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Embracing AI for People Due Diligence

In the high-stakes world of Venture Capital and Private Equity, due diligence is a crucial process, traditionally focused on financials, market opportunities, and competitive positioning. However, an often overlooked component is the people behind these numbers. People due diligence, i.e. assessing the behaviors, leadership styles, and potential of key executives, should be a fundamental part of both initial and ongoing evaluations. Neglecting this qualitative aspect can lead to significant risks, such as misaligned leadership, toxic workplace environments, failure to leverage key strengths, and ultimately, the jeopardization of the entire investment. An unbiased evaluation of executives' behaviors and team dynamics is vital in making informed, strategic investment decisions.

The Risks of Neglecting People Due Diligence

The consequences of inadequate People Due Diligence (PDD) can be profoundly damaging. Consider the scenario where an executive team includes toxic leaders—individuals exhibiting traits such as narcissism, manipulation, a reckless desire for risk, or a lack of empathy. These tendencies gradually erode a company's culture from within. Notably, companies led by such toxic executives are more likely to make poor strategic decisions, engage in unethical practices, and disregard long-term organizational health, all of which can trigger financial decline or even bankruptcy (A. Cohen, 2018).

Furthermore, it's not uncommon for such counterproductive behaviors to manifest in top positions, as individuals with these tendencies often rise quickly through the ranks. Research by Grijalva et al. (2013) highlights that narcissism significantly increases the chances of an individual emerging as a leader, especially in contexts where people have not known each other for long, such as in new teams or during brief interviews. This is because self-centeredness and lack of empathy, tend to take time to reveal themselves. As a result, individuals with these tendencies often benefit from their boldness and charm when they are new to a group.

Once toxic leaders take charge, they can create hostile work environments that lead to high employee turnover, diminished morale, and, ultimately, a severe drop in employee engagement. (Need a reminder? Luxembourg's engagement rate is a mere 8%.) These aren't just immediate concerns—they're significant triggers for plummeting productivity levels across the board. To grasp the scale of this issue, look to Germany, where disengagement was estimated to cost the economy a staggering 132.6 to 167.2 billion euros in lost productivity in 2023 alone (Engagement Index Germany 2023, Gallup).

Given these stakes, investors must be extremely cautious in their assessments, avoiding processes like unstructured interviews that might favor dark personalities and allow them to mask their traits (Brunell et al., 2008; Paulhus, 1998). This is where AI comes into play. AI can cut through biases and reveal deeper behavioral insights, uncovering nuances that human evaluators might miss and offering a clearer, more objective view of the leaders' potential impact on a company. Michael Lange, Operating Partner at One Equity Partners LLC, states, "AI enables us to analyze the top management of our portfolio companies more comprehensively. It helps us to identify team dynamics, potential risks, and even blind spots that might not be evident through traditional evaluations. This deeper insight allows us to manage and optimize our investments more effectively, ensuring that leadership teams are aligned with our strategic goals."

The Gains from Human Behavioral Insights

It's not just the darker aspects of personality that pose a threat to business success—overlooking the alignment between a leadership team's capabilities and the company's growth stage can be equally detrimental. A team that excels in the fast-paced, innovative environment of a startup might flounder when tasked with scaling

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operations or managing the complexities of a larger enterprise. Without a deep understanding of the psychological resources and individual skills of its leaders, investors may find themselves backing a company that, despite strong financials, lacks the essential drive and adaptability needed for sustained growth.

On the flip side, incorporating PDD into the investment process can unlock substantial benefits. A thorough assessment can uncover the entrepreneurial capital within a company—the drive, innovation, and leadership potential of its key individuals. Understanding these qualities allows investors to identify teams that not only have the technical skills but also the vision and adaptability to navigate challenges and capitalize on opportunities. Entrepreneurial capital is often a reservoir of untapped potential, and when properly harnessed, it can be the differentiator that pushes a company from mediocrity to market leadership.

However, PDD should not be seen as a tool for making definitive judgments or decisions but rather as a complement to the broader spectrum of information gathered during the due diligence process. It provides investors with insights that go beyond financial statements and past performance, adding an additional layer of understanding that helps them ask the right questions and make more informed decisions.

Time to Leverage Available Technology

This is where AI, particularly through Natural Language Processing, can transform PDD. Unlike traditional self-assessments or extensive interviews, which are often influenced by social desirability bias, NLP can analyze how individuals express themselves in text, providing a more nuanced and less biased understanding of their behaviors and leadership potential. AI has the ability to process vast amounts of data, from written communications to decision-making patterns, revealing insights that might be overlooked by human evaluators. By using AI, we can move beyond surface-level assessments and uncover more about a leader's potential impact on a company.

As this technology advances, it's critical that we leverage it in a controlled, tested, and verified manner to ensure reliable and ethical application. This is particularly important given the EU AI Act and GDPR. While alignment with both is achievable, it's essential to be aware of the complexity involved. Careful navigation of these regulations is necessary to ensure that AI is used responsibly, balancing innovation with the highest standards of data privacy and ethical responsibility.

Cost-effectiveness is another compelling argument for AI. Traditional human-led assessments, are often costly and time-consuming. AI tools, by contrast, are not only more affordable but also scalable. This scalability allows investors to apply PDD more broadly, increasing the likelihood of making successful investments. Prof. Dr. Dominik Matyka, Founder at Cavalry Ventures, emphasizes, "For early-stage investors like us, AI democratizes PDD by making it affordable and accessible. It allows us to gain deeper insights into founder teams, helping us to better support their development and make complementary hires that align with their growth trajectory."

Conclusion

In conclusion, the time has come for VC and PE investors to fully embrace AI in their due diligence processes. By integrating AI-driven PDD into both initial evaluations and ongoing monitoring, investors can make more informed decisions, mitigate risks, and ultimately drive better outcomes, at a lower cost. The future of due diligence lies in leveraging technology to gain deeper, more accurate insights into the people who lead the companies in which we invest. This approach not only enhances the quality of our decisions but also aligns with the dynamic, data-driven nature of modern investment practices. ●