

AS INVESTORS SEEK PRIVATE MARKET OPPORTUNITIES IN VOLATILE TIMES, OPERATIONAL DUE DILIGENCE EMPOWERS THEIR DECISIONS

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Private markets, which encompass private equity, private credit and debt, real estate, infrastructure and venture capital, have experienced a continued rise in interest from institutional investors due to the potential for generating above-average investment returns, with general partners (GPs) or their respective investment managers currently holding record levels of capital ready for investment.

Institutional investors with long-term investment horizons are ideal asset allocators for investing in private markets. Typically these investors have greater risk tolerance, scale and access to expertise required to permit the challenges of illiquidity and operational inefficiency that could come with such investments. Within recent years a meaningful allocation to private markets has become an expectation in modern institutional portfolio management.

Given increasing comfort with private markets, many institutional investors are no longer solely investing in funds as limited partners (LPs). Many are now working in parallel with GPs via co-investments or going further by engaging in direct private investments. Alternatively, with current market volatility, some investors may also consider increasing their private markets allocation with opportunities in secondary-market interests in comingled funds.

In addition to the inherent illiquidity risk of this asset class, there are other risks to consider, such as sophisticated valuation methods and ongoing operational risk. Asset allocators, particularly institutional investors, may have governance requirements which determine a need for third-party support in analyzing private investment risk before initially committing capital, and on an on-going basis, when determining whether to invest with the same GP through a new vintage offering or co-investment.

Given the unique considerations of private markets, and the specific requirements institutional investors may face, operational due diligence (ODD) can present an additional value.

Where Can ODD Expertise Add Value?

For the potential investment returns private markets can generate, a few examples of common practice for an expert operational due diligence analysis include the following:

- **ODD Provides Greater Oversight of Valuation Methodologies** – As private investments are inherently not traded in a public market or on an exchange, and various methods are used to value such holdings, greater oversight of valuation methodologies are often needed. This oversight could take into consideration:
 - Rationalization of the valuation method;
 - Consistency of the methodology;
 - Valuation transparency – Is there a valuation policy and is the GP adhering to it?

Before a private market investment manager allocates capital, a best practice for the GP is to hire a reputable third-party valuation firm to value or provide assurance on the valuation methodology of the underlying holdings. With a thorough ODD analysis, asset allocators can understand the risks of a valuation process conducted by both the GP and a third-party valuation firm, to ensure adherence to industry standards, or Generally Accepted Accounting Principles.

- **ODD Supports Heightened Transparency and Reviews of Conflicts** – Investment mandates set out by private market legal documents, such as limited partnership agreements, should define conflicts of interest, while GPs can also be subject to regulations applied to such registered investment managers. An asset allocator should keep aware that private market GPs hold the authority within a limited partnership to determine the fund's transactions, but an experienced ODD professional can assess the level of transparency, and confirm risks related to conflicts of interest presented by GPs.
- **ODD Can Assess Ongoing Operations During Market Volatility: Business Continuity and Cybersecurity** – During periods of financial market volatility, a thorough ODD exercise can be particularly valuable in assessing the ongoing operational resilience of a private market firm. In relation to current COVID-19 business disruptions, a prudent institutional investor would also require an analysis of a GPs business continuity plan. Here again, an expert ODD analysis could not only provide an assessment of a GP's plan, but also provide a risk analysis on whether the plan would be practical, effectual and cybersecure (i.e., when employees are required to socially-distance via a work from home environment).

How Institutional Investors Can Access ODD

There has been a growing trend by sophisticated institutions to insource portfolio management and other related functions, including ODD. However, a thorough ODD process requires budget, expertise and independence. Some institutional investors have underestimated the amount of time this process requires, which could be in addition to the investment of time and resources that go into retaining a team of ODD professionals.

Alternatively, at some institutions, there are teams that share the roles of both investment due diligence and operational due diligence within the same group of analysts. However, this approach presents immediate conflicts due to both the differing skill set required of both due diligence approaches, and the potential governance concerns of not having independent investment and operational research teams.

If an investor desires to maintain ODD expertise in-house a best practice would be to segment professional capabilities, rather than add additional responsibility to an existing team which has neither the expertise, nor the independence, to adequately conduct a thorough review.

Outsourcing ODD to a third-party service provider presents an appealing option for many institutional investors. An independent service provider can deliver investors the option of a la carte services which allow investors to engage in ODD projects on an as-needed basis, rather than retaining a full-time salaried team. In times of

increased deal flow, working with a third-party service provider gives the investor flexible capacity without the risk of lessening the rigor with which managers are evaluated.

Third-party ODD outsourcing also provides immediate access to established and expert professionals. As institutional investors continue to rotate their portfolios to private markets, increasing both sophistication and risk, they can engage and quickly scale-up their investment requirements through the use of flexible consulting arrangements. Frequently, an investment opportunity will require strategy-specific subject matter expertise on operational risk that only an external partner can provide.

While private markets present a number of asset-class specific risks inherent to the allocation of capital, such investments require the professionalism and independence of an expert operational due diligence team. By focusing on this process, and either developing an in-house capability or engaging a third-party consultant, institutional investors can thoroughly assess the operational risks of private investments, which can add value to both their general investment process and protect against potential investment loss.

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