Failing Due Diligence

by Charles B. Wendel

Last time we wrote about the importance of due diligence and how some Private Equity firms (with FTX) and banks (Chase with a student-oriented company, Frank) failed to protect themselves and their investors/shareholders.

How do people who often view themselves "the smartest in the room" frequently fail at due diligence? As mentioned last week, probably the most client valuable work we've done has been due diligence related, whether suggesting a purchase or warning off potential buyers. That hard-won experience has provided some insights into due diligence challenges.

There's some overlap between the six items below, and you may well have other issues to add to our list. I'd love to hear them.

1. **Avoiding deal bias.** I'll never forget a banker from years ago (my boss for a time until he was fired) who would cursorily look at a transaction and declare quickly, "I want to do this deal." That's a dangerous bias. Similarly, we have worked with Chairmen who wanted or needed to do a deal. The want was from the desire to be bigger; the need may have been using from the new deal to cover past mistakes with a new entity.

2. **Chasing the shiny penny.** What was sexier than crypto? What segment is more attractive than the young, people whom a bank believes they can lock in for years? We've seen the "hotness" of an area fog the mind of supposedly tough-mined investors.

3. **Relying on the other guy** Literally last week we heard the head of a large and very well-respected bank justify a bad partner by mentioning that this problem company had fooled many others. That's true, but so what? The one stupid bank loan I made occurred in part because both my boss and I looked admiringly at the other banks who had already committed to that borrower. I made that mistake just once.

4. **Bowing to the Emperor.** This point touches on one and two above. Years ago, we worked on a due diligence project for a long-time client. Our analysis (as well as that of other insiders) resulted in the recommendation not to buy the target, a company the Chairman thought would help fuel growth. He wanted to do a deal. We were not invited to be part of the next due diligence process, this one resulting in a deal that did not go well for the acquiror. Frankly, I think we were excluded because we gave the "wrong" or undesired answer the prior time. Others working on that due diligence team may have OK'd a deal because it was in their near-term self-interest to placate the big guy.

5. **"Coviding" laziness.** Doing due diligence remotely? NO. As a consultant, I've learned so much by meeting people face-to-face, observing their office and work styles, and finding papers that might have been overlooked otherwise. But at least one of the PE firms investing in FTX was willing to rely upon Zoom. That team appeared so eager to do a deal that an in-person meeting might not have mattered, but maybe it would have. Take a close look at the eyes accompanying this article.

6. **Assigning the wrong team.** One investor group I traveled with for a due diligence session spent much of their time on the phone ordering the right kind of limo to pick them up when they returned to at the NYC airport and take them to the Hamptons. This group may have been smart, but they were not about to roll up their sleeves and get into messy details.

   A Saturday article in the New York Times chronicles the story of Frank and asks how Chase could have made a $100mm+ mistake. The article pointed put that the site had only 67,000 unique visitors the month it was acquired for the 5mm customers it promised Chase. And it asked this question: "Did the bank's due diligence team include anyone who had been on financial aid, to see if the whole thing passed the sniff test…The bank would not comment on this or other aspects of the due diligence." I'm betting "no" is the answer to that question.

Last week, a retired banker formerly at a top tier bank described due diligence as a business segment at his bank, one that had a full-time leader who could cut across the institution to select the optimal team. Many companies lack the bank-width to do the same, but all can set clear goals for the team, supplement it with outsiders, and ensure that analyses and recommendations avoid emotions and special interests and are as fact-based as possible.

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