Indigenous Business Toolkit Project

Investment Decision Process

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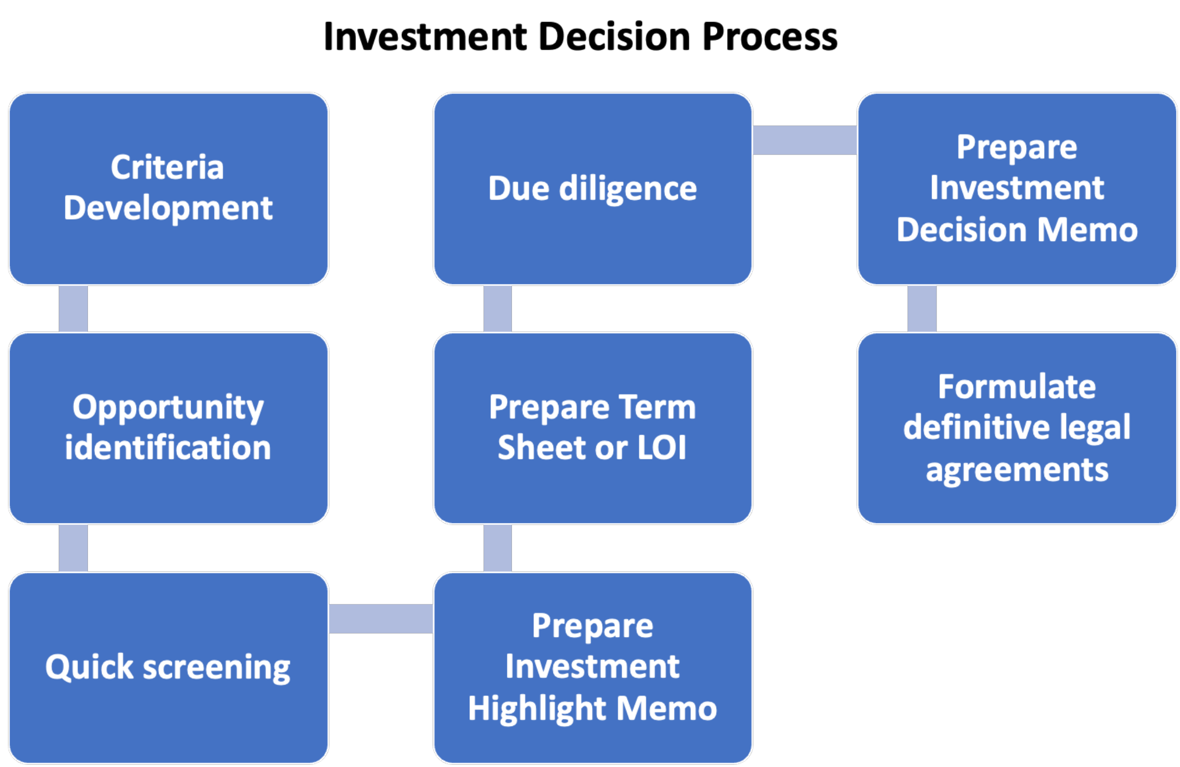
Summary

This module is designed to help senior managers make informed decisions about business investments by laying out a step-by-step process for evaluating potential opportunities. The information in this module may also be useful to board members. Although board members do not need to know the details of each step, they should understand the process so they can ask the right questions and make knowledgeable decisions.

This module provides a structured process for Indigenous businesses to make informed investment decisions. The process includes the following steps: criteria development (e.g., financial viability, management, growth potential, strategic fit, and community benefits); opportunity identification; quick screening; preparation of an Investment Highlight Memo; preparation of a Term Sheet or LOI; due diligence; preparation of an Investment Decision Memo; and the formulation of definitive legal agreements.



Steps in the Investment Decision Process

Businesses must invest, whether it is to maintain operations or to expand into new areas – otherwise they have no purpose. Making sound investment decisions is critical. If the price paid is too high or if the investment is not sound, the investment is unlikely to be profitable. The best way to make good investment decisions is to follow a structured process such as the one detailed below.

1. Criteria Development – The first step is to decide on the criteria that will be used to judge and evaluate the investment opportunity. The criteria chosen should be developed in a strategic planning session and should be consistent with the objectives of the business – e.g., is the primary purpose of the business to provide community services, to community benefits, or to create wealth.[1] Moreover, it is important to limit the criteria to no more than five. While each business will use different criteria, there are some common ones:

    a. Financial Returns – How important is profitability? If the goal of the business is to provide community services, then maximum profitability will be less important than if the goal of the business is to create wealth. Are profits needed immediately or can they be delayed? If the former, it is important to look at existing businesses with strong prospects; if the latter, start-ups and greenfield investments might be considered.

    b. Management – Management capability is one of the most important factors in any business. Thus, it is important to determine who will manage the investment once it is made. If the investment is in an existing business, will the current manager stay? Or will the manager need to be replaced, either because they are leaving or because a change in direction is needed? If a new manager is required or if the investment is in a new business, a plan will need to be developed for identifying and selecting a new manager.

    c. Growth – What are the prospects for growth and increased sales over time? If an existing business is being purchased, will new ownership mean access to new customers, greater sales, and larger profits? While the potential for increased profits is highly advantageous, it is important not to build the expectation for higher profits into the offer price that is made.

    d. Fit – Does the investment fit with the business's goals and values – i.e., investment mandate or purpose, cultural values, community goals, sustainability, and long-term benefits?

    e. Exit Strategy – While it may seem strange to think about an exit plan before an investment is even made, it is important to know how easy it would be to sell the investment in the future. The more difficult it is to divest, the greater is the risk that businesses will be stuck with poor investments that take up valuable management time and do not produce adequate returns.

f. Employment and Community Benefits – This criterion, which is a concern for many Indigenous businesses, focuses on the employment opportunities available for community members and the potential benefits that these opportunities may bring to the community.

2. Opportunity Identification – Investment opportunities can arise from various sources: existing businesses may indicate they are willing to be purchased; other businesses may desire a partner; and new ideas or opportunities may be presented by management or community members. Managing these opportunities can be challenging, especially if many present themselves at the same time. Most opportunities do not align with the Indigenous business's objectives or capabilities. In fact, up to 25 different investment opportunities may need to be evaluated before one is chosen. Thus, it's crucial that a systematic process to differentiate between promising and less promising opportunities is established.

3. Quick Screen – While it is critical that business opportunities undergo a rigourous examination, doing so is a very costly task, regardless of whether the evaluation is done internally by staff or externally by consultants. To manage these costs, it is important to develop a streamlined process for evaluating and assessing opportunities. The first part of this process, often referred to as the "smell test," is a rapid screening method to determine whether an investment opportunity warrants further exploration. The "smell test" helps in quickly answering the key question: Is pursuing this opportunity worth the additional time and resources it will take to do a full evaluation? An example of this quick test can be found in the Quick Screen Checklist in the Appendix.

4. Investment Highlight Memo – If an investment opportunity passes the quick screen test, the next step is to prepare an Investment Highlight Memo. This Memo is more involved that the quick screen test; however, it does not involve full due diligence. The Investment Highlight Memo should include the following:

    a. Company Description – A brief description of the investment in a paragraph or two. If the investment is a company, what product or service does the company sell, where is it located, approximate size, and why is it of interest?

    b. Sources and Uses of Capital – If the price has been finalized and negotiated, it is important to include how the transaction will be financed. Where will the capital come from? How much equity does the investment require? How much debt? How will that capital be utilized? How much will be utilized in the purchase price, for capital investments, and working capital? If the price is not negotiated until later in the process, this information should be included in the Investment Decision Memorandum (Step 7).

c. Management Team – The Investment Highlight Memo should include a brief description of the management team and their backgrounds. It is important for the board to know that competent managers are available to oversee the investment or run the new business.

d. Financial Projections – What are the financial projections for the next five years? Will the investment be able to support its capital structure – i.e., will the investment make enough money to operate profitably, support debt repayment, and fulfill growth plans?

e. Recommendation – Based on the information in the Investment Highlight Memo, management makes a recommendation to the board of directors either to abandon the opportunity or to proceed to the next step. If the recommendation is to proceed, it is important to realize that the next steps in the process will be very time consuming and costly.

5. Term Sheet or Letter of Intent (LOI) – The Term Sheet or Letter of Intent (LOI) serves as a foundational document outlining the main points of agreement for a potential transaction between an investor and an investee. The Term Sheet/LOI specifies the terms under which both parties agree to move forward. The Term Sheet/LOI is not a comprehensive legal document; instead, it is a framework or blueprint that encapsulates the essence of the transaction. The Term Sheet/LOI is usually negotiated by the managers involved and drafted by legal counsel. It provides a roadmap for successfully completing the transaction.

6. Due Diligence – Due diligence in investment opportunity analysis is a process of independently verifying information, with the depth of analysis varying according to the importance of the information being considered. For instance, the due diligence would be more extensive for a major supply contract that constitutes a significant portion of sales than for confirming more minor expenses such as office expenses. An Investment Manager, skilled in due diligence, is tasked with conducting this analysis. It is important that board members understand the products of the due diligence process even if they may not have the knowledge and skills to do the due diligence themselves.

   Beware of the temptation not to do the due diligence – it is never too much work. Doing proper due diligence can save considerable pain and trouble if the claims of the seller are incorrect. Indeed, proceeding with a poor investment decision is so painful that it needs to be avoided at all costs. A thorough due diligence process is the best protection against those who promote a business and make wild claims about benefits that are unsubstantiated. There are still “snake oil” salespeople who wish to take advantage of less informed buyers.

7. Investment Decision Memo – The Investment Decision Memo is management's recommendation to the board of directors. The Memo is a critical and detailed document that encapsulates the core findings of the due diligence process, and it plays a pivotal role in informing the board's ultimate decision on whether to proceed with an investment. It is only after the board has considered the recommendation in the Memo and made a decision that the transaction can move forward to closure and the subsequent release of funds. A copy of a sample Investment Decision Memo is included in the Appendix.

8. Definitive Legal Agreements – Definitive legal agreements in a business transaction are formally executed contracts that outline the final terms and conditions agreed upon by all parties involved in the transaction. These agreements serve as the binding documents that govern the relationship between the parties and the execution of the transaction. These agreements are developed after negotiations and due diligence have been completed and often build on preliminary documents such as letters of intent (LOIs) or term sheets, which are non-binding. Definitive legal agreements are legally enforceable and typically require the parties to undertake certain actions or refrain from certain actions. They also include provisions for handling disputes, breaches, and remedies. It is crucial for these documents to be carefully drafted, often with the assistance of legal counsel, to ensure clarity, compliance with applicable laws, and protection of all parties' interests. Given the time and cost associated with negotiating and drafting these agreements, this step is only undertaken when the parties are sure that a transaction will proceed.

9. Implementation – Once the legal agreements have been signed and all conditions met, the deal is now complete. The final step in the process is to implement the opportunity and to go about carrying out the business.

Conclusion

This module provides a structured process for Indigenous businesses to make informed investment decisions. The process includes the following steps: criteria development (e.g., financial viability, management, growth potential, strategic fit, and community benefits); opportunity identification; quick screening; preparation of an Investment Highlight Memo; preparation of a Term Sheet or LOI; due diligence; preparation of an Investment Decision Memo; and the formulation of definitive legal agreements.

While the entire process can be intimidating, it should not be overlooked or skimped on. The more the process is used, the better it will become and the greater is the likelihood of successful business investment decisions.

Resources

Bachiu, V., M.E. Fulton, and K. Jackson. 2024. *Economic Development Corporations*. Indigenous Business Toolkit Project. Johnson Shoyama Graduate School of Public Policy, University of

Saskatchewan. https://www.schoolofpublicpolicy.sk.ca/research-ideas/projects-and-labs/indigenous-leadership-governance-and-development-project.php.

Endnotes

[1] For a discussion of these three business purposes, see Bachiu, Fulton, and Jackson (2024) *Economic Development Corporations*.

Indigenous Business Toolkit Project

The Indigenous Business Toolkit Project is designed to provide Indigenous communities and individuals with the practical tools they and their advisors can use to undertake successful economic development. Indigenous economic development is more successful when everyone – community members, community leaders, consultants, business professionals, employees, and/or potential partners – understands its many aspects.

The Toolkit provides step-by-step instructions on selected aspects of economic development based on the best practices of leaders in the field. The modules in the Toolkit cover everything from the role of economic development in nation building, to the importance of business charters, to the various legal forms that can be used to pursue economic development, to the steps needed to identify and negotiate beneficial partnerships, to the governance challenges that economic development must address.

The modules are available for free and for use by anyone. The full set of Toolkit modules can be found at: https://www.schoolofpublicpolicy.sk.ca/research-ideas/projects-and-labs/indigenous-leadership-governance-and-development-project.php.

The Indigenous Business Toolkit Project is part of the larger Indigenous Leadership: Governance and Development project designed to support long-term Indigenous economic development. In addition to the toolkit, the larger project involves capturing the economic development experience of Saskatchewan Indigenous communities through a series of case studies. The case studies, along with a description of the larger project, can be found at the website listed above.

Disclaimer

The information contained in this document is designed to provide an overview of a particular topic and should not replace legal and other expert advice. Groups wishing to use the concepts discussed should receive the appropriate professional advice necessary to ensure their specific goals and circumstances are considered and recognized.

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