

# Commercial Red Flag Due Diligences in Service Industries – A Structured, Hypothesis-Driven Approach

## 1. Context and Objectives of Commercial Red Flag Due Diligences

A Red Flag Due Diligence is a deliberately lean and focused review conducted between a first indicative offer and a confirmatory (still non-binding) offer. In many cases its focus is on commercial topics and ends up in a validated buyer business case. The target of the buyer is to limit external costs for advisors before getting more comfort on the attractiveness of the target. It's the basis for a board / investment committee approval to continue, limiting the risk to abandon the deal at a later stage with higher external costs.

Red Flag Due Diligences focus on key risks, testing critical assumptions and identifying potential deal breakers. Based on its findings, a confirmatory offer is derived, which confirms, modifies or, in the case of material deviations, rejects the NBO. The following figure depicts the positioning of a Red Flag Due Diligence within the overall M&A process.

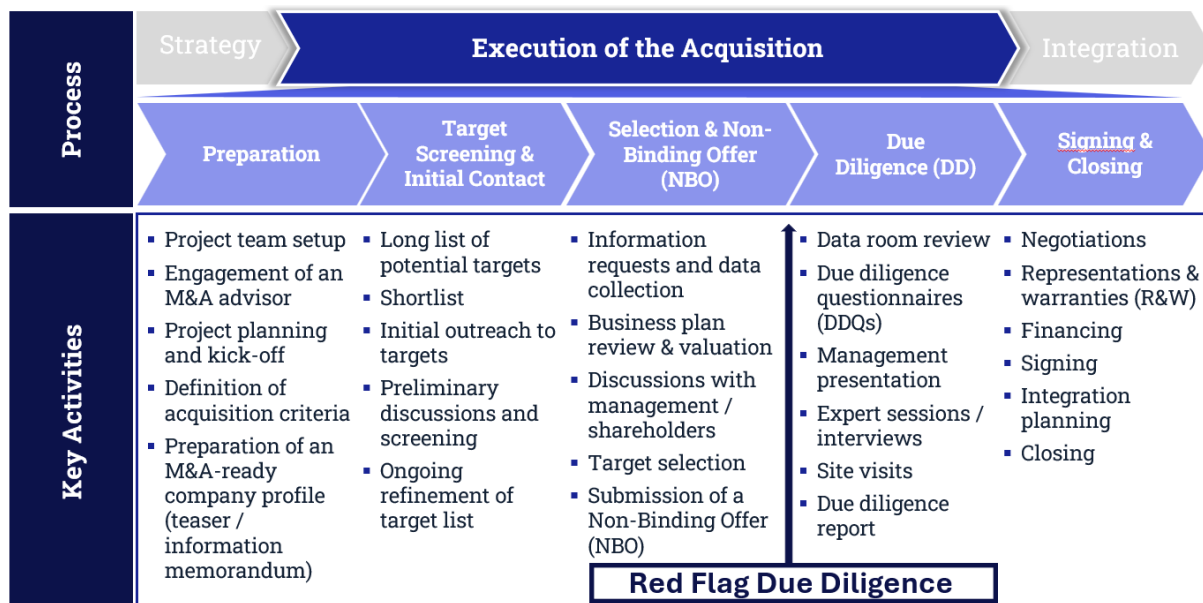


Figure 1: Positioning of Red Flag Due Diligences in the M&A Process (based on Axel Steuernagel, Mergers & Acquisitions im Mittelstand, Gabler Springer 2025)

In contrast to a comprehensive Commercial Due Diligence, a Red Flag Commercial Due Diligence is a focused, hypothesis-driven review. Within a very short period, key risk areas and focus topics are selectively assessed based on limited available information (e.g., data room materials, business plans, strategy documents, and market analyses). It does not constitute a bankable review but serves as a decision-making tool. It is particularly relevant service industries, where key value drivers lie less in tangible assets and more in customer trust, availability of personnel, process excellence and organizational scalability.

Often investors decide to do in parallel commercial and financial red flag reviews. Legal and tax are at maximum light at this stage. In this article, the focus is on commercial.



## 2. Key Analysis Areas in Service Industries

In a Red Flag Due Diligence in service industries, the following **nine elements** are frequently considered, as they capture the key areas for assessing the robustness of the business model and the underlying Business Case.

Typical Elements of Commercial Red Flag DDs in Service Industries		
1 Long-term Market Development	2 Competitive Positioning	3 Regulatory Environment
4 Digital Assessment	5 Management Capabilities and Motivations	6 Customers and Sales
7 Cost Efficiency of Operations	8 Potential Synergies and Organizational Setup	9 Impact on Financial Business Case

Figure 2: Typical Elements of Commercial Red Flag Due Diligences in Service Industries

- (1) The starting point of a Red Flag DD can be the assessment of the **Long-term Market Development** in the relevant customer segments. Common sense tells that a company focused on automotive clients faces fundamentally different prospects than one exposed to infrastructure, defence, medical devices or new energy related markets. But within these industries there are clear differences between various niche segments. This part of the analysis compiles relevant market studies and expert interviews on target markets, challenging the underlying seller business case assumptions which usually tend to be too optimistic. Red flags are market segments with long-term low growth dynamics. Financial investors tend to extend their analysis beyond the immediate 5 years investment period, as market dynamics need to have a positive outlook at the point of potentially reselling the company.
- (2) **Competitive Positioning** determines how effectively the company can capture market opportunities. The focus lies on service differentiation and pricing as well as the resulting development of market share. In practice, the Business Case is typically derived top-down, linking market growth with market share assumptions across relevant sub-segments. In due diligence work the assessment of a competitive positioning and market share development shall be based on expert interviews, challenging the seller case assumptions. Aside of existing local competitors it needs

to take into consideration market entry barriers towards international competitors and the probability of new entrants.

- (3) An in-depth understanding of the dynamics of the **Regulatory Environment** clearly overlaps and has a strong impact on the previous two parts. In many cases due diligence teams tend to define it as an extra red flag area with experts who are familiar with processes within policy making and relevant governmental institutions. Examples of industries with exceptional importance of the regulatory environment include service industries related to infrastructure, defence, energy and education.
- (4) A **Digital Assessment** covers two different points **a)** the exposure of the business model to substitution by AI and **b)** the current digital readiness of the company.
  - a)** In many cases **service business models are endangered by AI**. The authors have assisted clients in various industries where this question was the breaking point. A private equity firm decided not to invest into a customer service business, considering the declining share prices of incumbents due to new AI features. We could help our client on the sell-side to develop a strategy to cope with this challenge. A family-owned corporate was able to reduce significantly the price for an M&A investment in education services, arguing that one business line did not have any significant value due to a high degree of AI substitution. In some industries the question is of lower importance. Niche industries with a high degree of complexity tend to be more resilient. So are logistic sectors. Also, companies operating in B2G environments are less endangered by AI substitution. Public institutions demand human interaction.
  - b)** Aside of this, a structured **digital readiness check** is needed. A too low degree of digital readiness could become a “red flag”. This usually includes the following five factors: Digital Strategy & Digital Capabilities in Management, Digitally Based Delivery Process Excellence, Digital Sales Tools (CRM), Digital Culture and Team Capacities, Digital Innovation. In Red Flag DDs these points are tested along various sub-questions in the management and expert team sessions as well as an assessment of the existing digital tools by experts.
- (5) The ability to execute the business case depends on **Management Capabilities and Motivation**. In service industries, performance is often closely tied to individuals. It is therefore critical to assess both the first and second management levels, the talent base and the degree of independence from founders or key individuals. Assessment is a side product of management and expert meetings. A red flag could be a strong dependence on founders combined with their aspiration to exit quickly and a lack of alternative internal or external management resources. Another one could be the lack of willingness of core management to realize synergies after the take-over.
- (6) A major area in the commercial red flag due diligence is the **Customer & Sales Assessment** to identify short-, mid- and long-term revenue risks in the business case. The customer base must be assessed, identifying risks to lose business with existing customers as well as gaining new business. Concentration risks, contract structures,

pricing mechanisms and the balance between new and existing business are considered. In case of an acquisition by a peer company, a specific topic is the analysis of the risks to lose customers after the take-over. Sources of information are on one side aggregated customer data, management reports and information memorandum (if existent). On the other side, selected expert interviews with sales management helps to better understand current challenges. These interviews have the side-effect to assess the strength of the sales team in terms of talents, processes and tools which is the basis for later PMI efforts.

- (7) Whether the business case is operationally achievable and the cost base is calculated in a solid way, is reflected in an assessment of the **Cost Efficiency of Operations**. In service businesses the focus lies on how efficiently resources are deployed, how standardized and repeatable processes are, and to what extent operations are supported by systems and data. Relevant indicators include utilization, staff turnover, service quality and project margins, which typically provide a more reliable view than aggregated financial figures. On the cost side, personnel expenses dominate, with wage inflation and talent shortages directly impacting margins. The key question is about underlying risks and whether cost efficiency of operations can be improved through process improvements in case of a take-over.
- (8) In case the acquiring company operates in the same business, **Potential Synergies and Organizational Setup** must be assessed, preparing a future Post Merger Integration (PMI) process. Revenue synergies are usually focused on cross-selling opportunities between units which shall be merged. The challenge of the due diligence team is to question them, in particular considering ease of implementation. Cost synergies are more tangible but depend on the willingness for effective integration. In service industries, integrating back-office functions (finance, accounting, HR) are the most evident first steps. Also, the integration of IT systems is necessary.

Back-end integration usually takes longer than planned. This is particularly the case in cross-border deals where legal, HR and other practices differ. Therefore, conservative assumptions need to be taken, including provisions for initial investments (severances, IT investments, consultants). Integration of customer facing units (sales, marketing, delivery) need to be carefully discussed, more from a revenue than a cost perspective. Experience tells that the future organizational design, a joint management team and a joint brand are the most delicate areas which should be envisioned with care.

- (9) The previous eight elements need to be quantified determining the impact on the **Financial Business Case**. Revenue and cost projections by the seller are adjusted according to the insights gained on market development, competitive positioning, regulatory risks, AI robustness of the model, risks and opportunities in sales and operations and synergies. At this stage the commercial DD team needs to work closely with its financial counterpart.

### 3. Process of Commercial Red Flag Due Diligences

The Red Flag Due Diligence process in the service sector follows a clear structure. The following **three steps** reflect the process illustrated in the figure and describes how the Red Flag Due Diligence is conducted from the core investment hypotheses to the final red flag report.

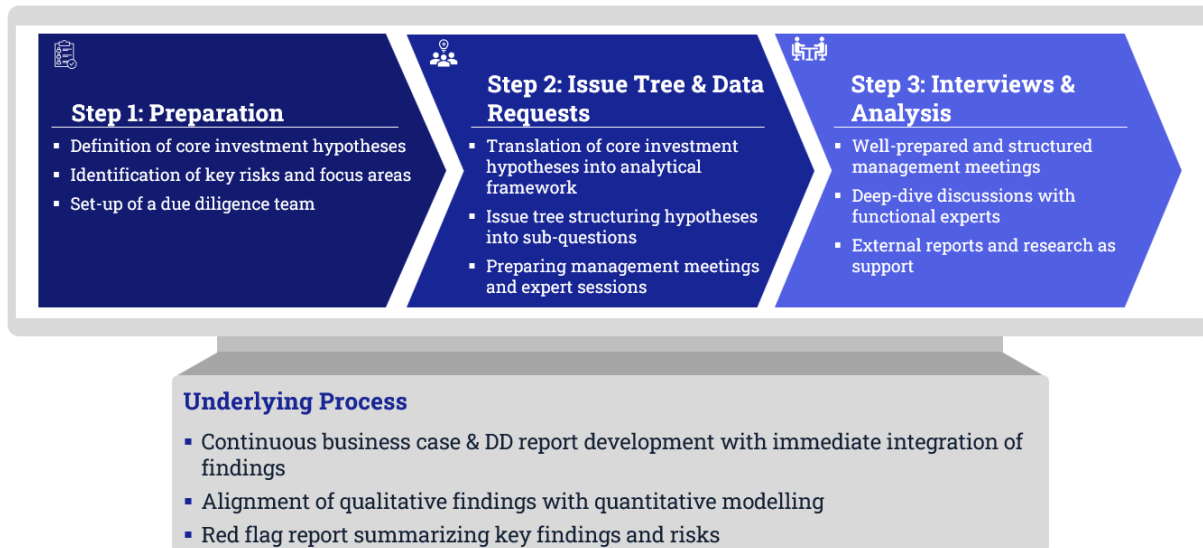


Figure 3: Hypothesis-Driven Commercial Red Flag Due Diligence Process

**Step 1: Preparation** starts with the definition of core investment hypotheses and the identification of key risks and focus areas with concrete hypotheses for potential red flags. For this purpose, the above-mentioned 9-area-framework can be taken as a basis. A due diligence team is set-up. It consists of an overall project manager who develops a project plan, makes sure that the timetable is kept, the data room constantly examined, questions delivered to the seller and properly answered, meetings arranged and prepared and the buyer business case regularly updated. The project manager is also responsible for a final report leading to a proposal for an evaluation and an assessment of the initial potential red flags. For each of the defined focus areas there needs to be at least one expert with the task to develop questions, assess data and conduct interviews. In case the acquiring entity has a similar business model (strategic buyer, “platform” portfolio company owned by Private Equity) the expert is an internal one. Ideally, he is supported by an external advisor. A steering committee is set-up, consisting of the CEO, the CFO and (in case PE-owned) an investment manager of the investors, getting regular feedback on progress. Here the coordination with the financial due diligence team takes place.

**Step 2: Issue Tree & Data Requests** translates the core investment hypotheses into a structured analytical framework, using the defined key risk areas and focus topics as the starting point. Based on this, an issue tree is developed, which breaks the hypotheses down into clear and manageable sub-questions. Each question is directly linked to the underlying hypotheses and allows for a targeted validation through analysis. Those sub-questions then form the basis for focused data requests, ensuring that information is gathered in a structured and efficient way. At the same time, management meetings and

expert sessions are prepared along the defined focus topics, allowing targeted and well-structured discussions.

**Step 3: Interviews & Analysis** are the core of the commercial red flag due diligence. Well-prepared and structured management meetings focus on core questions and serve to judge management capabilities and motivation. These are complemented by deep-dive discussions with functional experts, providing fact-based insights into the defined focus areas (e.g., market development operations, sales, digital, financial). Usually, due diligence teams lead interviews with external experts to get non-biased insights into market developments, positioning of the company, regulatory and business model risks. External reports and research supplement these views.

**Underlying Process:** In parallel, a continuous business case and DD report development ensures that all findings are immediately translated into the financial business case. This requires a consistent alignment of qualitative findings with quantitative modelling. A red flag report highlights key risks, deviations from the initial assumptions and potential deal breakers, and shows what this means for valuation.

#### 4. External Support for a Red Flag Due Diligence

The quality of a Commercial Red Flag Due Diligence depends less on the amount of data than on a clearly structured and prioritized approach. A high-quality M&A advisory firm assumes a project management role in this process, together with a team member of the acquiring company. This team is always on top of the core questions and the process. It makes sure that insights are transferred into the financial business case and finally into a report. It ensures adequate external and internal advice in the relevant areas.

In case of smaller transactions, the investor sometimes decides to operate commercial red flag due diligences only with internal resources and the M&A advisory firm. The firm who takes care of the financial DD is usually already integrated at this stage, like the company lawyer. In case of larger or more complex investments, it is advisable to engage the firm who will take over the bankable commercial due diligence already for the red flag due diligence. This can be done at a limited budget. In this case the M&A advisor keeps his project management role, challenging and coordinating the other advisors.

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