Reference Calls

From an allocator's perspective, regardless of how inclusive (for legitimate or CYA reasons) due diligence appears on the surface, it remains a very lonely endeavor. A research analyst's solitude is further intensified when assessing a private assets investment opportunity. In the private investment research profession, it would seem that the initial investment period that lasts three to five years, plus the relatively long term (generally 10 years or more) would invite a battalion of cavalier individuals. I have however found that the most thoughtful and elite analysts carry the responsibility of locking up capital for long periods with parent-like heartache and dedication. The fiduciary's (especially the ones that take it seriously) burden is heavy, and his/her journey is strewn with traps containing peer pressure, false narratives, complex biases, and occasional blinding introspection.

To help lighten the weight of expectancy and dull the very sharp self-doubt blades that haunt solitary pursuits, analysts have adopted some very thoughtful processes, tools, and mechanisms during due diligence. "Reference calls" have long served as a valuable component of conviction building. Speaking to folks who are directly or tangentially linked to the fund/sponsor being assessed is a vital way to reduce information asymmetry. Reference calls are of course not a panacea for a lack of real work, but they serve a purpose – this purpose sometimes leans toward "confirmatory", and other times, leans toward "discovery".

Reference calls provide an opportunity for creativity during due diligence. The creativity can be in the form of who you choose to speak to, what questions you choose to ask, what forum/medium you choose to ask these questions in, the tone (negative or positive) in which you choose to phrase your questions, how leading or non-leading you choose to make your questions, how closed- or open-ended you choose to structure your questions, etc. Triangulation of potential folks to call upon always caused my creativity to go into overdrive – the possibilities are endless. Co-board members, former employees, past/current co-workers, portfolio company management team members, failed investments' personnel, service providers, past LPs that no longer invest with the manager, current LPs that have been there since the beginning, potential LPs concurrently assessing the GP, historical strategic/financial acquirers of the GP's portfolio companies, etc., etc. – all have the likelihood to appear on a reference call hit list. Executed properly, reference calls have the potential to help piece together and unblur the intricate mosaic of a manager's character. It is important to note that reference calls would be unnecessary if there wasn't an inherent conflict created by the fact that most of the information used for manager due diligence comes from the manager being assessed.

Conducting reference calls at the beginning of manager assessments can serve to quickly determine which GPs are worthy of process advancement – I question the effectiveness of reference calls early in the consideration process because there is just not enough familiarity to ask pertinent questions. On the other hand, executing reference calls at the tail end of due diligence almost always becomes a check-the-box exercise that is massively prone to confirmation bias – reference calls executed as part of the conclusion phase of due diligence reduce the potency of received information because only the most heinous feedback is acted upon. At the late stage, the energy and will to pull on strings to see where they lead is understandably depleted. In my opinion, the midpoint of due diligence is the most appropriate time to start the reference calls process – the calls can be strategically peppered between other qualitative and quantitative work. At the mid-stage, enough acquaintance has been made with the manager to ensure that reference questions express a good amount of substance. Also, curious strings that emerge from reference calls at the mid-phase, can be tugged on and followed until satisfaction is reached. Additionally, bringing the whole due diligence process to a halt at the middle stage, although painful and irritating, is a lot easier to do than at the tail end. I have occasionally heard analysts/investors “humble brag” about killing a deal/opportunity at the 11th hour because of something they heard on a reference call. Well, kudos for being disciplined, stoic, and principled, but did you really have to wait that late in the process and expend so much energy/resources before probing for such information?

Yes, on paper, reference calls sound like an enchanted qualitative garden filled with blossoming and very fragrant confirmations, sprouting hearsays, and twining counter-opinions - but what about the real-world mechanics of conducting effective reference calls? How many reference calls should an analyst make? How should potential targets be prioritized? Should information from certain parties be overweighted in terms of significance above others? How do you deal with one extremely negative reference call? These are all good questions that I have pondered and debated over for many years. The simple (and very consultant-ty) answer is “each situation guides you to the right approach”. Some situations will alert you to the need to speak to more people. Others will nudge you to pay more attention to a particular group of stakeholders. There will be times when the precedence of industry reputation and/or the extreme similarity of initial feedback provides confidence to truncate the process - *you must follow the vibes young grasshopper – hahaha.* However, in all seriousness, when you remind yourself that although qualitative in nature, reference calls can be critical in strengthening or weakening quantitative findings – this knowledge allows an analyst to, using creativity, patience, and tact, fully embrace these reference interactions as a benevolent tool.

Lastly, it must be emphasized that a GP’s attitude towards reference calls is another treasure trove of direct and subliminal information. Absolute reluctance to share a reference list would be too much of a red flag to LPs, so most GPs provide prospective LPs with a curated aggregation of folks that can be contacted for references – these are commonly called “on-list references”. However, many prospective investors have developed a rational taste for going off-list, which involves coming up with names of related parties of the manager they wish to speak with. Off-list contact information can either be supplied by the GP or creatively found through an analyst’s own triangulation. Taking time and decorum into consideration, some GPs try to reduce the number of potential LPs calling the same reference – this makes sense because numbers could balloon very quickly without any controls. GPs who limit calls to specific individuals do so by only allowing access to certain (based on the size of the probable investment, the LP’s esteem, the absolute number of slots i.e. 20 maximum references per contact, etc.) potential LPs. Other GPs have chosen to go the “testimonial” route, where historical relationships provide accessible feedback. I have also seen circumstances where GPs use third-party (arm’s length) servicers to interview reference call targets and place responses in a data room repository for LPs to review (with the assurance that the GP has not tampered with the information). Whatever method GPs choose to provide transparency to LPs, especially regarding reference calls, careful consideration must be given, because the chosen methodology will either enhance or erode trust.

Like most things in life, to get to the cold hard truth, tension and discomfort must be present. To strengthen one's conclusions, reference calls can be a very effective way of harvesting opinions, experiences, and assessments of others.

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April 14th, 2024.