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Operational Due Diligence

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The next evolution in operational due diligence

Are you ready for the next phase in operational due diligence? The expectations are changing, and private capital firms that fail to meet those expectations are in danger of losing their competitive edge.

The private capital industry continues to mature, allocations continue to increase and the level of due diligence that investors are bringing to the process continues to rise. LPs are examining the behind-the-scenes operations of their fund managers in greater detail than ever before, and they're wise to do so. The strength of those operations have a direct impact on the firm's ability to manage funds effectively and add value.

As a result, the back office is becoming a front-facing operation, something that investors want to be able to see, evaluate and communicate with. Is your firm ready for that level of transparency? These are some of the expectations your firm should be ready to meet.

On-site reviews

In the past, due diligence has largely been an arms-length exercise conducted through electronic file transfer, but a growing number of LPs are taking a more hands-on approach and requesting an on-site review of the GP's operations as part of the process.

No longer satisfied with routine answers to questionnaires, LPs want to visit the fund manager in person and see with their own eyes how the GP is running their business. This level of involvement isn't an outlier: it's becoming standard practice. At this year's SuperReturn CFO / COO conference, a panel member representing a top fund manager estimated that 75 percent of the investors that commit to their fund perform due diligence on site. Another panel member estimated that 10 percent of their investors not only demand an on-site visit, but arrive with a separate, independent due diligence team in tow.

While these on-site reviews are generally a one-time event intended to help the LP get to know the GP, a number of LPs also require an annual on-site review. Some GPs are pushing back against the process because it takes two days out of their schedule—a day for prep and a day to hold the review. Others, recognising the need to meet their LPs halfway, are coming up with creative solutions, such as organising an "open house" for a few days each year during which all LPs are welcomed on site.

Ultimately, investor relations are moving in the direction of greater transparency and accessibility, and if the GP is unable to demonstrate that they can run their business effectively, it speaks poorly of their ability to maintain operational excellence within their portfolio of investments and is likely to erode LP confidence.

Technology reviews

Technology has become an integral part of a GP's ability to outpace their competitors. A GP's investment in technology impacts the firm's ability to monitor and manage their investments as well as communicate more proactively and effectively with their investors.

LPs can no longer justify management fees for a fund that's managed with first-generation solutions. While simple accounting and spreadsheet solutions such as Quickbooks and Excel are useful tools, investors want to know that the fund's management is being supplemented with more robust, secure and sophisticated products.

Investors are paying more attention to the technologies fund managers use for their operations and developing more rigorous processes for evaluating it. They want to know that the firm's platforms support business continuity, data security and data integrity—and it's an issue important enough to affect their decision to invest. (For more on the topic, read "Are data and content integrity issues undermining your credibility?")

LPs are also paying attention to how much of the firm's technology is in-house versus outsourced. If you're passing some of your technology operations to a third-party service provider, and if that technology sits outside of your business and your servers, how are you managing that process? How are you vetting your service providers? How are you ensuring cyber-security? How are you ensuring the safety and maintenance of the software and hardware your operations rely on? Your firm should have satisfactory answers to these types of questions at the ready.

Human resource reviews

Technology resources aren't the only ones under scrutiny: human resources are under the microscope as well. LPs have begun examining the processes the fund manager has in place to protect the skills and knowledge required to ensure operational continuity.

At the recent SuperReturn CFO / COO conference, succession planning, in particular, was identified by panelists as an issue with the potential to affect a fundraise. A GP's value is tied to the connections and expertise of its partners, and LPs want to know that the firm has a plan in place to retain that value when the partners exit. What does the phase-out plan look like? How will it affect the next fundraise? How will the firm attract comparable talent to replace the outgoing partners?

But LPs aren't just examining the stability of the firm's top-tier management. They are looking at the way fund managers recruit and support staff at all levels, and requesting interviews with the firm's junior staff members to find out how they are treated, how they are compensated and how they feel about their career path. This information is used to assess the firm's organisational culture and stability, which in turn is factored into its potential to manage funds effectively and create value.

Front-to-back transparency

Operational due diligence has evolved from an arms-length exercise to a thorough, hands-on examination of the fund manager's systems, talent and technologies. LPs are looking for GPs that are ready to open not only their books but their doors, and they expect greater transparency in exchange for their money and their trust. Fund managers that are ready and willing to share a wider range of operational information will attract top investors and build a stronger reputation in the investing community.

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