The third strand of due diligence for private equity funds investing in new markets

As private equity funds find themselves looking outside their normal areas of operation, Heyrick Bond Gunning, managing director of Salamanca Risk Management explains how the third strand in the due diligence process provides transparency around a deal, plugging the gap between the work of the fund, their lawyers and accountants.

In the existing climate, many private equity funds will be waiting patiently on the sidelines, whilst others see their investments unravelling before their eyes. For the former, a series of attractive opportunities are presenting themselves that may seem too good to be true. Conventional due diligence aside, there are a host of issues that are likely to arise when funds are entering new markets. Often, judgement may be clouded by predicted financial returns on a deal and compounded by the need for a swift completion which, in turn, makes due diligence simply become a box ticking exercise to fulfil regulatory and compliance requirements.

Reputational due diligence can help to identify problems early, and as a consequence, prevent wasting time on unrealistic opportunities whilst providing transparency on those that are fraught with risk. Presently, companies that deliver such services are finding that as much as 70 per cent of their projects are retrospective investigations into deals that have gone sour. They are being instructed to investigate the wrongdoings of directors and to help in the subsequent attempts at asset recovery and evidence gathering.

In a recent case, we were instructed by a fund to investigate a company that was experiencing huge product losses. In one incident, a container of product had gone missing between a port and a bonded warehouse which was located 20km away. The local police were at a loss as to how it was happening and an investigation ensued focusing on the dispatch, warehousing and logistics offices of the company. It was identified that details of the shipments were regularly leaked, resulting in containers being intercepted and stolen. Within three weeks, it was discovered that the losses were simply part of a payment that was in place with a local criminal organisation and something that the directors of the company were aware of.

In general, it is recommended that firms wishing to carry out reputational due diligence should undertake an overt check for transparency purposes, which is often cheaper and quicker. It also acts as a positive form of confirmation in itself, because if a potential partner refuses an overt check, it is highly likely they are hiding something. Covert or discreet due diligence investigations are possible but will usually take longer and can be combined with an overt check if necessary.

In a further recent example, a client of Salamanca Risk Management wanted to invest $50m into a Balkan private equity property fund that owned some land in the centre of a capital city and was extremely efficient at getting deals through the planning process. The client asked Salamanca to carry out discreet due diligence on the owners of the fund and their track record. The company was

investigated and was found to have exaggerated their track record and falsified their involvement in some deals in the Far East. These facts alone were not a cause to abandon the deal, however, upon checking the background of the directors, it was discovered that one of the principals had a brother-in-law who was the head of the state police. This explained why the firm had such a good track record of processing deals through the bureaucracy and red tape that often caused deal-breaking delays in similar cases. It was assessed that in the future, this could be a positive whilst the relationship was going well, but if the relationship faltered, it increased the likelihood that the client was going to lose their investment as it was likely that the local partner would be able to adversely influence the local judiciary and the chances of successful legal action would be minimal. The final nail in the coffin came from the lawyers acting for the client who discovered that the title for the land did not directly belong to the fund. Inevitably, the proposed deal did not go ahead.

On a more positive note, a client was keen to purchase a shopping mall in the centre of an Eastern European city with a view to redeveloping it with a joint venture partner. An international law firm carried out the due diligence around whether the title deeds were held by the potential partner. Salamanca were asked to carry out a reputational due diligence. The reality is that many successful businessmen in Eastern Europe today often have a colourful past and it was important to put this into context when investigating the individual so that the compliance department understood the realities of doing business in the region. With this established as a backdrop, the investigation was able to ascertain that the joint venture partner had been involved in some high-profile deals in the 1990s, of which ten per cent may have been linked to the "mafia" but that since 2000 his deals appeared clean. The investment progressed successfully and construction is currently underway.

These are just a few examples of how the third strand of due diligence complements in-house processes by checking on the reputation of investor targets and their track records. This can prevent misplaced optimism leading to flawed decisions and investment strategies by private equity funds' GPs.