Active Allocator

Due Diligence Framework for Direct Investing

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The Capital Allocator's Perspective

The capital allocator is in the business of entering into partnerships with fund sponsors[1] to potentially generate significant returns, mainly through long-term capital appreciation, by making, holding and disposing of privately negotiated equity and related investments. Such investments are usually made as a passive investor in vehicles directed by a third party fund sponsor; as a result, the investor[2] has only indirect influence over-achieving ultimate investment objectives.

We believe that a methodical approach to selecting sponsors—which combines scientific rigor with seasoned subjective judgment—may contribute to creating strong results in a variety of economic environments. We present here a 'best practices' framework for selecting financial sponsors. We draw attention to important issues, metrics and considerations deemed worthy of exploration. What follows does not represent an exhaustive list, of course. Each investment and operational diligence mission inevitably take one down paths that are not common to other missions. One must be prepared for this—and even seek it and relish it. For, it is forays beyond the common and readily available, that enable real insight into the people with whom one entrusts with one's capital.

1 *We use the term 'sponsor' very loosely in this article to facilitate ease of reading. Investment vehicle structures vary; for instance, the prevalent legal structure used by private equity sponsors is the Limited Partnership. The General partner is the legal entity with unlimited liability; it serves as the intermediary between external contributors of capital and businesses who seek capital. The "Management Company", a legal entity setup to serve as the investment advisor to the fund, is involved with the fund's day-to-day operations. The sponsor typically designates senior members of its organization, usually known as "the principals", to comprise the General partner who actively manage the partnership, act as agents of the fund and direct its affairs.*

2 *We use the term 'investor' very loosely here to facilitate ease of reading. Investors may be Limited partners, and as the name suggests, have limited liability and are not involved with the fund's day-to-day operations. They are passive contributors of capital and receive income and capital gains on their investment in the partnership. Their liability is usually limited to their paid and unpaid capital contributions.*

Diligence Metrics

The due diligence concepts described in this article are applicable to lesser or larger degrees to most alternative classes including hedge funds, private equity, real estate, commodities, infrastructure, timber as well as oil and gas partnerships. Direct investing in private markets has often been summarized as having three major components: *finding, grinding and minding.* In a narrow sense and for a particular transaction, that rhythmical summation is right. But these three factors alone quickly become insufficient when one is making long-term, illiquid blind pool commitments, often commingled with others. The issue gets even more complicated when capital is managed by a team that may be changing in its composition over time, or one that manages multiple funds in multiple disciplines, or one whose incentives do not map perfectly with the capital allocator's.

We group diligence metrics into four broad areas:

I. Investment Strategy
II. The People and Team
III. Track Record and Transactions
IV. Terms and Fit

It is important to recognize that these metrics overlap and must be considered jointly in arriving at a judgment. There is a blend of science and art in these judgments. It would be far easier to make capital deployment and sponsor hiring decisions if all of the data could be quantified, measured and then ranked. Some data lends itself to this approach—and one must be rigorous in performing the full menu of quantitative analyses on such data. The most interesting issues in ultimately making allocation decisions, however, usually do not lend themselves to a deductively reasoned, scientific analysis alone. Rather they entail making qualitative judgments. This is part of what makes the job of hiring sponsors interesting and challenging—and part of why hiring decisions, in general and for direct investing in particular, are anything but a sure shot. Excelling in making critical inductive-reasoning judgments, in turn, requires wisdom gained from experience *(doing it oneself and studying the successes and failures of one's own and others).*

We stress that this article is not intended to be a 'checklist' but rather a holistic framework with which to approach investment and operational due diligence in direct investing.

Process

The sourcing of investment sponsors marks the beginning of the due diligence process. Potential candidates may be drawn from:

- *Collective knowledge and experience of team members.*
- *Referrals from current sponsors.*
- *Network of financial institutions, including other professional allocators, prime brokers and service providers.*
- *Research based on subscriptions to periodicals and databases.*

After sourcing and assembling an initial list of sponsors, an investing team may begin to narrow down the pool to an actionable list. This is arguably the most time and resource intensive part of the due diligence process. The objective at this stage is to identify sponsors with a sustainable and repeatable process, which hopefully leads to a consistent returns stream in the future.

Initial review

This generally involves gathering preliminary information from initial calls and/or meetings. This provides a high-level overview of key investment and operational aspects of the fund, including:

- *Investment philosophy and strategy.*
- *Investment process.*
- *Quality and depth of research.*
- *Portfolio construction.*
- *Risk management.*
- *Corporate structure.*

Analysis

After an initial review, an investing team usually performs a more in-depth analysis to gain a complete understanding of investing process. Information is reviewed and analyzed to understand the process of returns generation as well as an understanding of risks being assumed to generate those returns. The endeavor usually is to learn more and build internal conviction.

The analysis process involves:

- *Multiple meetings and interviews.*
- *Documentation requests and a review of marketing materials.*
- *Provided references which may be both personal and professional.*
- *Completion of a due diligence questionnaire.*

After collecting and analyzing information, an investing team usually cross-references collected facts with unaffiliated sources. An independent affirmation of facts verifies sponsor assertions and further helps to build conviction. Here, the investing due diligence team may look at:

- *Background checks.*
- *Civil and criminal court checks.*
- *Industry checks, including with SEC, FINRA.*
- *Credit checks.*
- *Education verification.*
- *Review of government filings and forms—e.g., 13G/Ds, 13Fs, Form ADVs.*
- *Audited financial statements.*
- *Public information searches.*
- *Reference calls including calls made to former employees or former investors.*

Evaluation

A number of criteria are taken into consideration and will vary depending on the sponsor, the strategy being deployed or how the fund is expected to be offered to clients. Here, qualitative and quantitative considerations include:

Qualitative

- *The degree of conviction with the team and the investment strategy.*
- *Background and experience.*
- *Portfolio construction and risk management discipline.*
- *Strategy viability through a complete economic cycle, including a historical and expected future risk/return profile.*
- *Ability to generate consistent performance over time, on an absolute basis, and/or versus an appropriate peer universe if relevant.*

Quantitative

Relevant metrics include:

- *Absolute historical level of returns.*
- *Volatility which measures the dispersion of changes in price.*
- *Correlation which measures the degree to which the movements of two financial instruments are related.*
- *Drawdowns, which is another measure of risk.*

Performance comparison of the sponsor's performance to:

- *Other similar funds.*
- *Peer universe as applicable.*
- *Relevant indices.*

Operational Evaluation

Operational risk analysis is a key factor in avoiding fund failure and manager fraud. It is important to build review procedures to enhance the ability to protect from such risks. Operational due diligence typically includes an analysis of fund documentation, contractual arrangements, valuation methodology and pricing basis (including analysis of mark-to-market versus mark-to-model practices) and the strength of key service providers and administrators. It inevitably reviews operations infrastructure, systems, processes and controls including middle- and back-office staff qualifications and capabilities. It also includes ongoing media and background check monitoring and considers the independence and quality of service providers. Lastly, it involves understanding the firm's approach to infrastructure issues including ways in which the firm is positioned to handle growth in assets/or clients, personnel needs, client service functions and disaster recovery backup arrangements.

Ongoing Monitoring

After an investment decision is made it is important to conduct ongoing diligence and monitoring. As with any active management strategy, the goal is to arrive at an early identification of factors that could cause future under-performance. This is an ongoing check to ensure that the agreed upon investment strategy is deployed in a manner that is consistent with the expectations established during the due diligence process.

The investing due diligence team, may in instances, review and evaluate changes to the investment and/or operational framework and regularly reaffirm its commitment to a sponsor. Ongoing monitoring activities may occur on a bi-monthly, monthly, quarterly or annual basis, depending upon the task at hand. Of course, the unexpected may occur, which can lead to impromptu visits or discussions with a sponsor as well. It is important to develop a regimented process that consists of a number of activities, some of which include:

- *Conduct regular on-site visits and calls.*
- *Review performance.*
- *Understand the profit/loss attribution.*
- *Evaluate risk exposures.*
- *Review outlook.*
- *Explore any material changes to the organization.*
- *Ensure that there is no style drift.*

We now turn to examining in greater detail the four pillars of the due diligence process; the investment strategy, the team, track record and transactions, as well as commercial terms and fit.

I. Investment Strategy

The risk and return attributes of direct investments are determined by their investment strategy. The common element amongst strategies is the use of investment and risk management skills to seek positive returns; it is for this reason that good sponsors place particularly strong emphasis on the disciplined use of investment and risk control processes. Often direct investment sponsors have reasonably flexible mandates which allow for manager strategy to evolve as market conditions change.

The investment due diligence process involves reviewing the sponsor/key risk takers' professional pedigree, including their credentials, reputation, performance evaluation versus peers and benchmarks, as well as the duration of such track records.

Attributes of the good sponsors include:

- *Excelling in systematically and dynamically analyzing the underlying markets and identifying conditions that might provide absolute return opportunities.*
- *Having superior security selection skills and trade expression capabilities.*
- *Deploying a disciplined risk management approach.*
- *Being nimble in allocating capital across opportunities.*

Therefore, getting access to sponsors who have market knowledge and experience across varying markets and cycles, or who use advanced analytical tools, have developed risk management processes, provide expression in flexible investment vehicles, and have an edge in exploiting fleeting opportunities is important. The due diligence function involves assessing these attributes and several other aspects including:

- *Investment theses and the process of arriving at them.*
- *Investment philosophy.*
- *Complexity of the investment strategy.*
- *Sizing the trade and portfolio construction.*
- *Organizational stability.*
- *Employee turnover and compensation schemes.*
- *Assets under management.*
- *Costs, fees and pricing structure.*
- *Liquidity conditions.*
- *Operational and control checks.*

Next, we highlight questions that might help investors evaluate investment strategy:

What is the fund's investment strategy?

- *Categorize:*
  - *By geography*
  - *By industry*
  - *By stage of development*
  - *By fund size*
  - *By size of a typical transaction*
- *Why has this strategy been selected?*
- *How attractive is this strategy now?*
- *For how long will this strategy be effective?*

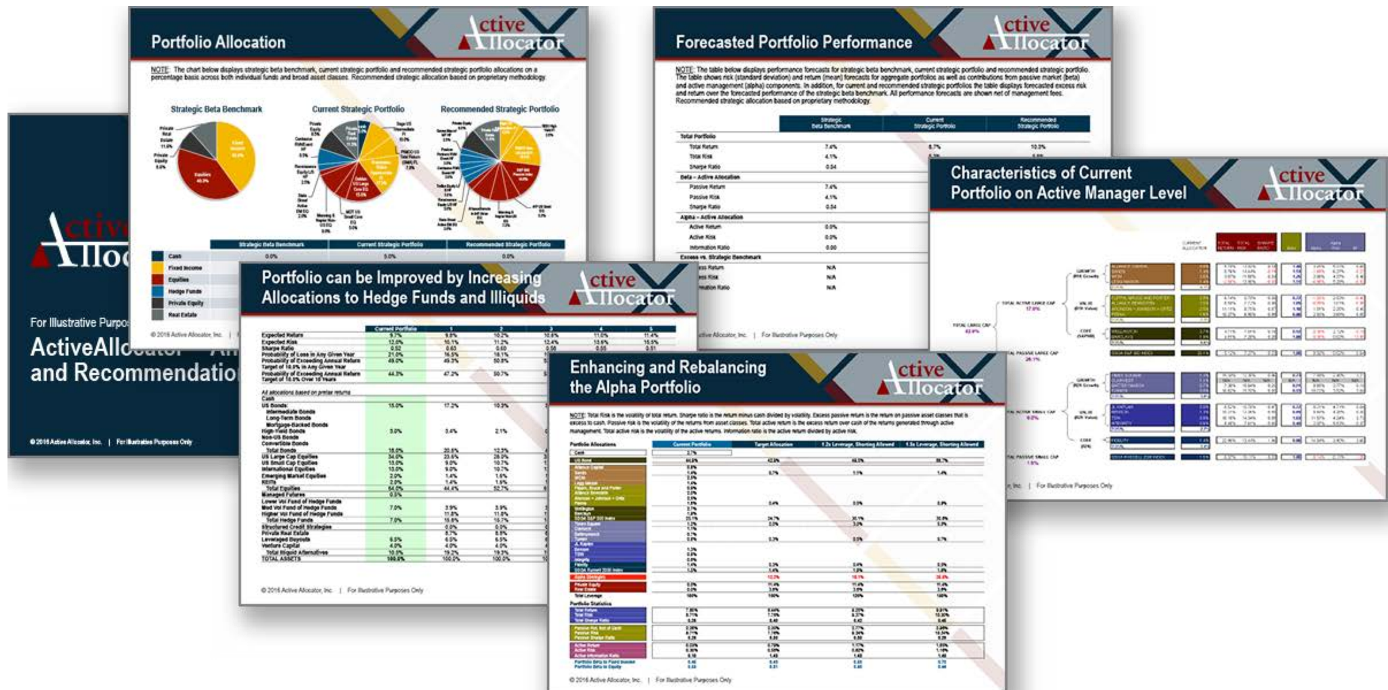
What are sources of likely returns?

- *These might include:*
  - *Growth in cash flow (organic and acquisitions related)*
  - *Financial leverage*
  - *Multiple expansion*
  - *Customer traction*
  - *Revenue growth*
  - *Growth in the size of addressable market*
  - *Path to profitability*

In executing this strategy, identify "edges"/sources of value creation?

For example:

- *Strategic relationships*
- *Leveraging the network and skills of operating partners/industrial partners*
- *Leveraging relationships and know-how of Board of Directors/Board of Advisers*
- *Effectiveness in corporate partnering*



Benchmarks: An acceptable industry-wide standard for comparing direct investing performance does not presently exist. The illiquid nature of such investments does not lend itself readily to comparisons with a single benchmark measure. Also, many funds do not usually publish their returns data, though a few fund of funds and consultants maintain their own proprietary databases.

- *What are the proper benchmarks for the strategy? How appropriate are they?*

- *What magnitude of returns ought this team generate in executing the strategy? How would returns compare with others executing the strategy at this time on a risk-adjusted basis?*
- *Factors affecting the ability of the fund to execute its investment strategy:*

In order to ensure that the sponsor does not raise more capital than it can effectively deploy without compromising the fund's investment thesis, upper bounds on fund size are quite frequent. Conversely, the fund memorandum may specify the minimum size at which the fund may close. Questions may be directed to ascertain:

- *The fund size.*
- *Number of transactions to be done.*
- *The intended investment bite sizes.*
- *The need for follow-on investment.*
  - *The availability of leverage*
  - *The need for co-investors*

II. People and Team

Investors in direct investment funds tend to emphasize an evaluation of team composition, individual and collective track record, team synergy, team resilience and team economics before they decide to invest. Inquiries may be made to establish:

- *What about the principals make them well-suited to execute their strategy?*
- *Have they ever executed this strategy previously? For how long?*
- *How well do the principals understand their sector and the factors that are likely to influence success or failure?*
- *How adaptable will the principals be if the environment changes so as to inhibit the effectiveness of this strategy?*

There are two major components to addressing the team's likelihood of success:

- Partner/Team Analysis: *appreciating the people.*
- Skills Analysis: *assessing to what degree the team possesses relevant skills.*

Partner/Team Analysis

Who are the partners of the fund? Who are the key contributors executing the strategy?

- *What are their backgrounds and accomplishments?*
- *What are their strengths and weaknesses?*
- *What makes each one "tick"? What has made them successful in their prior endeavors? Are they sufficiently motivated to succeed going forward? What might be influencing their motivation?*
- *When have they failed? Why?*
- *What, if anything, truly distinguishes each principal or the team as a whole? Have they developed a "franchise" with enduring value?*
- *For what are they known, if anything? Who respects them? Who doesn't? Why?*

What diligence and background checks have been done on the key people?

- *What can be learnt? In particular, what was said about the principals by:*
  - *Portfolio company sponsors.*
  - *Limited partners.*
  - *Those who have previously invested with them.*
  - *Capital sources.*
  - *Deal intermediaries.*
  - *Former partners and employees.*
- *Were there areas about their backgrounds about which the principals were not forthcoming?*
- *What inferences can one draw about the principals from meetings and the checks performed?*

- *Any existing or historical personal/professional interactions with the principals? How revealing were these? How exceptional were they?*
- *What has one learned from checkings beyond a provided reference list?*

What has been the experience of the principals working together in the past?

- *Have they invested together in the past? For how long? How successfully?*
- *For how long and in what way/capacity do the principals know each other?*
- *How did the principals come together to form their firm? When?*
- *Do the people comprise a good team? Are their skills and personalities complementary?*

What has been the change in the team's composition over time?

- *Who joined when? Why? Who has joined recently?*
- *Who has left the firm? When? Why, according to the principals? Why, according to the departed?*
- *Are the principals responsible for creating previous performance still as actively engaged? Is material change expected in this regard going forward? Are the newer partners doing a disproportionate amount of the work? What might this suggest about future performance?*

How many people comprise the sponsor?

- *Number of employees?*
- *Number and quality of partners? Senior partners? Junior partners?*
- *Number and quality of principals (those sharing in the profits)*
- *Number and quality of non-principals?*
- *Number and quality of "Operating partners"?*
- *Number and quality of "Entrepreneurs-In-Residence"?*
- *Number and quality of Advisory Board Members?*

Is the fund sized right? Do the team's track record and ability to source deals relate favorably to the size of the fund? How much capital will the team be managing?

- *Total in all vehicles*
- *Per professional*
- *Per partner*

Where are the team members located? How effectively do they communicate with each other? Do their locations and pattern of communications help or hinder the execution of their strategy?

How does the sponsor's investment decision process work? Does it really function as described? Do one or two people dominate the decision? Must all partners agree? Super-majority? Consensus? How often is there disagreement? Is the decision process consistent? Sensible? Adaptable?

How have the principals dealt with conflict situations with sellers, company sponsors, limited partners, partners of their firm, non-partners of their firm, other investors, lenders and other capital providers, deal intermediaries, and others?

Sponsor Investment. How much is each member of the Sponsor contributing as invested capital?

- *How does this compare with each person's net worth/liquid net worth?*
- *How much of his/her capital is in other funds managed by this sponsor?*
- *What percent of the fund do the General Partners represent in the aggregate?*
- *Are there other affiliated entities investing substantial capital? Are they receiving different forms or amounts of economic value for such investments?*

How are the economics shared among the members of the General Partner?

- *How are the allocation economics decided? Is the process fair and understandable?*
- *How frequently is the economic split re-evaluated? Has it been done recently?*
- *Is the sharing equitable? How does the team feel about the economic split? Are any of the key principals likely to leave over the course of the partnership?*
- *How many individuals have a share of the carried interest? How much is held by:*
  - *Founding partners?*
  - *Senior partners?*
  - *Junior partners?*
  - *Non-partner employees?*
  - *Affiliates and former affiliates?*

Is there a succession plan? How believable? Will investor's capital be well cared for?

Skills Analysis:

Do the individuals and the team have the requisite skills to execute the strategy well? Distinguish between a record of achievement in each of these skills versus a familiarity with the task.

- *Sourcing*
  - *Quality? Quantity? How "proprietary"? How "exclusive"?*
- *Analyzing/Selecting*
  - *How systematized is the analytical process?*
  - *How truly thorough is diligence?*
  - *How well does the team evaluate risks and rewards?*
  - *What has been the quality of thought about deals previously selected and those passed over?*
  - *Are the principals "good buyers" of businesses?*
  - *What is the quality of investment write-ups?*

- *Structuring/Negotiating Transactions*
  - *With owner/seller.*
  - *With company sponsors.*
  - *With capital sources.*
  - *Has the investment team demonstrated creativity in approaching the structuring and financing of transactions?*
- *Sizing Investments*
  - *Relative to the risk of capital loss.*
  - *Relative to fund/vehicle size.*
- *Adding Value to Portfolio (if relevant)*
  - *Strategy.*
  - *Acquisitions.*
  - *Hiring sponsors.*
  - *Operational issues.*
  - *Fixing problems.*
  - *Serving as "Interim-CxO" if situation warrants.*
- *Realizing Value*
  - *How well has the investment team assessed exit opportunities at the time of the investment?*
  - *How does the investment team make judgments about exiting after the investment is made?*
  - *How effectively has the investment team exited investments?*
  - *Does the team believe that they are "good sellers"?*
- *Communication and Valuation*
  - *How well does the fund communicate with its investors?*
  - *How efficient is the back-office?*
  - *How timely are quarterly/annual reports?*
  - *How well can one understand the performance of the fund and the underlying portfolio companies/ properties from distributed material?*
  - *When investors have questions, how helpful is the sponsor? Response time?*
  - *Does the investment team understand how to mark the portfolio properly?*
  - *Does the investment team understand how to value investments for accounting purposes?*
  - *How realistic and appropriate are portfolio valuations/marks?*

- *How good are their skills? In particular, how good are the principals in:*
  - *Assessing company sponsors?*
  - *Working with company management?*
  - *Monitoring portfolio companies or properties or underlying investments?*
  - *Adding value to portfolio companies?*
- *How does one assess the people and the team from the perspectives of:*
  - *Competence?*
  - *Trust and integrity?*
  - *Serving as a fiduciary?*
- *Are there meaningful differences between how one independently assesses the investing team's skills (versus how the principals describe themselves and versus how others assess them)? What do such differences suggest?*

III. Track Record and Transactions

Many direct investing firms start off small, often with in-house or proprietary capital, and build a track record of success. Those that succeed in creating good performance go on to market themselves to outside investors. As an indicator of having the requisite skills, it may be important to evaluate the track record and transaction history of the principals—remaining mindful that past performance is not necessarily an accurate predictor of future performance.

Fund management experience and ability.

- *As a group, have the principals managed one or more similar vehicles or funds previously?*
  - *How many? How much capital has been invested?*
  - *How many vehicles and how much capital is being currently managed?*
- *Have the individual partners managed one or more similar vehicles previously, but not as a team?*
  - *How many funds have they managed and with how much capital?*
  - *Are there sufficient grounds to assume that the investment vehicle in consideration is a quasi-first-time fund?*
  - *It often helps to understand returns by getting information on a cumulative basis, a fund-by-fund basis and a deal-by-deal basis for all deals completed by all partners of this sponsor (including, separately, any prior investments for which each person was meaningfully responsible).*

On a fund-level basis, performance evaluation may include:

- *Vintage year.*
- *Fund size.*
- *Management fee.*
- *Carried Interest (and Preferred Return, if any).*
- *Number of transactions completed.*
- *On a "net-of-all-fees, expenses and carried interest" basis:*
  - *Capital invested and capital committed.*
  - *Capital returned on both a "cash returned" and a "cash returned to investors + value of holdings" (valuation) basis.*
  - *Multiple of Capital Returned (on a "cash only" basis and on a "valuation" basis).*
  - *Internal Rate of Return (IRR%).*
  - *Average holding period.*
- *On a Gross Portfolio basis, on a Realized Transactions-only basis and on an Unrealized Transactions-only basis:*
  - *Capital invested.*
  - *Capital returned/valued.*
  - *Multiple of Capital.*
  - *IRR.*
  - *Number of Winners/Number of Losers.*

Analyze returns and their distributions (both IRRs and Multiples of Capital).

- *Understand dispersions of returns versus each of:*
  - *Amount of invested capital.*
  - *Time.*
- *What has been typical? Understand (and distinguish by type of deal if the sponsor invests in multiple types of strategies) the typical return profile of this sponsor's investments. What has been the:*
  - *Mean return? Median return ? Typical range of returns?*
- *Concentration. How concentrated are returns to one or two large successes? Was this part of the strategy? How would the investment vehicle perform absent such major successes (and perhaps an equivalent number of failures)?*
- *Comparative results. How does each vintage year fund compare with an appropriate universe of similar funds/ investments?*
- *Create a composite performance picture for all funds/investments managed by the principals.*

On a deal-by-deal basis, for each major transaction, focus on:

- *How was the transaction sourced, and by whom?*
- *What was the investment thesis? Was it sound? Was it executed well?*
- *How did the sponsor appraise the risks and rewards at the time of decision? In light of the transaction's potential payoff and the likelihood of the risks occurring, was it reasonable/prudent to assume those risks?*
- *How did the sponsor approach the valuation? Why was the price paid appropriate/attractive in the eyes of the sponsor? In particular, at the time of investment (and where relevant, at time of exit), what was the:*
  - *Date of first and subsequent investment(s).*
  - *Amount of capital invested for each investment*
  - *Purchase price (or valuation) for entire Enterprise or Pre-and Post-Money Valuation*
  - *Level of Cash flow or other metric (e.g., Run-Rate EBITDA, Trailing EBITDA-CapEx, Projected Revenues)*
  - *Relevant Multiple on a Total Enterprise Value basis relative to "cash flow" or other metric*
  - *Capital structure*
  - *Debt multiple*
  - *How fast was company growing/expected to grow?*
  - *How quickly did sponsor expect debt to be paid down?*
- *How thorough was the sponsor's diligence?*
- *How skillful was the investment team in structuring their investments and sizing them appropriately?*
- *Who was involved with the company post-closing?*
  - *Were one or more board seats held and if so, by whom?*
  - *In what other capacity was the fund sponsor involved?*
  - *How effective was the value-add?*

- *What were the sources of value-add?*
  - *Sourcing*
  - *Industry expertise/Contacts*
  - *Operational expertise*
  - *Recruiting*
  - *Financial engineering*
  - *Restructuring*
  - *Ability to work effectively with management*

- *Were any management changes required?*
  - *How well-anticipated were those changes?*
  - *How effective has the new sponsor(s) been?*
  - *How timely and effective was any remedial action taken?*

- *What were the investment results?*
  - *What was/has been the multiple of capital achieved (realized and total) and the IRR%?*
  - *How did the investment team exit/realize their investment?*
  - *What went according to expectations? What did not?*
  - *Could/should the situation(s) that arose have been anticipated?*

On an overall basis for all deals reviewed:

- *"Our kind of deals". Were these the kinds of transactions in which one would have liked to have one's capital exposed (both with and without the benefit of hindsight)?*
- *Will the future be like the past? Is there any reason to believe that past success will not be indicative of future success?*
- *Older, but wiser? Does it seem as if the sponsor has learned from prior investments and experiences?*
- *Selective disclosure. Is there any reason to believe that the track record, as presented, is not the complete story? Has the sponsor's presentation been inappropriately selective?*
- *Does the investment team have any distinctive advantages in sourcing their transactions? How well have they leveraged such advantages?*
- *How effective has the sponsor been in working with intermediaries/deal sources? Does this represent a competitive advantage?*
- *How effective has the sponsor been in working with capital sources?*
  - *With which lenders/capital sources has the sponsor worked?*
  - *How do these capital sources feel about the sponsor?*
  - *Are they inclined to work again in future transactions?*

- *Has the investment team demonstrated portfolio management skills:*
  - *As regards sizing of investments relative to the risk of loss of capital?*
  - *As regards number and size of investments exposed to same/similar risks?*
  - *As regards holding sufficient capital in reserve for follow-on investments?*

- *What has been the typical level of post-acquisition involvement?*
- *What has been the experience in working through troubled deals? Did the sponsor take timely remedial action? Was it effective?*
- *How has the investment team tended to exit investments? Does it usually have multiple ways out of an investment? What should one expect future means of exit to be?*
- *What have been the sources of fund sponsor's gains: financial leverage; multiple expansion; organic earnings growth; acquisitions-driven earnings growth etc?*

How might the volume of active deals in the portfolio affect future investment activity?

- *On how many active investments does each partner work?*
- *How many of these are as a member of the Board?*
- *How much time will this likely require?*
- *How might it impact the ability to make and monitor investments in the future?*

IV. Terms and Fit

How do the terms and their documentation fit the needs of the investor? Do the economic and non-economic terms adequately protect investor interest?

Management Fees are intended to defray normal operating expenses of the management company during the course of business. These expenses are broadly in the form of salaries and employee benefits, office expenses, travel, business entertainment, equipment rental, bookkeeping, conducting due diligence and fund administration. Formulaic applications of a fixed percentage of capital commitments may, at times, result in management fee accrual to the sponsor that exceeds actual expense needs, serving as an additional revenue source for the sponsor. In such cases, management fees may become a primary profit center, something that investors usually frown upon. The long-term incentives for all participants are perhaps best aligned when management fees are used to offset ongoing expenses while the majority of the sponsor's compensation derives from fund profits through their share of promote or "Carried Interest".

Ancillary Fees are revenues that the sponsor receives from investment banking transaction fees, portfolio company monitoring fee, and director compensation. These fees may be credited to the management company or to the fund, or in some proportion to both. Provisions that specify how these fees are split have a bearing on fund economics. Investors occasionally propose fee set offs by a percentage of the amount of any director fee, consulting, monitoring, investment banking, transaction or break-up fees or other remuneration received by the sponsor.

The 'waterfall' is the pre-defined mechanism for allocation of fund profits and capital distribution cash flows between investors and the sponsor and it is, during due diligence, important to understand:

At what level are fees paid to the sponsor by investors:

- *Management fees*
  - *What percent? Understand if and how such fees step down over time?*
  - *On what base is the fee assessed? Committed capital? Invested capital? What causes the base to be reduced? Returned capital? Mark-downs? Write-downs? Raising another fund? A "suspension period"?*
  - *Are there offsets to management fees (e.g., transaction fees, monitoring fees, broken deal fees, director fees, options) received by the sponsor ? Is the offset 100% or some lower amount? To the extent not used in the current period, do such offset amounts roll forward to subsequent periods?*
  - *How does this compare with similar funds in the market?*
  - *Will the magnitude of the fees received create misaligned incentives for the sponsor (vis-à-vis investors)?*

- *How do management fees received compare with the operating requirements of the fund and/or fund family?; While investors generally do not want the sponsor to do deals to earn transaction fees to meet expenses, nor do they want the sponsor to get wealthy from management fees (the "carry"[3] is for that), one does recognize that 'better' sponsors have been able to dictate terms so sometimes investors do trade-off quality of sponsor for economics/interest-alignment.*

› *Carried interest ("promote") and preferred return %*

- *What percent is being charged? If different from the standard, why is this justified?*
- *The hurdle rate is a minimum threshold rate of return that investors must receive prior to any distributions to the sponsor. Its intent is to provide downside protection to investors. Is there a hurdle rate or a preferred return? If so, is it within the typical 6%-8% range? If there is a preferred return, are there "catch-up" provisions for the sponsor? Is the catch-up 100% or less/slower?*
- *Are all transactions "pooled" such that losing deals offset winning ones in calculating the promote?*
- *Is there a "clawback" provision requiring the sponsor to return to investors any excess distributions at the end of the partnership? Is there a reserve, a guaranty, or some other reason to believe that the sponsor will honor the "clawback"?*
- *Does the sponsor's retention of some/all transaction, monitoring, breakup and other fees suggest that all in compensation may be excessive?*
- *How does the "promote" and its calculation compare with similar offerings in the market?*

› *Allocation of Profits/Distributions*

- *Prior to payment of a carry to the sponsor, what measure of investor capital must have been returned? Is this the same measure to which the preferred return (or hurdle rate) is applied?*
  - » *Does it include expenses and fees paid by partners?*
  - » *Is it just capital contributed for investments disposed?*
- *Do profits include interest income on uninvested capital contributions?*
- *Are expenses deemed to be capital for purposes of allocating profits/distributions?*
  - » *Do organizational expenses include legal costs? Cost of placement agent(s)? Do other items offset such expenses? Is there a "cap"?*
  - » *Are all operating expenses paid by sponsor out of management fees? Who pays for such things as the costs of the annual meeting?*
  - » *Are any transaction expenses charged? Is there a good reason that they are not covered by the acquired company or by the sponsor?*
  - » *Are any "broken deal" expenses charged? Will the sponsor pay or, if management fees are low, will the sponsor offset such expenses versus fees received (transaction, monitoring, director, break-up, etc.)?*
- *What is the specified period within which the sponsor must make distributions after receipt of proceeds?*

3 *The surplus income and capital gains that a fund generates after deducting expenses, subtracting cost of investments and making provision for liabilities are the fund's profits. These are distributed to investors and the sponsor in accordance with the terms set in the agreement in the form of carried interest. Carried interest is profit sharing that accrues to the sponsor. It is typically payable following contributed capital return to investors, reimbursements of management fees charged to investors and, in some cases, after meeting a pre-defined "Hurdle Rate" of return. Carried interest is the principal part of the sponsor compensation that aligns sponsor/investor economic interest and reduces agency cost. The sponsor, in turn, disburses the carried interest to principals and other individuals who constitute the partnership.*

Distributions

In many cases, the sponsor retains rights on how they choose to distribute realized fund proceeds back to investors in the form of combinations of cash, freely tradable securities or restricted/ illiquid securities. While this provides flexibility to the sponsor, most investors prefer to receive distributions in freely tradable securities or in cash. Cash has the advantage of being fungible and less volatile as opposed to a complex in-kind security distribution whose value usually carries valuation and/ or liquidation risk. On the other hand, cash distributions are taxable immediately while the tax incidence on in-kind security distributions is generally deferred until realization.

- *Must investors consent to distributions prior to liquidation of partnership being in instruments other than cash or marketable securities?*
- *Does the sponsor favor cash distributions? Under which circumstances will the sponsor tend to make in-kind distributions? Has the sponsor made in-kind distributions of illiquid, publicly quoted securities so that they can calculate the "promote" on a higher expected valuation than they price at which the securities can be sold?*
- *Must all in-kind distributions be made pro-rata to investors by class and type of security?*

Side Letters

The sponsor may negotiate or offer preferential terms for certain investors for a variety of reasons. "Side Letters" have the effect of establishing new rights, prioritizing rights, altering existing rights and supplementing the terms of the standard subscription agreement. Disclosing to all investors the existence of side letters promotes transparency and enhances investor confidence.

- *Will one investor be receiving the same, better or worse terms than others? If so, it is important to understand significant differences.*

Commitment amount, period, and scope

- *Is the entire length of the partnership appropriate for the strategy? Can it be extended? For how long? Under what conditions?*
- *Is the investment period appropriate for the strategy? Can it be extended? For how long? Under what conditions?*
- *Are there limitations on capital commitment drawdown amounts for a single capital call or within a specified time period? Do such limitations effectively protect investors?*

- *Are there diversification requirements? If so, do the diversification requirements and other limitations on investments match the fund's objectives? Are the requirements constructed so as to limit the concentration of investments in:*
  - *A particular security*
  - *A particular issuer*
  - *A particular industry/sector*
  - *A certain type of transaction or securities (e.g., venture stage, securities of bankrupt companies, public securities, or debt securities)*
  - *A certain geography*
- *In the case of a capital commitment drawdown vehicle structure, will those who subscribe to later closings participate in transactions already closed? Do subscribers in later closings gain an "unfair" informational advantage? Do such later subscribers pay interest or penalties?*
- *Does the sponsor have the ability to "recycle" capital? Is this consistent with the strategy? What amounts can be recycled: contributed principal, gains or both? For how long after a realization? Until what date/occurrence?*
- *Is the investor's liability limited to commitment[4] amount/distributions received?*
- *How much must/will be contributed by: the individual principals; the team as a whole; and, other affiliates of the sponsor? Does this sufficiently align the interests of the sponsor and the investor?*
- *In calculating the commitment amount, are management fees included or additional?*

Investor Protection and Governance

It helps to evaluate whether termination provisions adequately protect the investor.

- *Should there be a "key-man" provision? Is there one? Is it appropriately constructed? Does it lead to the same outcome as the "no-fault divorce" discussed below?*
- *Is the right to terminate the sponsor for cause well-defined and sufficiently inclusive? At a minimum, does it include fraud, felonies, and breach of fiduciary duty?*
- *Is there a "no-fault divorce"? Can investors vote to terminate without cause? Does it require a super-majority? What is the threshold percentage? Are affiliates of the sponsor excluded from such a vote? What are the provisions for calling for and executing such a vote? What then happens if the vote meets the super-majority threshold? Is the commitment period or life of the fund shortened? Or, is the sponsor removed?*
- *Is there a "suspension period" for a sponsor's breach of obligations during which no new investments can be made without the consent of investors or an Advisory Committee?*

Conflicts/Other funds

- *Are there restrictions on forming competing funds during the investment period? What are the conditions that must be satisfied?*
- *Sharing of deals. If the sponsor manages funds with an overlapping investment strategy, how will deals be shared by such funds?*
- *Sponsor's time. Will the sponsor and key personnel be devoting substantially all of his/their time to the partnership? How much time will be required by prior funds with a similar strategy and funds having a different strategy?*

4 *Investors in private equity fund structures commit to providing a pre-agreed sum of capital to the fund over a specified period of time. This is called the 'Capital Commitment'. However, the entire funding may not be needed immediately. The sponsor draws down or calls the capital over a period of time as and when investment opportunities arise. Drawdown usually occurs over a 4 to 5 year investment period though this can be sooner. This is different from the practice employed in the non-traded REIT or the hedge fund world where capital is immediately invested.*

- *Are there sufficient conflict of interest restrictions on the sponsor/affiliates to protect investors against:*
  - *Sponsor/affiliates selling securities to or purchasing securities.*
  - *"Crossover investments": the fund having the ability to invest in companies in which sponsor/affiliates (including prior funds) have an existing investment in any type of securities.*
- *Does the investment vehicle/fund have an Advisory Board/Committee to review and approve all conflict of interest transactions? How has the sponsor used this entity in the past?*
- *Have there been previous conflicts with investors? How have they been addressed? How can one be comfortable that the sponsor will not conduct itself in such a way that are likely to suffer from conflict of interest situations?*
- *Do conflicts arise from how the sponsor and its affiliates invest in the fund/underlying transactions? Are such investments by affiliates and employees of the fund:*
  - *Pro-rata based on commitments (i.e., no "cherry-picking").*
  - *On terms no more favorable.*

Transfer of Interests

- *What are the limitations on the transfer of sponsor interests to non-affiliates? Must sponsor approval be obtained?*
- *Are there any conditions restricting an investor from transferring some or all of its interest to its own affiliate(s)?*
- *Is sponsor consent required to transfer interests to a third party? Must such consent not be unreasonably withheld or delayed?*
- *Do investors have the right of first refusal or the right of first offer on transfers by other investors to third parties?*
- *Are defaulting investors penalized sufficiently so that they are deterred from doing so? Are the penalties worded in such a way that investors might inadvertently default? Is there a sufficient cure period before ownership interests are cut?*

Valuation of Securities

There are no globally accepted standards for arriving at private investment valuations. The general idea is that valuations be prudent, reflecting the fair value of underlying holdings. Industry bodies have proposed valuation guidelines which are often followed. However, his is easier said than done; issues often arise as to whether investments should be carried at cost, or at cost with adjustment for subsequent financing events- and if so whether financing need to be material or not, or valuations be marked to market using available public comparable. While exchange-traded freely tradable securities are at the easy end of the valuation spectrum, non-tradable ones form the long tail at the other end. For example, freely tradable but volatile securities may be valued as the arithmetic average of the closing prices for a pre-specified number of days preceding valuation date. For non-freely tradable securities, the fair market value is sometimes appraised by an independent party.

How well-defined are the valuation procedures by which the fund sponsor:

- *Must value securities both for accounting and tax purposes?*
- *Will mark securities for valuation purposes?*

Are publicly traded securities valued based on publicly quoted prices? Is it a quoted price at one point in time or an average of prices over multiple days? Is a discount applied? Does the amount of the discount vary under different circumstances?

Are non-publicly traded securities valued based on objective criteria in good faith?

Are there effective limitations on the write-up of securities, especially non-marketable ones?

Do investors and/or an Advisory Board have the right to review and challenge sponsor valuations?

Conclusion

Now, more than ever, individual and institutional investors alike need meaningful ways of addressing risk across their investments. While offering potential diversification benefits when combined with a "traditional" stock and bond portfolio, direct investments carry their own potential rewards and unique risks. Rigorous due diligence can help reduce sponsor specific unique risks by thoroughly vetting sponsors and their investment strategies.

The performance of due diligence is the cornerstone of any investment program. This need is heightened in direct investing, where public information sources may not be adequate to immediately form an investment opinion on the merits of the investment opportunity. Generating attractive risk-adjusted returns is a key objective of the sponsor research function. We believe that one has to look beyond performance results to understand both the drivers of returns as well as the amount of risk being used to generate those returns. This paper provides a framework with which to approach due diligence in direct investing.

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