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Investment appraisal

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1. Introduction

This note outlines the questions to consider when appraising a business. You will find this helpful when you are looking at other businesses with view to investing in the business or buying it outright. You may find some of the questions appropriate to ask yourself if you are thinking of launching a new company in your target market. And you will find this helpful if you are yourself looking for investment because the financial institution will be asking many of these questions of your business.

Note that appraisal is not the same as 'due diligence'. An appraisal is what you do to decide whether there might be a business case to invest in or buy a business. Due diligence is generally used to cover the questions that you might ask later to ensure that the business is honest, legal decent and truthful. So in appraisal, you would not ask for evidence to support the answers that you are given but in due diligence, you will want to be sure that what you have been told is the truth, so will want more evidence.

These notes should be regarded simply as a starting point and not as a checklist. Remember also that you are assessing the entire proposition - the people are just as important as the plan, possibly more so, since they need the determination, knowledge and experience to make the business work according to plan.

2. The business plan

A business plan is a complete description of a business and its plans for the next 1-5 years. It explains what the business does; who buys the product or service (and who will buy a new product or who in a new market will buy the existing product) and why; and the finance available and the financial requirements.

Most people only write a business plan when they need to raise finance. However, the ideal business plan is like a road map - it defines the business's destination (that is, goals and strategic objectives) and the route to get there. Business plans should, therefore, ideally be revised at least annually, setting out revised targets and providing new sales targets and financial forecasts. If you are assessing another business, therefore, you will want to see their business plan. If they do not have an explicit plan, do they have an implicit plan? If so, ask as many questions as you need to be able to draw conclusions about its efficacy.

[1] This factsheet is based on material originally published by David Irwin on appraising business propositions.

The ideal business plan should be clear, concise and logical. The main part of a business plan normally requires no more than 8-10 pages though it may also require detailed appendices.

The business plan is any business's first piece of marketing so it is important that they get it right. For most businesses, it will be their main method of convincing prospective funders that the business proposal is viable and that the proprietor has the commitment and determination as well as the experience and, if necessary, qualifications to succeed. It is important to ensure that the content has been research carefully and that it is presented professionally.

A business plan should include a number of key sections:

- Summary – both of the business and the proposed project
- A description of the business
- A description of the market
- The proposed marketing plan
- The proposed organisation structure and way in which the business will be managed
- Financial history, if already in business
- Financial forecasts (ideally including a sensitivity analysis)
- Financial requirements
- Appendices

3. The appraisal

The ideal appraisal process will include an initial desktop appraisal – to identify any gaps for which additional information should be sought – followed by a personal interview which should, if possible, also look at the business's premises. Appraisal should seek answers to questions under each of the headings outlined below.

If you were preparing the report for a third party, such as an investment panel, you would expect to prepare a written report. Since you are doing this for yourself, that is less important, but it will help you to structure your appraisal if you do write everything down into a report. Banks and financial institutions have coined acronyms to remind themselves of the areas to evaluate. These include PARSER (Purpose, Amount, Ratios (or some say Repayment), Security, Expediency, Repayment (some say Remuneration)) and CAMPARI (Character, Ability, Margin, Purpose, Amount, Repayment, Insurance, that is, security). Venture capital funds generally look most closely at the people, the market, the intellectual property and the exit.

Although this factsheet is only intended to be a guideline you may, nevertheless, find it helpful to structure your assessment (and thus the content of the report) broadly as follows:

3.1 Level of assessment

Name of the business that is being assessed; a very brief description of what they do; who, if anyone, is providing them with business advice; who performed the appraisal; when the meeting took place; was the visit made to business; who was interviewed; how much money, in total, is being sought and how much from the fund for which the report has been prepared.

3.2 Nature of business

What does the business do? Name, address, telephone number of contact. Start up or expansion? When was the business established? Legal identity, shareholders and directors. Source of application and amount sought?

Is the applicant clear about what s/he proposes to do? What is the purpose of the business? Does the proprietor have clear goals? And an idea of how those goals might be achieved? Have the business's target customers been clearly defined? How does the business intend to position itself in the market-place?

3.3 Assessment of principals

Assessment of education, training, experience, competence, integrity, motivation and commitment of principals and other key staff. Do they have all round management skills (including, for example, marketing, finance, production, quality, people etc)? Age of principals? Family support? Does the business have professional advisers and does the business seem to respond to advice? Financial standing and commitment of individuals? Levels of achievement? Could the managers be described as leaders? Do they command respect? Do they delegate effectively? Obtain CVs if available.

3.4 Assessment of existing operation

Current operation

Description of main products or services. Is there an overall strategic plan? Does the business set and meet performance targets? Description of equipment, production capacity, utilisation and premises. Description of marketing strategy; marketing materials; key customers; market share; etc. Does the product have a competitive edge? Is there anything unique about the product or is it in a highly competitive, cost sensitive market? How well does the business market itself? Does the business operate TQM or comply with ISO9000? Are the health and safety regulations being met?

Present financial state

Last year's turnover? Is the business profitable? Is the net worth positive? Are the margins adequate? What about the trends? Ideally you will want to look at the figures for at least the last couple of years and for the current year. If they have forecasts, combine the figures into a single table. How many employees? Give a brief summary of the business's present financial position. How does this reflect the principal's ability? Is the business adequately capitalised? Does it have sufficient working capital? Has the product or service been properly costed? What is the break-even point? What is the margin of safety? Is the business registered for VAT? Is it up to date with its VAT and other tax payments? If possible, give an outline of current assets and current liabilities. Give the key ratios: gross profit margin, net profit margin, return on capital employed, current ratio, quick ratio, gearing interest cover, debtor days, creditor days, etc.

Does the business have a credit history with you? It may for example already be a customer and you may be used to giving it credit. How quickly does it pay?

Financial and other controls

Does the business produce budgets and management accounts? How often? Has it been possible to assess the adequacy of systems and controls within the business? Do the principals have sufficient financial acumen to keep adequate control of the business? Does the business have an effective credit control policy? What is the record of bad debts?

Does the business have an effective stock control policy? What is the stock turn? What is the level of dead stock?

Human resources

How many staff? Do the staff appear to be skilled, qualified and committed? Describe the personnel involved. Give brief curricula vitae for the key personnel. What particular strengths do these people bring? Strengths may include technical skills (such as joinery of sales experience), personal attitudes, (such as enthusiasm, energy, ability to work under pressure), education and specialist training undertaken.

If there are weaknesses, explain how these will be overcome (for example, by undertaking further training, by buying in staff, by sub-contracting, etc). Staff turnover, disciplinary problems or quality problems may give clues.

Is there a formal training policy? Is training ad hoc or on the job? Do all staff receive training? Is training a continuing process or just as the need arises?

For larger businesses it is helpful to provide an organisation chart.

3.5 Assessment of business proposal

Description of business proposal

If this was an assessment of a business for a third party, you would need to give a brief description of project. In the case where you are thinking of investing, you should instead set out the benefits conferred by the business being assessed and consider whether they are going to be a good match for your business. Describe what you will do together – and which business will take responsibility for what roles. Then consider whether the business being assessed will be able to deliver.

Product or service

Describe the product or service. What needs does the product fill in the target market? One way to answer this is to describe both the features of the product and, importantly, the benefits to the customer. Benefits might include ease of use, comfort, safety, flexibility, convenience, social status, taste, etc. What is its competitive edge? What is its unique selling point? Why is it preferable to products offered by competitors? Is it fully developed? What is its likely life cycle? Give details of patent, design registration or copyright if appropriate. Is it seasonal? How easily can the product be imitated? Can it be developed into a range of products or services? Are there follow-on products or services already in the pipeline? Statutory or other requirements?

3.6 Market research

Outline what research has been undertaken. What are the results of primary research (surveys, interviews, focus groups, test marketing, etc)? What has been found from secondary sources? It may be helpful to include the information in tables or graphs.

What is the overall size of the market? Give estimated demand in the short and long term and explain why this demand is expected?

What sales are forecast for the particular product(s) or service(s) covered by the business plan? Who are the target customers? Are there particular groups or market segments?

Business environment

How well does the business understand the wider environment in which it is operating? What are the driving forces and key trends in the environment which may affect the business. It may be worth doing a brief PEST (also known as STEP/STEEP) analysis looking at political, economic, environmental, social and technological factors.

Competitive analysis

How well do the principals know their industry (including customers, competitors, technology, trends etc)? What is the size of the market? Is it growing or contracting? What is the potential for the business? Who are the competitors? Has the business an established customer base? Is the business dependent on a few major customers or does it have a wide customer base? How realistic are the business's marketing plans? Price? Promotion? Competitive edge? Are there unexpected market opportunities or is the market already well served? Is there likely to be further competition in the future? What are the barriers to entry to this particular market?

3.7 Marketing plan

How will the product (and the business) be positioned in the marketplace; how will it be positioned against its competitors? Is the product a quality product targeted at a quality market (and therefore able to command a premium price)? Is the product a commodity – with nothing to choose between competitors except price? Marketing objectives should be quantifiable, measurable, challenging and achievable. You need to review the marketing plan because you are attempting to assess whether the sales targets are realistic and achievable. Remember that the profit will depend on achieving the targeted level of sales, so this is an important assessment.

Product

The product has already been defined. Set out plans for future development, say, over the next couple of years. Are there add-ons which are to be phased in? Will initial products be piloted to test the market? Will additional products be added to the range later?

What distinguishes the products from its competitors? Why will people buy this product rather than similar products from other businesses in the same field?

Price

The price charged needs at least to cover the costs plus provide a profit margin. Will the market stand the proposed price? Will the price be varied in order to gain a foothold in the market?

Place

How will the product or service be sold to customers - directly or via dealers or agents (such as wholesalers or retailers)? Location may also be important. How will items be transported to point of sale? Can the business be reached conveniently?

Promotion

How will customers be told about the product? How will the business break into the market?

3.8 Financial projections

You will need to review financial forecasts for the business, even if the assumption is that everything will simply continue as it is at the moment. How realistic are the business's projections, particularly in relation to its recent history and its plans and assumptions? Are the forecasts for income and expenditure realistic? Are the sales figures aspirational? In my experience, far too many businesses inflate their sales projection in the mistaken belief that this will help them to raise more investment. Do not be afraid to question aspirational targets and forecasts. Ask for evidence to support the assertions.

Look at the expenses carefully. Do they seem legitimate? Are there unexplained costs? Look, too, at commitments that might not be immediately obvious from the forecasts – for example, lease payments, mortgage payments, and especially deferred loans where the business is not yet repaying the capital – all of which will affect the cash requirements.

Has the product or service been properly costed? Do changes in levels of stock, debtors and creditors appear reasonable? Are items such as capital expenditure and grants shown in the correct period? Do the budgeted profit & loss account and balance sheet reconcile with the cash flow forecast? How will debtors be financed? What is the working capital requirement?

Price should relate back to the market research. Businesses need to charge a price which will cover their costs and generate a reasonable profit. However, the price should be the maximum amount that people will pay for the product or service. Maximising profit does not necessarily mean selling high volumes at low profit. It may be possible to sell low volumes at high profit.

Does the cash flow projection demonstrate sufficient cash coming back into the business to repay the loans sought?

Profitability, margins and financial control

How profitable will the project be? Are there any off-balance sheet liabilities? Are there high levels of goodwill or capitalised development costs? What is the implication of writing these down to zero? What returns to shareholders are expected? What is the sensitivity to changes in sales or in costs?

It will help to undertake some basic ratio analysis and to provide forecasts of ratios such as

- gross profit margin
- net profit margin
- gearing
- interest cover
- return on capital employed
- current ratio (or quick ratio if business has high stock level)
- average collection period
- average payment period

Risk

How well does the organisation manage risk and return? Has the business been realistic in assessing the critical factors in its projections? Has the business contingency plans? Is there security available? Are each of the principal disciplines (that is, production, marketing and finance) adequately covered? Do the principals really know and understand the business and their proposal? Do the principals 'own' the plan? Are they totally committed to it? Have they written the plan themselves? Or has it been done for them? In short, how likely is that our investment will be repaid?

3.9 Financial requirements

How much will the project cost? Not just in terms of your immediate investment but in further investment and support as well. Capital costs? Additional working capital? Are the requirements realistic? Is the business eligible for specific types of finance, such as government grant? Are there government incentives to encourage investment, including grants and tax breaks? What difference do they make? Is there likely to be an additional requirement for finance at a later date? (Split long term, medium term and short term financial requirements.)

3.10 Economic benefits

Job creation? New industrial theme? Area of high need? Long term potential for growth? Economic impact - will it help others? Is it job substitution? If you are creating jobs, will this unlock government incentives?

3.11 Conclusion

Summarise the strengths and weaknesses of the proposition. Give an overall assessment of whether the business is likely to achieve its projections. Is it possible to recommend specific assistance to improve chances of success? Risk/reward ratio?

4. Financial returns

If all of the above is positive, then the next step is to decide whether to invest and, if so, how much. Clearly the level of investment has to be high enough to enable the venture, whether now jointly owned or perhaps wholly owned by you, to progress and grow. However, you also need to assess the likely return that you will make on your investment. If it is not high enough, then it is not worth doing. Larger firms have specific thresholds and will not invest if they do not believe that they can achieve the threshold. A rule of thumb, if you do not have a threshold, is that the return should be above the level of return that you would get if your money was invested elsewhere, and indeed should be enough above it to reflect the risk. It is easy to calculate the 'internal rate of return' and thus come to a decision (see the PROFIT factsheet *Internal rate of return*).

5. Conclusion

You should approach the assessment of a target business in much the same way that you would approach an assessment of a business if you were considering them for an investment from a third party. Indeed, you might be even tougher since it is your money that you are risking. But if you adopt a systematic approach and ask all the questions, you will quickly be able to come to a decision. If you are not sure about some of the answers, feel free to discuss them with your mentor. Think carefully about the level of return that you seek and whether that is likely to be achieved. But also think about how you will manage your investment, which essentially is a question about how your will manage the investee business and how you will manage your relationship with it.

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