GUEST ARTICLE

Taking Aim At 'Gut Feel'

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Most private equity fund investors spend half of their diligence time assessing sponsors' teams and view this as a core skill. Yet, research shows that limited partners view "people mistakes" as the main cause of underperforming fund investments in 55 percent of all cases, making it the single greatest impediment to delivering attractive returns.

People mistakes are largely driven by lack of structure and over-reliance on "gut feel." While successful direct investors have begun to deploy structured approaches to management assessment, most fund investors still rely on informal approaches. Even the most experienced investors admit that their "gut feel"—while valuable—is not always right. Cracking the code on assessing managers will go a long way to separating future winners from also-rans in this maturing private equity market, particularly since fund investors back people rather than hard assets and, once invested, their ability to replace or significantly influence the team is extremely limited.

In our view, the challenge boils down to answering two, ostensibly simple questions: 1) What are the characteristics that distinguish the best general partners? 2) How can fund investors accurately assess these characteristics, getting behind the marketing "spin" inherent in the mutual wooing process?

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We tapped into our combined experience to address these questions: ghSMART has served over 100 private equity clients since 1995 and conducted over 40 confidential interviews with major LPs representing over a trillion dollars in total assets under management in the largest study on this topic. **Morgan Stanley Alternative Investment Partners** is Morgan Stanley's private equity fund of funds business with about $7 billion in assets across primary and secondary interests in buyout, venture, and special situation funds, and in direct co-investments globally. What are the characteristics that distinguish the best GPs? In their due diilgence of a team, fund investors typically consider investment skills, personal values and drivers, and organizational factors.

What To Look For

Quantitative and qualitative analysis of track record data is typically used as the key tool to evaluate investment skills. In the current market there is a growing emphasis on not only the "What" but more importantly the "How" of the track record—to ensure sustained performance, particularly with younger managers who haven't lived through a downturn of this scale.

Assessment of personal values and drivers is most frequently cited as the greatest challenge: What will keep this multi-millionaire partner in the office on a Friday night and on a prop-plane to Podunk rather than enjoying his yacht or a game of bridge? Investors focus a lot of time on gaining comfort that the drive, work ethics, discipline, and fiduciary responsibility a GP demonstrated in the past will continue, and that GPs remain focused on maximizing returns rather than assets under management. To predict future behaviors with greater certainty, fund investors would benefit from rigorous interview techniques and analytical approaches exploring in detail individuals' past behavior, even starting from early in life.

In assessing organizational factors, LPs look for team cohesion and for rational approaches supporting fund strategy rather than one particular "perfect" model. The industry is full of firms with dominant founders. Although on a personal level some fund investors would like a more collaborative approach, most believe this structure can be effective for generating investment returns, as long as it doesn't impede open debate of investment opportunities and doesn't result in turnover of high performers. Carry allocation is most frequently used as an objective metric for alignment of interests among the team. Most investors like to see carry allocated down to two to three levels below partners, with concentration of economics with those senior professionals who deliver most value. Overall, investors look for stable teams that are disciplined in how they approach the investment process and organizational issues but aren't overly institutionalized to the point where excessive structure impedes entrepre-

Exhibit 1: Questions To Ask In Topgrading Interview®

Early years (before the first job):

- Who/what were the most important people and events?
- What are you most proud of?
- What are you most disappointed about?

For each job they held for over a year within the last 10 years:

- What were you hired to do?
- What accomplishments were you most proud of?
- What were some of your mistakes in that job?
- Why did you leave that job?

Let's talk about the people:

- What was your boss's name?
- What will he/she say were your biggest strengths and areas for improvement?

Managing Talent:

- Tell me about the team you inherited.
- How many people did you hire? Fire?
- What was your hiring success rate?

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neurial zeal, creativity, and rapid decision–making that enable the private equity governance model to deliver attractive returns. How can fund investors get behind the marketing "spin" to assess these characteristics?

Knowing what to look for is only half the battle. It's hard to find a GP today who doesn't present his vision and abilities in a highly convincing way during fund raising. Separating the A players from the rest of the pack takes the following three elements (AIM): **A**ssessment criteria that are robust and well understood by the deal team; **I**nterview techniques to collect accurate data on each of the identified criteria; **M**ultiple points of view on each individual.

Assessment Criteria

Investment recommendation discussions where partners have divergent views on the same individual or where one hears vague descriptors like—"He clearly gets it, I can just feel it"—are often a sign that assessment criteria haven't been clearly defined. Absent clearly defined criteria, investors often "fall in love" with individuals who are more socially adept or remind them of themselves—a good litmus test for a golfing partner but with little predictive value for delivering top-quartile investment returns.

Similar to other aspects of due diligence, accurate assessment of people starts with clearly defining what you are looking for—a people due diligence check-list. Such a check list will have some common elements across investors and will also encompass unique components based on the investment strategy and on the geographical/cultural segment targeted. Key components of a check list include:

- Measurable business outcomes critical to success (e.g. clear end-to-end attribution for 1-2 successful deals per year);
- Capabilities required to succeed in a specific strategy in a particular investment environment (e.g. reputation as a go-to investor in the segment, supported by extensive rolodex of deep relationships);
- Key "red" and "green" flags signaling likely performance on these outcomes and capabilities (e.g. repeated over-achievement; hunger and tenacity of a first generation immigrant who has "made it").

Interviewing Skills

Let's face it, interviewing skills are a lot like sex appeal—our self-perception is typically in excess of reality and in both cases inflated self-perception can lead to painful mistakes. The good news is that investing in improving one's interviewing skills is within everyone's reach and is sure to pay handsome dividends. In our experience there are several key principles to capturing data predictive of future performance:

- Spend 90 percent of the time asking questions on past history rather than hypotheticals or the future. Psychological and marketing research proves that even with the best of intentions people are poor predictors of their own behavior, so only patterns of actual past behaviors can be reliable indications of likely future behaviors;
- Prepare for your interview to capture maximum data most relevant to assessment criteria;
- Ask open-ended questions—not leading or yes/no questions. Probe to get specifics of what this person did and how he achieved the results;
- Allocate at least 50 percent of interview time to probe on weaknesses and mistakes. A typical interviewer spends 80 percent+ of the time on accomplishments and less than 20 percent on mistakes and is too easily satisfied with vague answers and even blatant clichés.

ghSMART applies these principles in the Topgrading Interview® (see Exhibit 1) to help predict individuals' future behavior and performance based on a rigorous analysis of patterns of past behaviors from early years through to the current role. The Morgan Stanley Alternative Investment Partners approach to fund investing places great emphasis on people evaluation using a variant of this approach via formal and informal interviewing, and extensive interview-based reference checking led by senior, experienced team members.

Multiple Viewpoints

To further de-risk your people decisions, it is critical to collect multiple data points on each individual:

- Conduct at least eight to 10 references on each person. Many investors conduct 30+ references on a team;
- Ensure that 50 percent+ of references are "off the list," creatively using personal and professional networks;
- Ensure "360" coverage: other LPs, portfolio company CEOs/CFOs, direct reports and junior team members, past bosses;
- Assign areas of focus to due diligence team members e.g., each may focus on getting data on two to three criteria in a one hour interview;
- Adopt an "ABCD" mindset: Always Be Capturing Data. Use presentations, dinners, and elevator rides;
- Have each due diligence team member independently score each individual and discuss results as a team.

While many investors practice some of the elements of this approach, few—if any—apply them consistently. Perfecting these techniques takes time and organizational commitment but it may easily be the highest IRR investment you will make this year and no doubt the one that will address the #1 source of underperforming investments—people mistakes. ❖

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Exhibit 2: Red Flags and Green Flags

Green Flags

- Hungry to win; embraces challenges
- Loves to make money. Numbers/target driven.
- Pulled from job to job by former employers/clients
- Builds relationships with much more senior people and maintains over long time
- Repeated evidence of leadership
- Owns up to mistakes
- Attracts and retains A talent; replaces underperformers quickly
- Develops a point of view on an investment amidst ambiguity and kills bad deals early
- CEOs proactively call to get input on issues beyond capital e.g., people, strategy
- Treats others fairly and fulfills commitments even when there is little chance of being "discovered"

Red Flags

- Not enough skin in the game
- Unimpressive departures from jobs e.g., "It was mutual." "Politics got to me."
- Won't provide references or answer "sensitive" questions directly
- Consuming interests unrelated to the firm
- Uncomfortable admitting mistakes, blames others or circumstances
- Boils the ocean and "hangs around the hoop" on lackluster deals
- Leverages "grey area" to gain unfair advantage (e.g., "Lenders made a mistake in the calculation and we benefited from it.")