Manager (General Partner/Sponsor) Due Diligence Challenges

Some of my recent writings have discussed what can destroy or disrupt relationship-building momentum between general partners (GPs) and limited partners (LPs), as well as what typically populates the "Concerns" section of LP due diligence reports. These topics garnered a lot of feedback because of their voyeuristic qualities. A key takeaway from the feedback was the recognition that asymmetric information propagates in both directions (from GPs to LPs and vice versa). A common investing sentiment in investor/LP circles is “we will never know what really goes on internally within that asset manager”. Well, I am coming to the realization that GPs also don’t know what really goes on within allocator organizations. Unsurprisingly, hearsay is rampant on both sides, and the flow and clarity of information always seems to have a tinge of murkiness. Anything that involves a group of humans working (hopefully) towards a common goal can never be all the way simple. Every endeavor will likely be complicated by some mix of emotions, biases, bureaucracy, processes, and sometimes, bad actors.

Pre-commitment, investors try to inoculate against misinformation, disinformation and bad human behavior by conducting thorough due diligence. Here, I am talking about the real due diligence that occurs post the initial funnel and vetting stage. At this point, a worthy target has been identified and sleeves have been rolled, pencils have been sharpened, and the intellectual snorkels have been donned in preparation for a deep dive. This is usually a positive signal to the chosen GP because it means the manager has exhibited enough initial positive qualities to garner further focused attention. There are, however, certain actions by GPs at this critical time that make the prospective LP's pursuit more difficult rather than easier. I list a few of these hindrances below.

- **Being rushed – tick-tock, tick-tock, tick-tock…..**: Some GPs choose to use an LP’s indication of a deeper dive to start a psychological squeeze. This usually takes the form of an amplified stressing of imminent fundraising timelines together with direct or subliminal highlighting of other LPs (usually writing bigger checks) who have hard- or soft-circled commitments. Of course, this is always done under the innocent (and may be truthful) guise of transparency, but it is always apparent that the goal is to speed things up. Depending on how early a GP chooses to apply such pressure, LPs who adhere to a disciplined approach to due diligence can get turned off by being rushed. While most investors do have the power to speed up things when deemed necessary, given the variety of investment options available in today’s market, exertion of this type of pressure can easily backfire.

- **Drowning the investor in a large pool of unorganized information**: Since transparency is always a huge talking point between LPs and GPs, some GPs have resorted to a “kitchen sink” approach when asked for information. Although I do not have an issue with this per se, this information is often unorganized and places the burden of finding what is important 100% on the prospective LP. It is a way to say, “I am not hiding anything because I gave you access to 1000 documents in the data room”. From an LP’s perspective it always feels like the manager is slyly saying “if it is information you want then it is information you shall get”. In truth, LPs should know what they want, or what they are looking to verify during due diligence, but I also know firsthand that important details can be hidden in vast swaths of data. In my opinion, being overwhelmed with unorganized information is even more annoying than being drip-fed information. GPs should be aware that prospective investors may see this as an orange or red flag and walk away to preserve their sanity.

- **Competitor paranoia**: To ensure thoroughness of selection, prospective investors typically evaluate the competitive landscape of a target when conducting deep due diligence on it. The majority of GPs are aware of this step of due diligence from questions posed by prospective LPs or from knowledge of common procedures. Some of these GPs choose to go super offensive or super defensive about their competitors. It is a bad look either way. I fully believe that competition can bring out the best in people, but I have come to realize that the opposite is also true. I have heard some of the vilest, most self-deprecating and most undermining things from some GPs immediately competitors are brought up. Though I am not asking for kumbaya kind words across the board, statements like "our track record speaks for itself" or "ask our investors who have exposure to our competitors' funds what they think" exude confidence and civility, which goes a long way when you're trying to convince someone to lock up capital with you for a long time.

- **Out of focus full picture or incomplete mosaic**: I am yet to come across an investor with absolute seer powers. Due diligence is really an attempt to confirm "known knowns", acknowledge that "known unknowns" exist, be creative/imaginative with the "unknown knowns" and surrender to the "unknown unknowns". A key objective of due diligence is to gain a comprehensive understanding of how a GP runs its business and the individuals (and things) responsible for creating its secret sauce. In many instances, GPs will say something like "we are a well oiled machine" or "value is created on a case by case basis". This is not sufficient. The challenge of describing singularity clearly and succinctly is understandable, but all GPs must hone a narrative that demonstrates the power of their mix of people, processes, and data. If you cant tell me what your superpower is, just be aware that I cannot make it up.

- **Data portrayal**: Due diligence may encounter some information that GPs provide that can be defended as "not untruthful", but still walks a fine line between "truth" and "deceit". Footnotes, endnotes and "available upon request" statements can make everything seem above board, but as these start to stack up, a prospective investor's feet can dip in temperature. Adjusted EBITDAs (that can affect portrayed entry multiples), projected versus disposition value, pre- and post-money value description preferences per deal, synthetic track records, etc. all tell useful stories. However, when too many things in a GP's resume don't seem clear cut, seeds of doubt start to sprout during every conversation and within every provided/reviewed document.

- **Transparency**: No due diligence list is complete without a cry for utmost transparency. All the previous bullets touch on this in some manner, but "transparency" always deserves its own shout out. GPs committed to ongoing transparency will eventually find that nothing needs to be forced - their tribe will find them and stick by them.

GPs need to know and feel comforted that LPs will invest regardless of neatness or perfection. Nothing is ever all good. Life has already taught us that risks exist with every decision. A prospective LP's due diligence process can be greatly facilitated by GPs who do not rush them, bog them down with unnecessary noise, callously decapitate competitors, distort narratives, or self-servingly tweak datapoints.

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