LP/GP Horror Stories, Meltdowns and Crash Outs

All allocators who have been playing this GP due diligence game for a while have a memory bank of legendary stories that can be booted up at the drop of a dime. These stories (without divulging actual names, of course) are usually reserved for “you would not believe what happened today” conversations with spouses, enticing junior colleagues with mind-blowing OG lore they could one day themselves experience, LP to LP industry gossip, and clutch mood enhancers for the occasional slow news day research meeting. The most fabled stories tend to be the most extreme, as their deviation from the norm indelibly etches them into neural pathways. Despite the sensational nature of these extreme events, their buildup was innocuous, highlighting how quickly things can escalate from seemingly innocent beginnings.

Below, I present three real-life examples of strange encounters with GPs as cautionary tales for investment managers to avoid or guard against.

- **The inability to endure a thesis challenge**: This was quite an unusual one, to say the least. It was a meeting with a sector-focused real estate manager who had invested in a specific non-traditional sector (one outside of office, residential, industrial, and retail) for a very long time. The meeting commenced with the customary chest beating of the GP, proclaiming how the organization was uniquely qualified to invest and generate substantial returns in its selected sector. It was unmistakably evident in the opening minutes of the meeting that this individual viewed himself as the leading authority on investing in that space. Fortunately or unfortunately, a team member on our side was also quite knowledgeable about real estate and had considerable experience. This colleague would not accept broad proclamations and glib generalizations at face value simply because they were voiced with intimidating authority. Challenges from my colleague that struck at the core of the manager’s main thesis began to be launched with increasing frequency. Evidently, the GP had never been challenged in such a way, particularly in a manner that targeted the foundation of his strategy. His frustration turned into pure anger – he took it as though his history and existence were being unfairly questioned, so he had to go into full fight or flight mode. It was like watching a slow but gruesome car accident. The increasingly loud back-and-forth arguments and counterarguments began to verge on unprofessionalism, prompting the meeting to be halted to maintain some degree of decorum. I am sure there is enough blame to go around, but I would expect that a manager seeking capital based on a specific premise would have sufficient factual and quantitative evidence beyond just saying, “ I have been doing this for a long time,” to assuage the skepticism of any relatively boisterous allocator. I expected someone raising capital from a wide range of prospective investors to have thicker skin.

- **Taking offense to fair inquiries**: This was another real head scratcher, but it can probably be better understood or at least empathized with when emerging managers' individual plights are considered. The initial meeting began innocently enough with a GP, who had successfully executed fundless sponsor deals for some time, embarking on an initial commingled vehicle fundraise. To digress a little, raising capital for individual deals differs in a few ways from raising capital for a fund, and the GP must research and learn these differences. For one, many fundless sponsors typically raise capital for an already identified target, which means there is relatively more clarity on how capital will be spent. On the other hand, fund vehicles typically raise capital before specific deals are identified – most managers will show some sort of pipeline of desirable deals, but there is no assurance that these will end up in the fund. Secondly, although this is gradually changing, investors in fundless sponsor deals typically consist of those with discretionary capital or relatively greater autonomy to make investment decisions. For instance, the firm I worked for served a client base of endowments and foundations. Although we offered comprehensive investment advice, most of our clients were non-discretionary, which required us to undergo a relatively tedious process to add anything to a portfolio. Limited bandwidth and the desire to use time efficiently result in less appetite for fundless sponsors than fund vehicles. Back to the story – I believed I was asking questions no different from those I would pose to an established manager. However, this manager was particularly sensitive to my inquiries due to past experiences of perceived unfair treatment and rejection from other prospective LPs that they viewed as prejudiced. One question that sent the meeting into a tailspin was when I asked a question about the attribution of past successful deals. I wanted to understand which individuals were responsible for the hands-on value creation within their past investments. Unknowingly, I had stepped into a landmine that would send the meeting spiraling out of control. This question was viewed as a roundabout way of saying I did not believe they could deliver such returns, and I thought someone else must be behind their results. The GP's point was that the principals should get all the credit for developing and overseeing the playbook. That was a fair view to me, but like with all managers we reviewed, we wanted to understand who, among the principals, the operating partners, outside consultants, etc., does what in the value creation process. I think the moral here is "not to punish someone for the perceived wrongs of others" and "visceral sensitivity to certain questions can reveal insecurities that can subsequently adversely affect your overall narrative".

- **Novice mistakes**: To be fair, this combination of incidents cannot be regarded as a full-blown crash out, but it is an interesting depiction of how a GP's good intentions, mixed with naivete, can be a deadly self-sabotaging concoction. This case involved an emerging venture manager raising its second fund. Its first fund was a small vehicle composed mainly of high-net-worth individuals and small family offices as investors. In recognition of their immense trust and willingness to invest in the maiden fund, the Fund 1 investors requested go-forward terms regarding confidentiality, co-investment access, and strategy flexibility, all of which the new fund was eager to accommodate. These agreements were not documented in written form; instead, they existed as a pact based on mutual trust between the parties. However, as institutional investors who were seriously reviewing Fund 2, many of our questions conflicted with the Fund 1 agreements. The manager's initial instinct was to dismiss many of our probing inquiries by referencing previous arrangements with past LPs (who were re-upping). The GP's loyalty to past LPs was commendable but impractical in many ways. We wouldn't be the last institutional LPs to ask these questions, and they would drastically be reducing their pool of potential investors by blindly adhering to non-industry-standard terms that were agreed upon out of sheer naivete. It took a while to understand why an emerging manager was being so opaque about certain things and explain to them why their reasons were unsustainable for the long term. We ultimately reached a reasonable compromise and invested, but we were dangerously close to completely walking away due to the manager's lack of awareness regarding institutional investor expectations.

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