



Brave New Operational Due Diligence

A conversation about excellence
in **GP infrastructure and compliance**

Part of the Gen II Fund Services thought-leadership series,
Unlocking the Power of Private Equity Data

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Before investing in a private equity fund, institutional investors must carefully vet the fund manager. Historically, this has meant a laser focus on past performance. And while the veracity and source of performance remains the central focus of manager due diligence today, investors are increasingly interested in the quality of a the fund's operational infrastructure. In other words, how professional is the back office? How seriously does it approach the tasks of cybersecurity, compliance, and treasury? Today's LPs believe that a firm that has delivered good returns in the past is more likely continue doing so if the firm itself is expertly run. Hence, operational due diligence (ODD) is becoming a regular part of every GP vetting process. Privcap recently spoke with two veterans of ODD to get a sense of what the scope of the process is today and how prevalent it will be in the future.

Privcap: For those who don't quite know the definition of operational due diligence, what is it?

Patrick Kotras, Hamilton Lane: Historically, before the Bernie Madoff crisis, it was more of a check-the-box activity. Do they have an auditor? Are they producing reports? Is there an office? Things like that. But today, ODD is becoming an integral part of the diligence process. In Hamilton Lane, it is being leveraged by several different teams. My team works hand in hand with the investment diligence team to do everything from verifying the returns data and working with legal to make sure everything is appropriately documented in LPAs and side letters.

Steven Alecia, Gen II Fund Services: ODD has undoubtedly become a focus of the LP community. A couple of years ago, we would perhaps get emails asking, "Are you the administrator? Please confirm." And that would be the end of it. Now there are full-scale questionnaires that are 40 pages long, and regular onsite meetings with limited partners. So the scope of ODD has definitely changed.

Kotras: Yes. ODD now doesn't stop at the manager. It goes one step further to a fund administration group like Gen II. The group doing due diligence will not only want to verify that the relationship exists, they'll want to put boots on the ground.

Can you give an example of a type of information being sought out that wasn't in years past?

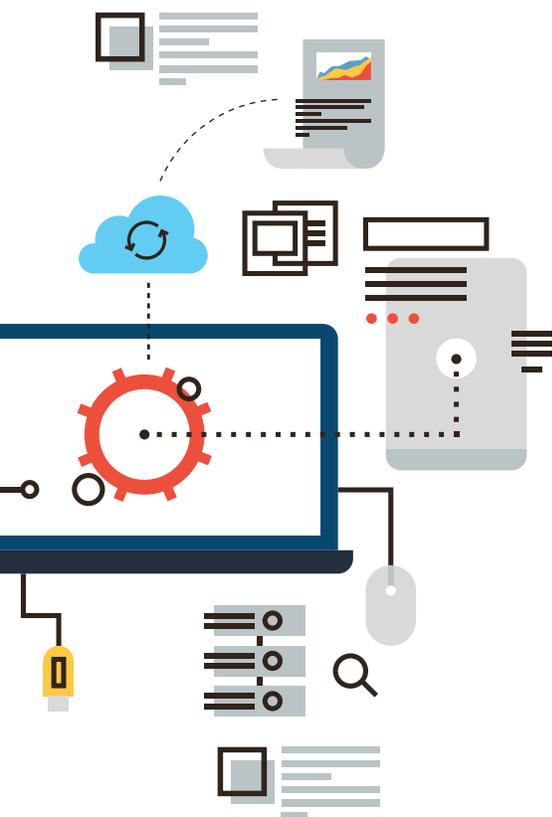
Alecia: On our side, the questions have expanded to now include in-depth details on processes and controls, privacy, cybersecurity and data protection.

Kotras: We're adding things to our questionnaire weekly. It's a more complex regulatory environment and a more complex world we live in. So we'll ask managers how they are thinking about complying with things like GDPR [European Union General Data Protection Regulation]. We'll ask what they are doing around sexual harassment and discrimination policies.

What are LP expectations around ODD?

Kotras: LPs just want their managers to be transparent, which hasn't always been an easy pill for GPs to swallow. But LPs want to make sure that they're given all the information they need to make an informed investment decision, and that no longer means just getting investment return data. GPs now need to open up and explain their back-office infrastructure, to demonstrate they are able to operate in a much more complex environment.

Alecia: LPs expect their managers to have institutional-grade infrastructure in



addition to a strong track record. While the GP may be a small boutique shop, investors still want to be comfortable with the GP's operations, processes, controls, and data security. Investors want both timely and accurate information, and also comfort that their GPs have selected a fund administrator that can enable the GP to meet the LP operational requirements.

Can GPs do everyone a favor by preparing much of the ODD information in advance of a fundraise?

Alecia: Yes. We are regularly speaking with our clients in the fundraising market to help them put together responses to due diligence questionnaires. You can't anticipate every question, but there are already guidelines out there from groups like ILPA [Institutional Limited Partners Association]. In our case, we can create responses ahead of time to questions about our processes, our SOC 1 report, our interactions with client around the review function, the deliverables to the LPs, the controls around the treasury function, and other areas of LP interest.

Kotras: Before a fundraise, GPs need to take a step back, look at the risks affecting their businesses, and make sure they have policies and procedures in place to address those risks. Then the key here is to document everything. It's no longer acceptable to not have these things documented and written down so that everyone's aware of what's expected of them from an operations standpoint. In an ODD diligence meeting, it's very helpful when managers have their own prepared items and don't wait for the LP to request them.

What does it look like when a manager is unprepared for today's level of ODD scrutiny?

Kotras: Sometimes it's scary—there's a lack of transparency. They just won't provide you with the data you're asking for. That right there is a bad sign. It's even worse when you receive a GP's materials and they obviously have not been updated since the last fundraise. They're just dusting it off. It becomes clear that it hasn't been a priority for them to think about their everyday

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-Patrick Kotras, Hamilton Lane

operations. It's a big red flag when you meet people who only think about these things when it's time to raise money.

What are ODD onsite meetings like?

Alecia: I've participated in quite a few, and they can be very in-depth. Sometimes the LPs want to meet us separately without our GP client. They may carve out an hour for us during their all-day site visit. You can expect questions around the fund's operational processes and controls, the treasury function, the release of payments, thresholds, authorized signatories, and risk management. LPs discuss the timing of when they can expect to receive reports and what the reports are going to look like. They'll ask for samples of capital call and distribution notices and partner capital statements. We've even had very large, well-known state pension plans come into our office and just focus on waterfalls, because they said they have encountered way too many situations where the manager did not understand the waterfall. They will spend hours with us reviewing how we prepare the economic allocations and the waterfalls, and gaining comfort that we are performing it accurately.

Kotras: The way I always think about site visits is, it's your opportunity to verify what the managers told you. You want to make the most of your time with the manager and really verify that the procedures they documented and told you about are actually operating in the way they described them. You're meeting not only with key executives but also lower-level employees.

What is an example of a weakness that you've uncovered during ODD?

Kotras: I've encountered groups that are still referencing U.S. GAPP, when obviously the standard switched to ASC 820 years ago. Even little things like that worry you that other parts of the story don't make sense. Then you'll see that what they're saying in their compliance manual doesn't agree with

what they're saying in the LPA versus what they're saying in their marketing materials.

A question about first-time funds: How completely institutionalized do these newer groups need to be to get taken seriously by investors?

Alecia: Emerging managers need to have the right outsourced providers helping them, one that has long standing track record with first time funds, including deep LP relationships. That can be Gen II as a fund administrator, a well-known audit firm, a leading compliance firm, and an IT outsource provider. They don't need to build their own in-house teams initially, as out-sourcing to top-quality providers gives them the controls they will need and credibility with LPs. We see that the LPs are very comfortable with and in some cases insistent on a third-party administrator being involved, and we're starting to get referrals from LPs when they are trying to help out emerging managers.

Kotras: Unfortunately, the barriers to entry for new GPs are getting higher and higher all the time, thanks to growing regulatory requirement. Looking at first-time managers, we don't expect them to be like a public investment advisor, but we expect them to have a certain level of institutional control and to be staffed appropriately. It helps if they are engaging with knowledgeable service providers to help them with things like accounting, compliance, and cybersecurity.

How is private equity doing relative to other industries in embracing ODD?

Alecia: Private equity has lagged behind other asset classes, like hedge funds. Many of the ODD documents we receive have clearly been lifted from hedge fund questionnaires and morphed into a private equity questionnaire. Some of the questions are not applicable to private equity. But as private equity matures and ODD becomes more prevalent, these types of questionnaires will be far more pertinent and the GP's answers far more important. ■

About the Experts



Patrick Kotras

Vice President,
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Patrick is a vice president on Hamilton Lane's client service team, where he is responsible for operational due diligence, compliance, and risk management.

Prior to joining Hamilton Lane in 2016, Patrick served as controller and head of operations at Dreamit Ventures, where he managed finance and back office-operations. Previously, he worked at Camden Partners, ABS Capital Partners, and PricewaterhouseCoopers.

Patrick received an M.S. in taxation from the University of Baltimore and a B.S. in accounting from the University of Maryland. He is a CPA.



Steven Alecia

Chief Client Officer,
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Steven is a founding member of Gen II Fund Services, LLC. He has spent over 22 years in the private equity administration industry. Steven oversees all of the client service team operations at Gen II.

Prior to founding Gen II, Steven was a managing director of Citi Private Equity Services, Inc., a senior vice president of BISYS Private Equity Fund Services, and a partner of DML Fund Services, a pioneer in the fund services industry. Steven is a recognized leader in the field of private equity fund administration. He is a CPA and holds a B.B.A. in accounting from Hofstra University.