

**SECTION 1**

**DUE DILIGENCE GUIDELINES  
FOR REVIEW OF PROSPECTIVE MANAGERS**

**(THE “DUE DILIGENCE GUIDELINES”)**

## **Due Diligence Guidelines for Review of Prospective Managers**

This section is designed for review of both separate account and commingled fund managers. For commingled fund reviews, please also refer to other tools such as the ILPA Private Equity Principles (Appendix 1) and the enclosed LPA Checklist and Model Provisions. Note that the term “Manager” refers to the fund’s sponsor and investment manager. “GP” refers to entity that serves as the fund’s general partner or managing member. “LP” refers to a fund investor that is unaffiliated with the Manager.

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## 1) Organization and Personnel

- a) Document the history of the organization
  - i) Growth in firm AUM<sup>2</sup>
  - ii) Appropriateness of firm growth in response to AUM growth
  - iii) Is real estate the only strategy of the firm?
    - (1) If so, does Manager have multiple real estate strategies and how are resources allocated among those platforms?
    - (2) If not, how does firm allocate resources to the real estate team?
    - (3) If not, how critical is the real estate asset class to the firm?
  - iv) Does the firm intend to grow into other asset classes?
- b) Assess the organization's reputation
- c) Competition and competitive advantage
  - i) Identify Manager's competitive set
  - ii) Identify Manager's competitive advantages
- d) Understand the organization's legal structure
  - i) Who owns the firm?
    - (1) If privately owned, owned by the firm's principals?
    - (2) How broad is the ownership of the firm among the investment professionals?
  - ii) Strength of ownership/sufficiency of capital base
  - iii) How is the firm financed?
    - (1) Is there substantial corporate debt, or substantial debt that is recourse to the principals (excluding household debt)?
  - iv) Do the firm and/or its principals possess substantial clawback liability to prior funds?
- e) Determine if there are any criminal, civil, or administrative proceedings pending or threatened against the firm or its principals
  - i) Understand the history of proceedings
- f) Identify other office locations
- g) Obtain an organization chart and employee tenure
- h) Assess the appropriateness of
  - i) Structure and size
  - ii) Positions and experience level
  - iii) Reasons for and level of turnover at each level
- i) Assess Manager's current investment capacity
- j) Assess internal communication

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<sup>2</sup> Calculated in accordance with the October 2011 NCREIF Discussion Paper on Assets under Management Reporting

- i) Decision-making
- ii) Approval processes
- iii) Other formal communications
- iv) Other informal communications
- k) Key principals including department heads
  - i) Assess:
    - (1) Educational backgrounds
    - (2) Employment history
    - (3) Applicable experience
    - (4) Applicable knowledge
    - (5) Leadership abilities
    - (6) Communication styles
    - (7) Market reputation
- l) Administrative and back office personnel
  - i) Assess
    - (1) Level of resources
    - (2) Organization of resources
    - (3) Skill levels
- m) Personal investment, compensation and profit participation
  - i) Assess
    - (1) The level of personal investment by each principal and employee
    - (2) Determine what percentage of each principal's net worth is invested; meaningful to the principals and to the fund?
    - (3) The compensation structure
      - (a) Percentage of base, bonus, and carry respectively
    - (4) The profit participation
- n) Identify any current or potential conflicts of interest
- o) Identify and assess outside support
  - i) Legal counsel
  - ii) Audit activities
  - iii) Research activities
  - iv) Other outsourced activities, if any
- p) Social responsibility:
  - i) Manager's sustainability policy
  - ii) Manager's responsible contracting policy

## **2) Investment Strategy**

- a) Obtain a clear and concise understanding of the strategy
- b) Determine what makes Manager qualified to execute it
- c) Determine the risks
- d) Describe the market conditions in which the strategy will perform best/worst
- e) Identify the key determinants to successful implementation (timing, investment pace, diversification of geography/asset type/etc.)
- f) Assess Manager's past performance and future abilities with regards to those key determinants
- g) Verify Manager's implementation of the strategy with previous investors
- h) Assess the potential of the strategy going forward
- i) Identify Manager's problem-solving process and assess its ability to deal with unanticipated events
- j) Assess any conflicts of interest, including competing strategies by Manager and how these have been/will be handled
- k) Assess transaction sourcing capabilities
  - i) Network
  - ii) Off-market sourcing capabilities
  - iii) Underwriting of expected return, risks, and exit
  - iv) Speed of execution
- l) Review exit strategy and liquidity mechanisms

## **3) Performance**

- a) Review historical returns
  - i) Relative to peer / benchmark performance
  - ii) Realized versus unrealized
  - iii) Extraordinary events/items that affected returns
- b) Recalculate sample of return history:
  - i) Obtain fund return details:
    - (1) IRR basis
    - (2) Time-weighted return basis
    - (3) Equity multiple basis
  - ii) Recalculate project/company-level returns
  - iii) Review fees and promotes paid to third parties
  - iv) Review appropriateness of partnership level expenses
  - v) Verify calculation of fees

- vi) Recalculate net return to investors
- vii) Verify historical returns with a previous investor
- viii) Review auditor opinions on prior funds
- c) Assess components of return:
  - i) Cash flow versus appreciation
  - ii) Alpha versus beta
- d) Assess the level of risk taken to achieve the returns
  - i) Strategic
  - ii) Leverage
  - iii) Foreign exchange
- e) Review the rate of contributions and distributions

#### **4) Compensation**

- a) Document all fees to be paid to Manager during the life of the fund
  - i) Management fee level, timing and level of service included, plus any other fees
  - ii) Management fee per professional
  - iii) Determine fee drag (gross-to-net return spread) and impact on performance
- b) Determine if any investor or outside party shares any of the fees including rebates
- c) Assess the appropriateness of total fees to management's costs
  - i) Estimate and evaluate the management platform profit margin
  - ii) Contrast to level of expected/target performance-related income
  - iii) Consider appropriateness of fees relative to the risk/return profile (for example, REITs, debt, development, etc.)
  - iv) Determine alignment of Manager with LPs through fee structure (acquisition and management, origination fees, etc.)
    - (1) Incentives created by fees based on gross investment price versus equity invested versus market value of gross assets or equity
    - (2) Assess minimum base management fees
    - (3) Incentives created by acquisition versus disposition-based fees

#### **5) Investor Base**

- a) Identify Manager's historic investor base and dollars committed
  - i) Length of investor relationships
  - ii) Investor dependency: Do one or two investors represent an inordinate amount of capital committed?
    - (1) Do those investors drive the decision-making, strategy, or exercise more control than other LPs, either directly or indirectly?

- (2) If those investor(s) were to terminate Manager, would that pose a risk to the firm's survival?
- b) Assess Manager's current and future fund investor base and dollars committed
  - i) Obtain list of other LPs considering or who have committed to the fund being raised
  - ii) If any prior investor is not planning a commitment to future funds, determine rationale
- c) Review underwriting strength and transparency of other LPs
- d) Review consistency of LP co-investor investment strategy and liquidity needs

## **6) Reporting and Investor Communications**

- a) Review Manager's historic reporting processes
  - i) REIS compliant? (See Appendix 4)
  - ii) Contributes data to industry-accepted indices such as the PREA/IPD Index?
- b) Assess quality of communication and interaction between LPs and Manager
- c) Assess the adequacy, completeness and timeliness of:
  - i) Quarterly reports
  - ii) Annual reports
  - iii) Annual meetings
  - iv) Legal communications
  - v) Other communications
- d) Assess communication process
  - i) Web site access
  - ii) Email distribution
  - iii) Physical distribution
- e) Obtain contact information for:
  - i) Key principals
  - ii) Investor relations
  - iii) Accounting
  - iv) Tax
  - v) Legal

## **7) Office Site Visit**

- a) Meet with key department personnel
  - i) Heads of acquisitions and underwriting/due diligence
  - ii) Head of dispositions
  - iii) Heads of asset management and portfolio management
  - iv) Head of fund management

- v) Head of finance
  - vi) Head of research
  - vii) Head of investor relations
  - viii) Head of back office/accounting
  - ix) Head of legal and/or tax
  - x) Internal and external investment committee members
  - xi) Internal representatives of advisory boards/committees
- b) Meet with representative support personnel from relevant departments
  - c) Assess competency, motivation and collaboration
  - d) Assess general atmosphere of work environment
    - i) Leadership style—team approach or single decision-maker
    - ii) Formality/informality
    - iii) Demeanor of office
    - iv) As a place to work
  - e) Observe physical conditions of space:
    - i) Layout of offices and personnel
    - ii) General work flow within office
    - iii) Overall organization of common spaces
    - iv) Organized nature of individual offices
    - v) Cleanliness of space and condition of furnishings
  - f) Assess location
    - i) Appropriateness of city
    - ii) Appropriateness of submarket
    - iii) Importance of location to work
  - g) Observe computer systems and software capabilities
    - i) Acquisition and asset management systems
    - ii) Financial reporting and portfolio analysis tools
  - h) Understand lease arrangements
    - i) Length of lease
    - ii) Above- or below-market rent structure

## **8) Reference Checks**

- a) Perform investor reference checks with regard to the following:
  - i) Prior fund performance (general and specifically returns)
  - ii) Appropriateness of strategy
  - iii) Ability to execute strategy



- iv) History of Manager's sticking to articulated strategy
- v) Overall assessment of Manager
- vi) Competition and competitive advantages
- vii) Conflict of interest issues
- viii) Other risks
- ix) Reporting and communication
- x) General recommendation and intention to reinvest
- b) Perform investment team and/or key person reference checks
- c) Perform service provider reference checks
- d) Perform operating partner reference checks

## **9) Background Checks**

- a) On key employees
  - i) County assessor
  - ii) Previous employment verification
  - iii) Education verification
  - iv) Federal bankruptcy court
  - v) Criminal court
  - vi) UCC, liens
  - vii) Terrorism
  - viii) Sex offender
  - ix) Drivers license verification
  - x) Vehicle registrations
  - xi) Civil courts
  - xii) News articles
- b) On organization/entities
  - i) SEC
  - ii) Federal bankruptcy court
  - iii) Criminal court
  - iv) UCC, liens
  - v) Civil courts
  - vi) News articles

## **10) Legal**

- a) Refer to the LPA Checklist, the Model Provisions, and the ILPA Private Equity Principles
- b) Obtain and conduct legal review of the following documents:
  - i) Private placement or offering memorandum
  - ii) Limited partnership agreement
  - iii) Partnership incorporation documents
  - iv) Subscription documents
  - v) Management agreement
  - vi) Side letters
  - vii) Other legal documents
- c) Review the legal structure for tax and UBIT issues
- d) Identify permitted liquidity options
- e) Identify investor blocks that can carry issues on which the investors will vote

## **11) Risk management**

- a) Assess vendor and operating partner selection process and oversight
- b) Review cash management and reconciliation process
- c) Review recordkeeping policy
- d) Review formalized investment processes and procedures
- e) Review business continuity plan
  - i) Frequency tested
  - ii) Existence of business resumption site
  - iii) Crisis management
- f) Review alignment of interests with other LPs
- g) Review fund terms related to risk management:
  - i) Scope of permitted investments and investment limitations
  - ii) Existence of and limits on insurance coverage for Manager, GP and advisory committee (per-occurrence and aggregate bases)
  - iii) Limitations on amounts and types of leverage (recourse, cross-collateralization, etc.)
  - iv) Limitations on use of derivatives
  - v) Interest hedging strategy
  - vi) Cash and liquidity management
    - (1) Minimum and maximum level of cash held by fund
    - (2) Assess type and risk of permitted investment of cash
      - (a) Low versus high risk/yield cash investment

- (b) Distribution of interest income
  - (3) Assess dividend distribution and/or re-investment policy
- vii) Currency/foreign exchange management
  - (1) Funding in foreign currency
  - (2) Hedging of investments in foreign currency
- h) Review past and current arbitration, litigation or disputes with partners and/or investors
  - i) Assess nature, outcome and payments
- i) Understand sponsor advisory board representation, structure and authority
- j) Review copies of prior funds' advisory board and/or investment committee meeting minutes (topics discussed, areas of focus, meeting participants, etc.)
- k) Assess qualifications of independent auditor

## **12) Valuations**

- a) Frequency and responsibility of internal / external valuations
- b) If applicable, describe firm's approach to the FASB ASC 820 (Fair Value Measurements and Disclosures) and ASC 825-10 (Financial Instruments – The Fair Value Option) requirements relating to marking investments to market
- c) Determine if policy differs from the policy used in prior funds
- d) How have valuations been done historically in comparison to the industry (i.e., does Manager tend to implement valuation changes ahead of or behind the market in general)?

## **13) Financing**

- a) Assess use of debt in the fund's investment strategy
  - i) Maximum debt on asset and portfolio level; long-term target
  - ii) Assess use as return enhancer or cost (tax) reducer
- b) Use of subscription facility
  - i) Review assess fees
  - ii) Review limits on size and restrictions as to use and time
  - iii) Assess whether and how the facility is included in reporting total levels of debt
- c) Type of debt
  - i) Bullet versus amortizing loans
  - ii) Balance sheet versus conduit/securitized debt
- d) Review debt terms
  - i) Assess diversification by debt maturity
  - ii) Interest rate base
  - iii) Review and evaluate margins
  - iv) Debt fees, including origination, pre-payment penalties, etc.

- v) Covenants
  - (1) DSCR and LTV
  - (2) Soft versus hard covenants
  - (3) Testing periods
  - (4) Assess whether covenants are in line with asset risk
- e) Collateral
  - i) Recourse versus non-recourse financing
  - ii) Master leases and other forms of implicit recourse
  - iii) Cross-collateralization versus asset-by-asset financing
- f) Origination
  - i) Use of brokers versus use of internal team
  - ii) Diversification of banking relationships
  - iii) Experience of partner/team
  - iv) Quality of lender relationships
  - v) Origination cost/fees
  - vi) Examples of debt sourced
- g) Assess Manager's ability to deal with covenant/refinancing issues

#### **14) Deal pipeline and seed assets**

- a) Blind pool versus seeded with assets
- b) Review existing or pipeline assets
- c) Assess pipeline in light of investment strategy and expected time to closing
- d) If seeded
  - i) Review ownership history
  - ii) Acquisition/transfer process
  - iii) Basis of transfer valuation (number and nature of valuations)