contrasts sharply with drift. Several issues could emerge if searchers spend too much time in preliminary or confirmatory diligence. First, as we explored earlier, is seller burnout. Keep in mind that the deal requires the consent of both parties every step of the way and a seller could terminate a deal if they feel time slipping. However, searchers should not blindly zip through the diligence process to appease the seller. Hurdles will inevitably slow down the deal at times, and it is crucial for entrepreneurs not to overlook them. Rather, we recommend sticking to an urgent pace and using the thoughtful relationship management and communication tools we have mentioned. Rather than viewing speed bumps as detriments, we encourage searchers to maintain their momentum and use the opportunity to engage their stakeholders more closely.

Second, urgency is important because the possibility for re-trades increases as time goes on. For example, many sellers insist on a floating valuation for their companies, which means the price is based on a variable accounting figure, such as trailing 12-month EBITDA. If that is the case and a searcher finds a wonderful and growing business – which many do – then a longer diligence process could catalyze a re-trade at the

eleventh hour if the business posts an outperforming next month of EBITDA, bumping up the deal price to the searcher's detriment.

It is important to note that interns can be incredibly helpful for time management needs. For example, college or MBA students can stay focused on deal sourcing, which requires less experience and training, while searchers concentrate on diligence. Interns with certain experience levels can also prove helpful for early-stage diligence, helping identify comparable deals for a valuation model or compiling quick primers on quirky industries and a target's competitors.

Moving forward once diligence is completed

If a searcher decides to move forward, they should consider whether to do so under the same terms and conditions as those agreed to in the LOI. Perhaps a company's fundamentals and outlook remain optimistic, but discrepancies uncovered during the quality of earnings can be used as a bargaining chip for extending the transition period for the former owner. Or perhaps disagreements over the working capital peg can be addressed via adjustments to earnouts or seller debt.

If surprises and concerns pop up along the way, creating genuine worries about moving forward, then the searcher can decide whether to jettison the deal, adjust the price, or change terms to box the risk. For example, uncovering troubling information about an employee may lead a searcher and their team to call out this risk and assign liability in a legal document. Diligence, however, is not a precursor to re-trade, and changing the valuation price or dramatically adjusting terms can be difficult to deploy. We do not recommend it. If the fundamentals and positive outlook for the company remain consistent, we encourage searchers to stick with the pre-agreed price and settle disagreements elsewhere or walk away if the outlook changes considerably. Walking away should not entail burning bridges. Relationship-focused entrepreneurs recommend that searchers stay honest about why they are walking away, sincerely tell sellers they want to remain in contact and shepherd them towards a deal, and share ideas for how to improve the business and reporting going forward.

Conclusion

Search fund due diligence is an exciting opportunity to get in the company's driver's seat. Entrepreneurs should robustly engage in the eight diligence pillars we have identified and explored above while adroitly focusing on key bets, relationship management, and time management. Then, when the exclusivity period concludes and it is time to make the personal decision on whether to acquire, we encourage entrepreneurs to pause, reflect, synthesize what they have learned, and lean on investors and advisors for advice.

If diligence catalyzes the entrepreneur to close on the deal – that is great. Luckily, the work searchers do during due diligence will feed seamlessly into the CEO role after the acquisition, informing 100-day plans and giving new owners a sense of conviction in their strategies to generate value.

We hope this case note brings you success on your diligence journey, giving you a toolkit to prioritize tasks and – most importantly – test out the company you hope to own in the future. Good luck!

Exhibit 1: Sample Industry Scorecard (courtesy of Radien Legacy Partners)

Industry Scorecard

Industry: [INDUSTRY NAME]

INDUSTRY SCORE	72%

MARKET SIZE	RANGE	WEIGHT	SCORE	COMMENTS
> X million	5	10%	4	
$X billion - $X billion	4			
$X million - $X million	3			
$X million - $X million	2			
< X million	1			

MACRO TRENDS	RANGE	WEIGHT	SCORE	COMMENTS
All macro trends create tailwinds	5	10%	4	
Majority of trends are tailwinds	4			
Mix of headwinds/tailwinds	3			
Majority of trends are headwinds	2			
Significant headwinds from macro trends	1			

MARKET GROWTH	RANGE	WEIGHT	SCORE	COMMENTS
>X%	5	10%	4	
X%-X%	4			
X%-X%	3			
X%-X%	2			
X%	1			

BARRIERS TO ENTRY / COMPETITIVE ADVANTAGE	RANGE	WEIGHT	SCORE	COMMENTS
No competitive entrance possible	5	10%	2	
Major barriers to entry	4			
Some barriers to entry	3			
Minor barriers to entry	2			
No barriers to entry	1			

COMPETITIVE INTENSITY	RANGE	WEIGHT	SCORE	COMMENTS
Highly fragmented competitors, no major companies	5	10%	4	
Small companies have established position	4			
Some major companies present; leadership unclear	3			
Formidable competitors, target could be a player	2			
Formidable competitors, target isn't a player	1			

SUPPLIER AND CUSTOMER STRENGTH	RANGE	WEIGHT	SCORE	COMMENTS
Company has power over suppliers and customers	5	10%	4	
Company has power over suppliers or customers on parity w/ others	4			
Company has power parity w/ suppliers & customers	3			
Supplier or customer have power over company	2			
Suppliers and customers have power over company	1			

EBITDA MARGINS	RANGE	WEIGHT	SCORE	COMMENTS
>X%	5	15%	3	
X% - X%	4			
X%-X%	3			
X%-X%	2			
<X%	1			

# OF TARGET COMPANIES	RANGE	WEIGHT	SCORE	COMMENTS
>X	5	5%	3	
X-X	4			
X-X	3			
X-X	2			
<X	1			

EBITDA Multiples or Revenue Multiples for ARR Businesses	RANGE	WEIGHT	SCORE	COMMENTS
<Xx EBITDA	5	20%	4	
Xx-Xx EBITDA	4			
Xx-Xx EBITDA	3			
Xx-Xx EBITDA	2			
>Xx EBITDA	1			

Exhibit 2: Sample Financial Diligence Narrative Overview (courtesy of Boulay Group)

Quality of Earnings Sample Information

Key Due Diligence Findings

Summary Quality of Earnings (QofE)

EBITDA Key Finding 1: The Company has not historically applied overhead or direct labor costs to inventory. These costs have been expensed in the period incurred rather than capitalized and expensed upon the sale of goods. We have adjusted costs of goods sold to reflect the application of such costs

EBITDA Key Finding 2: The current owners continue to receive salaries from the Company. We understand they are not engaged in daily operations and will not need to be replaced post acquisition. We have removed their salaries and wages from operating costs

EBITDA Key Finding 3: During the TTM, the Company formed a partnership with a local business to remove its metal scraps free of charge. We have removed the impacts of metal removal costs from the Diligence Period

EBITDA Key Finding 4: The Company has taken advantage of early-pay discounts with its major vendors, recognizing savings of $261 and $339 thousand in the FY2 and the TTM periods, respectively

EBITDA Key Finding 5: In performing warranty work, the Company has historically grossed-up revenues and warranty expenses. We have reduced revenue and warranty expense for this gross-up, and have estimated a warranty reserve based on historical warranty work performed

QofE Highlights
($ Thousands)

For the Periods Ended	FYE Dec 'XX	FYE Dec 'XX	TTM Sep 'XX
Revenues	$21,844.1	$32,312.3	$34,121.9
Discounts	($332.3)	($564.3)	($677.8)
Net Revenues	$21,511.7	$31,748.0	$33,444.1
Reported EBITDA	$ 2,731.7	$ 6,449.6	$ 7,261.1
(±) Diligence Adjustments	$149.2	($349.7)	($225.7)
Diligence Adjusted EBITDA	$ 2,880.9	$ 6,099.9	$ 7,035.4

Summary Quality of Net Working Capital (QofNWC)

NWC Key Finding 1: As noted above, the Company has not historically burdened inventory with overhead and direct labor costs involved in the manufacturing process. We have adjusted finish goods inventory to reflect the capitalization of such costs

NWC Key Finding 2: The Company offers a standard two-year warranty on all its manufactured units that guarantees its products meet agreed-upon specifications. The Company has historically expensed warranty costs, typically the manufacturing of a replacement unit, as incurred. Because the Company does not maintain detailed records of warranty claims, we have estimated a warranty accrual using historical claims with regards to net sales

NWC Key Finding 3: The Company paid out an employee performance bonus for the first half of 20XX in July of 20XX. Amounts paid to employees were not accrued over the time that they were earned. We have adjusted bonus expense and bonus accruals to reflect the amounts earned by employees on a monthly basis

NWC Highlights
($ Thousands)

For the Periods Ended	TTM Sep 'XX	Monthly Averages 3Mth	6Mth	12Mth
CF Current Assets, As Reported	$6,808.6	$6,499.8	$6,163.4	$5,639.8
(±) Diligence Adjustments	$62.6	$81.4	$68.3	$59.8
CF Current Assets, As Adjusted	$6,871.2	$6,581.2	$6,231.7	$5,699.6
DF Current Liabilities, As Reported	$855.6	$852.3	$921.9	$889.5
(±) Diligence Adjustments	($7.3)	$16.9	$25.1	$26.2
DF Current Liabilities, As Adjusted	$848.3	$869.2	$947.0	$915.7
Reported DFCF NWC	$5,952.9	$5,647.6	$5,241.5	$4,750.3
Adjusted DFCF NWC	$6,022.8	$5,712.0	$5,284.7	$4,783.9

Debt & Debt Like Items

We have searched for debt and debt-like items and claims against the Company. The Company currently has a line of credit with the 1st Generic Bank of America that expires on December 31, 20XX. As of September 30, 20XX, the Company did not have any borrowings against this line of credit

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Exhibit 3: Sample Quality of Earnings Report (courtesy of Boulay Group)

Quality of Earnings Sample Information

Quality of Earnings

Quality of Earnings

($ Thousands)

For the Periods Ended		FYE Dec 'XX	FYE Dec 'XX	TTM Sep 'XX
Revenues		$21,844.1	$32,312.3	$34,121.9
Discounts		($332.3)	($564.3)	($677.8)
Net Revenues		**$21,511.7**	**$31,748.0**	**$33,444.1**
Materials		$12,672.1	$17,443.7	$17,671.9
Freight		$837.6	$1,214.1	$1,247.7
Direct Labor		$1,763.3	$2,291.3	$2,315.9
Purchase Adjustments		$1,073.0	$1,456.7	$1,660.2
Total Cost of Goods Sold		**$16,345.9**	**$22,405.7**	**$22,895.8**
Gross Profit		**$5,165.8**	**$9,342.3**	**$10,548.3**
Gross Margin %		*24.0%*	*29.4%*	*31.5%*
Net Income		**$2,495.5**	**$6,237.2**	**$7,053.9**
(+) Depreciation & Amortization		$92.6	$146.9	$168.3
(+) Interest		$126.7	$45.6	$15.5
(+) Taxes		$16.8	$19.9	$23.5
Reported EBITDA		**$2,731.7**	**$6,449.6**	**$7,261.1**
(±) Out-of-Period Items	*DD.1*	$0.0	–	–
(+) Loss on Sale of Fixed Assets	*DD.2*	$9.3	$17.0	–
(–) PPP Loan Forgiveness	*DD.3*	–	($493.7)	($493.7)
(–) Non-Operating Income	*DD.4*	–	($23.6)	–
(±) Overhead Adjustment	*DD.5*	$1.4	($7.5)	$11.5
(+) Owner's Compensation	*DD.6*	$107.2	$142.2	$174.6
(+) Key Man Insurance	*DD.7*	$6.1	$6.1	$3.5
(+) Antitrust Litigation	*DD.8*	$0.6	$1.8	$0.5
(±) Warranty Gross Up	*DD.9*	–	–	–
(±) Warranty Reserve Adjustment	*DD.10*	$7.2	($11.5)	$0.6
(+) Metal Removal	*DD.11*	$16.4	$19.5	$3.7
(–) Insurance Claim	*DD.12*	($41.4)	–	–
(+) Disposal of Equipment	*DD.13*	$42.4	–	–
(+) Deal Fees	*DD.14*	–	–	$73.5
Diligence Adjusted EBITDA		**$2,880.9**	**$6,099.9**	**$7,035.4**

DD.1 Out-of-Period Items

- During our procedures we noted certain expenses recorded in the improper accounting period. We have adjusted those amounts into the correct monthly period
- We were unable to quantify an out-of-period adjustment related to the recognition of vendor early pay discounts. These discounts should be reducing inventory costs and would then be recognized as cost of goods sold upon shipment
- We were also unable to quantify potential timing differences on warranty cost recognition

DD.2 Loss on Sale of Fixed Assets

- We have removed the impacts of losses on the sale of fixed assets as they reflect one-time events, and do not reflect the normal operations of the Company

DD.3 PPP Loan Forgiveness

- The Company received a PPP loan under the CARES Act in April 20XX
- Management has indicated this amount has been fully forgiven. Loan forgiveness income was recognized in November 20XX

DD.4 Non-Operating Income

- The Company had the Small Business Association pay several months of its long term note payable during 20XX, with the Company booking those payments to other income
- We have adjusted for these amounts as they do not reflect the normal operations of the Company

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Exhibit 4: Sample Working Capital Peg Summary (courtesy of Boulay Group)

Quality of Earnings Sample Information

Quality of Working Capital Summary

Debt-free, cash-free net working capital is a measure of operating current assets providing near term benefits and operating current liabilities obligating the Company. We have estimated diligence adjustments to accrue various assets and liabilities of the Company

Quality of Net Working Capital

($ Thousands)

														LCY	TTM	Monthly Averages		
For the Periods Ended		**Oct 'XX**	**Nov 'XX**	**Dec 'XX**	**Jan 'XX**	**Feb 'XX**	**Mar 'XX**	**Apr 'XX**	**May 'XX**	**Jun 'XX**	**Jul 'XX**	**Aug 'XX**	**Sep 'XX**	**Dec 'XX**	**Sep 'XX**	**3Mth**	**6Mth**	**12Mth**
Cash		$2,032.8	$2,451.3	$748.6	$1,313.7	$1,140.1	$1,672.8	$1,277.6	$1,911.1	$1,554.8	$1,044.5	$686.2	$943.0	$748.6	$943.0	$891.3	$1,236.2	$1,398.0
Accounts Receivable		$2,028.2	$1,426.1	$1,981.0	$1,882.4	$2,234.3	$2,175.3	$2,039.5	$1,759.7	$1,968.4	$2,010.7	$1,741.1	$2,455.2	$1,981.0	$2,455.2	$2,069.0	$1,995.8	$1,975.2
Inventory		$2,688.1	$2,904.1	$2,877.3	$3,102.2	$3,189.9	$3,768.3	$3,669.4	$3,760.7	$3,728.9	$4,221.7	$4,640.0	$4,330.3	$2,877.3	$4,330.3	$4,397.3	$4,058.5	$3,573.4
Prepaid Expenses		$14.8	$18.8	$21.0	$127.7	$126.1	$131.5	$141.9	$135.6	$276.9	$55.2	$22.2	$23.1	$21.0	$23.1	$33.5	$109.1	$91.2
Total Current Assets		**$6,763.8**	**$6,800.2**	**$5,627.9**	**$6,426.0**	**$6,690.4**	**$7,747.9**	**$7,128.4**	**$7,567.1**	**$7,529.0**	**$7,332.0**	**$7,089.6**	**$7,751.6**	**$5,627.9**	**$7,751.6**	**$7,391.1**	**$7,399.6**	**$7,037.8**
(–) Cash		($2,032.8)	($2,451.3)	($748.6)	($1,313.7)	($1,140.1)	($1,672.8)	($1,277.6)	($1,911.1)	($1,554.8)	($1,044.5)	($686.2)	($943.0)	($748.6)	($943.0)	($891.3)	($1,236.2)	($1,398.0)
Cash-Free Current Assets, As Reported		**$4,731.1**	**$4,348.9**	**$4,879.3**	**$5,112.3**	**$5,550.3**	**$6,075.1**	**$5,850.8**	**$5,656.0**	**$5,974.1**	**$6,287.5**	**$6,403.4**	**$6,808.6**	**$4,879.3**	**$6,808.6**	**$6,499.8**	**$6,163.4**	**$5,639.8**
(+) Inventory - Applied Labor & Overhead	*NWC.1*	$47.9	$35.4	$34.1	$71.0	$36.8	$82.6	$50.4	$26.9	$88.1	$68.8	$112.8	$62.6	$34.1	$62.6	$81.4	$68.3	$59.8
Cash-Free Current Assets, As Adjusted		**$4,779.0**	**$4,384.3**	**$4,913.5**	**$5,183.3**	**$5,587.1**	**$6,157.8**	**$5,901.2**	**$5,682.9**	**$6,062.2**	**$6,356.3**	**$6,516.2**	**$6,871.2**	**$4,913.5**	**$6,871.2**	**$6,581.2**	**$6,231.7**	**$5,699.6**
Trade Accounts Payable		$294.4	$441.5	$205.1	$513.0	$421.0	$621.7	$374.8	$290.6	$667.1	$393.9	$483.4	$282.9	$205.1	$282.9	$386.8	$415.5	$415.8
Accrued Payroll Liabilities		$120.9	$137.2	$90.0	$111.7	$109.6	$136.0	$123.4	$152.5	$155.9	$126.7	$135.1	$153.2	$90.0	$153.2	$138.3	$141.1	$129.4
Other Current Liabilities		$368.0	$542.3	$191.4	$186.5	$252.2	$361.6	$350.2	$398.0	$440.5	$231.3	$312.5	$396.6	$191.4	$396.6	$313.4	$354.8	$335.9
Sales & Use Tax Liabilities		$5.7	$8.5	$8.7	$9.2	$3.2	$3.2	$9.4	$6.4	$6.0	$5.8	$12.5	$22.9	$8.7	$22.9	$13.7	$10.5	$8.5
Line of Credit		–	–	–	–	–	–	–	–	–	–	–	–	–	–	–	–	–
Current Maturities on LT Debt		$47.1	–	–	–	–	–	–	–	–	–	–	–	–	–	–	–	$3.9
PPP Loan		$493.7	–	–	–	–	–	–	–	–	–	–	–	–	–	–	–	$41.1
Total Current Liabilities		**$1,329.9**	**$1,129.6**	**$495.2**	**$820.4**	**$786.0**	**$1,122.5**	**$857.8**	**$847.5**	**$1,269.5**	**$757.7**	**$943.5**	**$855.6**	**$495.2**	**$855.6**	**$852.3**	**$921.9**	**$934.6**
(–) Short Term Debt Maturities		($540.8)	–	–	–	–	–	–	–	–	–	–	–	–	–	–	–	($45.1)
Debt-Free Current Liabilities, As Reported		**$789.1**	**$1,129.6**	**$495.2**	**$820.4**	**$786.0**	**$1,122.5**	**$857.8**	**$847.5**	**$1,269.5**	**$757.7**	**$943.5**	**$855.6**	**$495.2**	**$855.6**	**$852.3**	**$921.9**	**$889.5**
(±) Accounts Payable	*NWC.2*	($2.8)	($1.5)	($0.2)	($0.5)	$1.3	$0.3	–	–	–	–	–	($35.3)	($0.2)	($35.3)	($11.8)	($5.9)	($3.2)
(+) Warranty Reserve	*NWC.3*	$31.5	$27.7	$21.9	$26.5	$27.7	$31.8	$32.7	$33.7	$33.3	$30.4	$27.6	$28.0	$21.9	$28.0	$28.7	$31.0	$29.4
(±) Bonus Accrual	*NWC.4*	–	–	–	–	–	–	–	–	–	–	–	–	–	–	–	–	–
Debt-Free Current Liabilities, As Adjusted		**$817.9**	**$1,155.8**	**$516.8**	**$846.4**	**$814.9**	**$1,154.5**	**$890.5**	**$881.2**	**$1,302.8**	**$788.2**	**$971.1**	**$848.3**	**$516.8**	**$848.3**	**$869.2**	**$947.0**	**$915.7**
DFCF Reported Net Working Capital		**$3,942.0**	**$3,219.3**	**$4,384.2**	**$4,291.9**	**$4,764.3**	**$4,952.6**	**$4,993.0**	**$4,808.5**	**$4,704.6**	**$5,529.8**	**$5,459.9**	**$5,952.9**	**$4,384.2**	**$5,952.9**	**$5,647.6**	**$5,241.5**	**$4,750.3**
DFCF Adjusted Net Working Capital		**$3,961.1**	**$3,228.5**	**$4,396.6**	**$4,336.8**	**$4,772.3**	**$5,003.2**	**$5,010.7**	**$4,801.7**	**$4,759.5**	**$5,568.1**	**$5,545.1**	**$6,022.8**	**$4,396.6**	**$6,022.8**	**$5,712.0**	**$5,284.7**	**$4,783.9**

NWC.1 Inventory – Applied Labor & Overhead

- Direct labor and other overhead costs are not capitalized into inventory in accordance with GAAP
- We have estimated direct labor and overhead rates based on historical expenses and production amounts, and have adjusted inventory to reflect these burden rates

NWC.2 Accounts Payable

- During our diligences procedures we noted specific expenses that were not recorded in the appropriate accounting period
- We have adjusted amounts noted to be reflected in the appropriate accounting period

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Exhibit 5: Customer Diligence Process Map

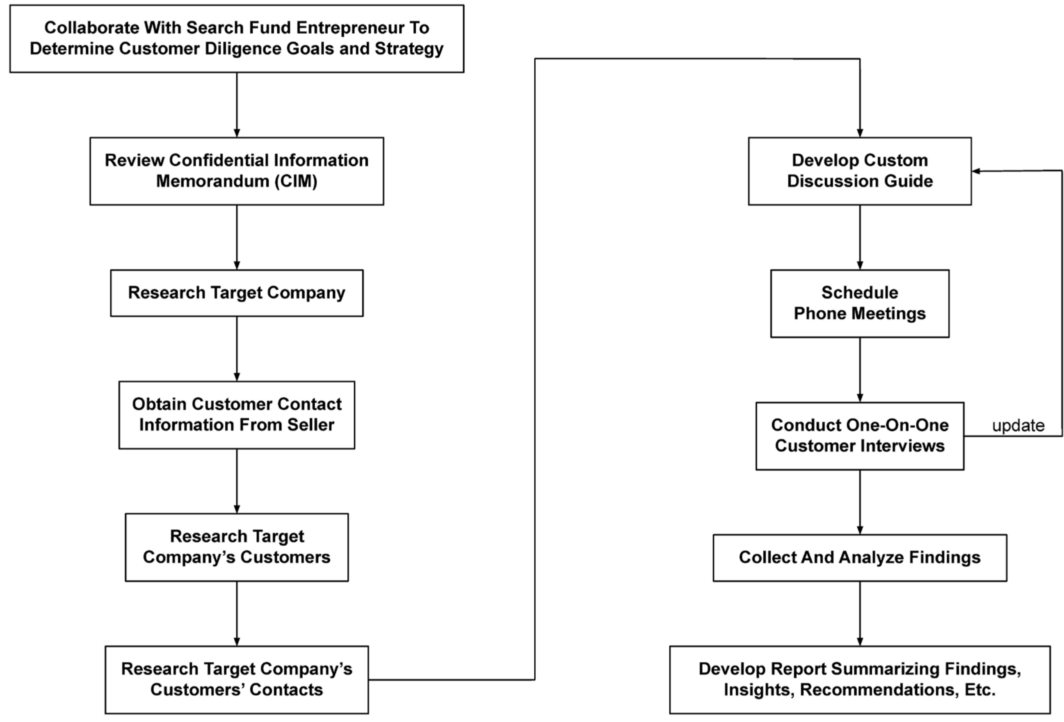

Exhibit 6: Illustrative Due Diligence Budget***

Diligence Area	Deliverable	Range
Financial	• Proof of cash and quality of earnings • Other	• $30,000 - $40,000 • $5,000 - $10,000
Legal	• Contract reviews and ad hoc questions or projects*	• $75,000 - $125,000
Commercial	• Database subscriptions** • River guide and expert calls	• $5,000 - $15,000 • $2,000 - $5,000
Customer	• Third-party customer survey/interview analysis	• $10,000 - $35,000
Technological	• Third-party technological survey/interview analysis	• $10,000 - $40,000
Other	• Travel	• Varies widely by owner location

Note: Deal size, historical revenue, business complexity, seller responsiveness, and accuracy of documents and filings will impact costs.

* Legal diligence does not include transaction services, including drafting of purchase and sale agreement, any ancillary agreements, and closing costs, which can be another cost of approximately $100,000 to $200,000 per deal.

**Indicates tools that come out of general search fund budget and do not need to be repurchased or reapplied to individual diligences.

Source: Prepared by case writers

*** Many service providers will defer fees until a deal closes. This prevents incurring costs for broken deals.

Exhibit 7: Additional Resources

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- The Search Project

Exhibit 8: Acknowledgements and Resources Consulted for this Case Note

The greatest characteristic of the search fund community is its collaborative and supportive nature. Investors, service providers, and current and former searchers are always willing to pay it forward. We would like to thank the following community leaders who helped us learn for this case note and from whom we hope you will be able to learn as well.

Name	Organization
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Larry Dunn	Endurance Search Partners
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Ivy Millman	WHIZDOM, Inc.
Sandro Mina	Relay Investments
Ronald Overson and Ryan Turbes	Boulay Group
Tony Pilnik and Chris Reese	PARC Partners
Steve Ressler	Self-employed Investor and Advisor
Jack Rong	Suncordy Pacific
Marcus Rush	Black River Growth Partners
Tarra Sharp	JHMacon Capital
Jan Simon	IESE Business School and Vonzeo Capital
Chris Smith	Spellbound
Michael Warady	EAI Water
Lacey Wismer	Hunter Search Capital
C. Robert Zelinger	Hinckley Allen

This case has been developed for pedagogical purposes. The case is not intended to furnish primary data, serve as an endorsement of the organization in question, or illustrate either effective or ineffective management techniques or strategies.

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Endnotes

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[2] A. J. Wasserstein is the Eugene F. Williams, Jr. Lecturer in the Practice of Management at the Yale School of Management.

[3] Dunn, Larry, and Richard Augustyn. "The Due Diligence Phase: More than Meets the Eye." NIP Investments, 22 Dec. 2016.

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[5] Divitkos, Steve. In the Trenches Podcast. Mineola Search Partners, 31 Mar. 2022, mineolasearchpartners.com/2022/03/31/quality-of-earnings-analysis-what-you-need-to-know-before-buying-a-business/. Accessed 11 Apr. 2022. Podcast.

[6] Ruback, Richard S., and Royce Yudkoff, pp. 219–221.

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