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PRIVATE EQUITY FUND INVESTMENT DUE DILIGENCE

Strategies for evaluating and selecting top performing fund managers

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Staffing for success: The human capital factor

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Introduction

The breadth and volume of opportunities for institutional investors have dramatically increased with the maturation of the private equity asset class. Private equity now encompasses a wide variety of investment styles, from buyouts, to venture capital, distressed debt, mezzanine, infrastructure, real estate, natural resources and turnarounds, to name but a few. Examining and investing in these different strategies, across geographies, requires a diverse skill set and an increasingly efficient use of technology and data.

The long-term nature of private equity fund investing demands that investors conduct rigorous and detail-oriented due diligence processes. The resources needed for conducting an effective diligence process can vary significantly by fund strategy, geography and structure; for example, the resources required for a first-time small cap fund are vastly different from those required for a well-known mega manager. Investors considering the question of how to staff their private equity programmes often have two choices: 'buy' (outsourced staffing model) or 'build' (in-house staffing model). Each option has multiple variations. Buying or building both personnel and expertise to create and manage an investing programme are not mutually exclusive options. Increasingly, programmes are balancing the tasks and skills between external staff and internal personnel, as very few sizeable LPs entirely buy or build their programmes.

This chapter discusses how different investors can deploy internal and external human and technological resources to meet their investing objectives. Of particular focus is the way investors can deploy different functional experts to create a team capable of handling the breadth and depth of high quality private equity investing and monitoring. The discussion centres on six main areas related to investing through an effective private equity programme:

1. Sourcing.
2. Due diligence.
3. Legal and structuring.
4. Monitoring.
5. Back office/reporting.
6. Distribution management.

Models for implementing a private equity investing strategy are then discussed in detail. Although the precise skill sets and networks that GPs who invest in companies and businesses require are different from those of LPs, the broader themes discussed in the first part of this chapter around effective human and technological resourcing still apply.

Table 7.1: **Building a holistic sourcing model**

	Step	Defining	Landscaping	Ranking	Relationship building & access	Monitoring & referencing
	Description	• Create strategic plan. • Define relevant sub-asset classes and geographies of interest. • Define appetite for risk, reward and diversification targets. • Define benchmarks.	• Develop holistic investment landscape including timing of fundraising. • Desktop research on investment targets in each relevant market. • Uncover fund sizes, timing for fund raise, strategy and track record at a high level.	• Rank investment opportunities by performance and strength of relationship.	• Assign relationship managers within the investment team to strengthen relationships with general partners.	• Keep abreast of material changes in strategy, track record and management teams to keep the sourcing process dynamic.
Human capital	Key human resource	• Senior decision maker/CIO.	• Locally based professionals with networks to be able to source reference materials; make reference calls. • Resource to collate data into systems.	• Experienced local team with selection and investment skill sets. • Monitoring resource to keep database dynamic.	• Senior local professionals with strong reputations who can forge relationships and access. • Smart resource who can enhance reputation as a 'solutions provider' across the LP products.	• Local market presence to monitor factors such as (expected) management team changes. • Analytical resource to monitor track record changes.
Human capital	Key external resource	• Macroeconomic research. • Benchmarks.	• Existing landscaping documents from placement agents (private equity brokers). • Local private equity governing/collaborative bodies.	• Consultant.	• Relationships with placements agents and brokers can be helpful, particularly for secondaries sourcing.	• Industry-specific media outlets, investor meetings, brokers, working groups.
Technology	Key technological resource & data	• Systems to track portfolio construction against targets. • Systems to track capital flows.	• Internal systems, archives and databases. • Online data providers. • Scalable system to collate and access data with ease.	• Dynamic database for performance and relationship ranking. • Dynamic models which keep general partner track records up-to-date.	• Proactive engagement with GPs via newsletters/emails and physical forums. • Materials to educate GPs on broader market trends, evolution of the best fund management techniques, etc.	• CRM system to track interactions with general partners and latest updates on them. • Dynamic models which keep general partner track records up-to-date.

Source: Hamilton Lane.

Sourcing

In order to achieve outstanding performance, investment opportunities must first be found. For most successful private equity investors, this means having some combination of an established reputation (either built or bought through outsourcing), and an appropriate set of resources focused on building relationships and sourcing opportunities.

For LPs with a global investment programme, having local professionals in key markets around the world can enhance their ability to understand local market dynamics and get access to the best opportunities. How else could an investor based in Chicago staffed only with English speakers conduct diligence on a Beijing-based fund manager whose portfolio companies' CEOs speak only Mandarin? How would that investor understand the local culture and form a deep bond with a local fund manager? Would that investor get access to the best investment opportunities, ahead of a locally integrated investor? Having a local presence is the key for sourcing in this global and competitive asset class.

Within that context, there are five steps to building a sourcing machine:

(i) Defining.
(ii) Landscaping.
(iii) Ranking.
(iv) Relationship-building and access.
(v) Monitoring and referencing.

These steps and the role of human and technological resources are highlighted in Tables 7.1 and 7.2.

Due diligence

Once the sourcing machine is fully operational, selection of the 'best' investments becomes the focus. For private equity, more than many other asset classes, manager selection is crucial. The spread in investment returns between the various sub-strategies over time is significant, as Figure 7.1 illustrates, and within these, the performance dispersion at the fund level is even more significant. For example, within the venture capital segment, selecting a top-quartile fund could deliver well in excess of 14 percent net returns annually. Selecting a bottom-quartile fund in the same segment could actually have a decremental effect on value, as shown in Figure 7.1.

Given the potential dispersion of returns coupled with the diversity of investment sub-strategies, investors should have functional experts who really understand their areas of focus. These functional experts should have both asset-specific skills (for example, buyouts, real estate, credit, venture capital and infrastructure) and structuring skill sets (such as primary, secondaries, co-investment, credit and legal).

Each set of experts also need technological solutions that can help them to conduct diligence in the most effective, structured and informed manner. Table 7.2 highlights

Figure 7.1: **Dispersion of returns by strategy, 1979–2011 vintages**

Source: Hamilton Lane Fund Investment Database as of 31 December 2015 (May 2016).

some of the more prominent human and technological resourcing requirements for investors.

For sophisticated investors, an experienced investment committee guides the investment selection process and forms the governing body to ensure consistency of investment selection and creation of a balanced and strategic portfolio. A clear decision-making process with experienced individuals is important across all sub-investment strategies.

On the primary investment front, it is worth noting the increased focus that investors today have on holistic, not just commercial, diligence. That includes a high level of scrutiny around aspects such as, but not limited to:

- *Operational and back office:* including governance, monitoring, cash flow management, tax and audit procedures.
- *Litigation:* both for the firm and its senior management.
- *Other business interests:* in order to understand potential conflicts of interest, or external management team time drain.
- *Environmental, social and governance (ESG):* increasingly important, particularly for clients such as pension funds and labour unions, and those conscious of headline risk.
- *Public relations:* increasingly important, particularly for clients such as pension funds and labour unions, and those conscious of headline risk.

These factors increase the level of complexity, resourcing and cost required for diligence. In some areas, such as operational diligence, there is need for dedicated resources with specialist skill sets.

Table 7.2: **Human and technology resources required for effective due diligence**

	Investment type	Primary	Secondaries	Co-investment	Specialist (credit, infras-tructure, real estate, etc)
	Investment definition	• Investing in a fund at the start of the fund's life.	• Buying positions in funds with existing assets.	• Investing alongside a general partner directly into a deal.	• Direct and fund investing, requiring specialist knowledge.
Human capital	Key human resource	• Experienced professionals with ability to analyse strategies, markets and GP's team; networks for reference calls. • Analytical resource for detailed analysis on track record, cash flows and attributions.	• Senior team ability to form a view on the GP's team in conjunction with the primary team; a view on the quality of assets. • Analytical ability to model cash flows, valuations, and IRRs at different price bids.	• Senior team ability to form a view on the GP's team in conjunction with the primary team; a view on the quality of asset and its management team. • Experience in sectors and geographies increasingly imperative for high-quality deal selection. • Analytical ability to stress test GP's models.	• Deep expertise in relevant sub-asset class to accurately diligence opportunities. • Analytical ability around cash flow modelling and relevant metrics depending on specialism.
Human capital	Key external resource	• Current research on macroeconomics, sectors and geographies.			
Human capital	Key external resource	• Networks for reference calls.	• Market knowledge on pricing. • Intermediaries.	• Networks for reference calls.	• Differs by niche.
Technology	Key technological resource & data	• Detailed cash flows across 1000s of funds for accurate return and J-curve benchmarking; Detailed models for deep analysis into cash flows and attribution; PMEs. • Efficient CRM system recording interactions with GPs over time, noting evolutions in team and strategy and more subjective observations.	• Detailed models for deep analysis into cash flows and comparables valuation analysis. • Integration with, or access to, primary team models and CRM systems.	• Systems capturing private and public market comparables. • Integration with, or access to, primary team models and CRM systems.	• Vary by type of investment, but broadly in line with other sub-asset classes.

Source: Hamilton Lane.

Co-investments and secondaries

As with primary investing, co-investments and secondaries (or credit or any other investment vertical) require the same breadth of opportunities at the top of the deal funnel. Each requires dedicated resources for diligence, structuring and execution, and a similarly iterative and governance-led investment process. However, the experience, skill sets and networks of professionals can, and should, be drastically different.

Unlike primary investing, co-investment and secondaries investing are reactive for the most part, yet typically require faster decision-making and execution. Investors need a process that accommodates the speed required to turn around complex legal documents, and both human and technological resources which can aid review and diligence as well as make recommendations to the investment committee. Primary investing gives an LP access to GPs and other LPs to generate deal flow for both secondaries and co-investment programmes, as well as the requisite level of detailed data on GP portfolios. On the secondaries front, it also allows sourcing bilateral deal flow, which avoids the need to constantly participate in broker-led auctions that invariably lead to high entry prices.

As noted in Figure 7.1, co-investments have the second largest dispersion of returns among any sub-asset class within private equity. Therefore, for participating LPs, it is important to have not just the breadth of sourcing resource in individual markets, but also dedicated professionals to evaluate the opportunities, with deep sector knowledge built over time. It is also important to have access to relevant and accurate comparable public and private market data with integrated systems.

An increasing number of LPs are making direct investments. Compared to co-investments, the additional complication here is that LPs often lack the deep-rooted networks in all markets globally to be able to source differentially compared to locally incumbent GPs. Hence, there is a risk that direct deals completed by LPs are either leftover deals from local GPs, or won because they were the highest bidder (and therefore the lowest underwriter) in a multi-party auction. We also question whether LPs are better placed than GPs to create value in portfolio companies post-acquisition.

Legal and structuring

Once investments have been selected, terms must be negotiated and legal documents such as partnership agreements, side letters and subscription agreements must be completed.

There is an ever-increasing focus on terms, whether it be fee offsets, organisational expenses, or type of carried interest waterfalls. These can be valuable tools for LPs. If they are large enough and have conviction in the investment, they can have significant negotiation power with many GPs when it comes to defining magnitude and timing of fees, for instance, which have a direct impact on LP net returns.

Table 7.3: **Legal costs for private equity commitments**

Commitments per year ($m)	Annual legal costs		
	Low $15,000	Average $30,000	High $50,000
5	$75,000	$150,000	$250,000
10	$150,000	$300,000	$500,000
15	$225,000	$450,000	$750,000

Source: Hamilton Lane.

With this in mind, one option for LPs is to bring the legal function in-house, as opposed to outsourcing it to independent law firms. Motivations behind this choice include the cost of negotiating the documents and round-the-clock availability of lawyers who specialise in negotiating hundreds of limited partnership agreements (LPAs) with dedicated focus on private equity each year. This also provides a more seamless approach in cases where complex term sheets are being negotiated in tandem with the investment team. From a cost standpoint, a reputable law firm can charge $30,000 or more per partnership to perform such work.

Table 7.3 gives a sense of the magnitude of legal costs for a private equity programme as the number of commitments grows.

Monitoring

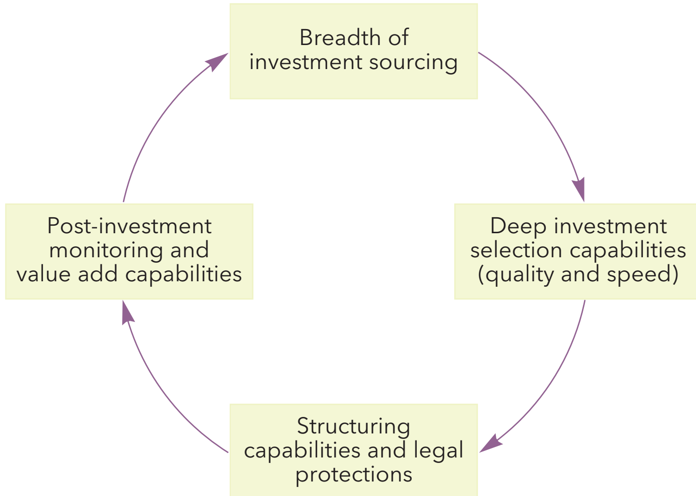
Given private equity's illiquid nature and long-term fund life, it is essential for LPs to keep a regular dialogue with fund managers to ensure that portfolio construction and performance are meeting expectations. Annual meeting attendance is normal for all investors, and for larger investors there are often more formal responsibilities such as advisory board seats. The monitoring function creates an additional drain on investment team resources and can be costly when factoring in travel expenses.

However, monitoring and referencing efforts also help in sourcing future investments, and should be seen as a key part of LPs' operations (see Figure 7.2). As the performance of various investment opportunities improves or worsens, or indeed, more investment options enter the market, an organisation must have sufficient staff with 'boots on the ground' to keep on top of these developments. Industry-specific media outlets, periodic investor meetings and working groups provide detail such as changes in the investment landscape, upcoming fundraises and information about performance and team changes.

Back office/ reporting

Once the investment decision has been made, the terms have been negotiated and the fund is closed, what is often a 10- to 14-year series of cash flow events begins. Here, LPs should employ professionals who are experienced in the management of cash

Figure 7.2: **Life cycle of investment sourcing and decision-making**



Source: Hamilton Lane.

flows and the accurate monitoring and reporting of the portfolio's performance. Significant controls should be in place for data integrity purposes. Failure to successfully execute cash flows can result in strained relationships with desirable GPs or, worse, defaults. Professionals with knowledge and experience of the accounting and management of private equity cash flows equipped with necessary technology solutions and software are essential to successful execution.

Historically, private equity was an asset class that lacked information; however, that is changing. Increased scrutiny from regulators coupled with LP demand is driving a trend toward greater transparency within the industry. The growing trend for increased transparency will continue to create additional administrative demands in order to effectively track the augmented data. Technology is playing an increasingly crucial role in providing secure access to data and analytical tools to monitor and report portfolio performance.

An extensive database of historical fund investment performance can contribute significant value to the private equity investor as it can be used to benchmark existing and/or potential investments. Further, such a database can be used to better understand the behaviour of private equity capital calls and distributions over varying economic cycles, which can be of great value when developing commitment models.

The need for human and technological resource in the back office cannot be understated. Attempting to successfully manage a private equity programme using a small staff and spreadsheets can create significant lag time between reporting cycles; this cannot be easily scaled as the programme grows and transparency within the industry increases. On the other end of the spectrum, building a stand-alone, customised solution can be more difficult and expensive. With this in mind, investors must make the determination whether or not to outsource the technology and human resources required to effectively operate their back offices.

Publicly traded stock distributions

When staffing a private equity programme, one consideration is how to liquidate in-kind distributions of publicly traded stock. The realised value of in-kind distributions can be enhanced through active portfolio management, thereby increasing the overall return of a private equity programme. To maximise returns, LPs should employ dedicated research, trading and operations individuals whose focus is the management and liquidation of publicly traded positions, or at a minimum, consciously outsource this function to skilled outside individuals.

Buy or build?

The best approach to completing the body of work discussed above is dependent on the size and scope of the private equity programme (to be built), the desired amount of control, and the cost sensitivities around managing the programme. Buying or building personnel and expertise to create and manage a programme are not mutually exclusive options (see Table 7.4). Responsibilities can be shared, or carried out in tandem, by contracted external staff and the LP's internal staff. Additionally, investors can 'buy to build' where internal staff uses external expertise in the early years to gain knowledge and subsequently transfers those skills in-house over time.

When selecting a model, many questions must be answered: Does the organisation have the requisite staffing and technological resources? How will internal staff or external contractors work together in the diligence and planning processes? Does the external manager have discretion over investment decisions? What cost constraints, if any, exist?

Table 7.4: **Scale of 'buying' to 'building' a private equity programme**

	Advisory	Separate account	Fund of funds
Description	Investor hires internal staff that implements and maintains a private equity portfolio with the help of an outside advisor or consultant	Investor awards a mandate, within a set of guidelines or objectives, to an external management firm and expects the firm to construct or expand a portfolio based on expertise	Provides investor with a diversified portfolio of private equity investments with minimal internal staffing resources required
Staffing requirements	5+	0–3	0–1
Annual commitment level	$300m+	$25m+	$5m+

Build → Buy

Potential model usage

Source: Hamilton Lane.

This section discusses the three most common models: advisory, separate account and fund of funds. The hub-and-spoke model is highlighted as an example of the ways in which the balance of tasks and skills shared by the external staff and internal personnel can shift as the organisation and its investment programme matures. The hub-and-spoke model has become increasingly more commonplace with the rise of specialised strategies.

Advisory model

Some of the longest-standing institutional investors in private equity use the advisory model as it caters to large institutions, typically with sizable staff dedicated to the asset class. In this format, an LP hires internal staff that implements and maintains its private equity portfolio with the help of an outside advisor or consultant as noted in Table 7.4. An advisor can provide a wide array of services tailored to complement the investor's internal capabilities and address specific needs, including due diligence, cash flow forecasting, strategic portfolio planning, ongoing portfolio reporting and administration, performance analysis and board presentations. In this model, functions such as legal review and negotiation can be assigned to either party.

In most cases, the size of both the internal and external staff will be significant. Each party has individuals who possess private equity or capital markets experience and perform extensive due diligence and financial analysis on potential investment candidates, typically in collaboration. Often, the internal staff is required to manage very specific constituencies such as investment committees or boards. In some cases, the investment committees or boards may legally require an outside, independent opinion in order to complete an investment.

This model requires the largest amount of internal, specialised human resources. It is important to note the impact this model has from a cost perspective. In a typical year, a large sovereign wealth fund or pension plan invests at least $1 billion (if not multiples of that) into private equity. Paying a traditional management fee would result in millions of dollars each year in fees. The advisory model is more of a fixed-fee model whereby the service provider and client enter into a multi-year contract with a pre-arranged fixed fee, regardless of the size of the assets deployed. This, combined with the cost of internal staff, is still a significant amount of capital, but is usually far less than what the investor would otherwise invest in building a full team with deep analytical and technological resources.

Separate account model

The separate account approach is another common model that provides a customised solution. The investor awards a mandate, within a set of guidelines or objectives, to an external management firm and expects the firm to construct or expand a portfolio as noted in Table 7.4. Separate accounts can be broadly based, global mandates or specialised in nature. Further, the mandate can be fully discretionary, non-discretionary or somewhere in between; for example, a separate account client could have an opt-out or veto right over the asset manager's proposed investments. The manager conducts its own sourcing and diligence activities, undertakes strategic planning and uses proprietary insight to build a private equity portfolio, ultimately committing to partnerships on behalf of the investor client. Although the investor has awarded discretion to the manager, there is often a fair amount of communication between the two parties related to portfolio construction, investment selection and portfolio monitoring.

A separate account can be structured according to the investor client's needs. This often takes one of two forms: governance by an LPA or an investment management agreement (IMA). A fund of one structure is governed by an LPA whereby all discretion, cash and investment is covered by the manager. Often investors that require an audit and want to limit cash flow direction oversight choose this option. Otherwise, an investor client may use an IMA, which allows it direct ownership and management of all funds and transactions within the portfolio and the investor becomes the limited partner of record. This allows the investor to utilise the expertise and sourcing skill of a dedicated manager, while preserving relationships with the underlying general partners. Here again, responsibility for legal review and portfolio reporting varies, but most often the outside manager handles these functions.

Although some level of internal staffing is needed, the separate account manager is much more a 'buy' or outsourced model, where the investor is more reliant on the resources, skills and expertise of the hired external manager. Accordingly, the internal investment staff is typically smaller, with responsibilities less specifically assigned. Rather than several individuals assigned to a private equity investment team, there may be more general investment functions or leads; for example, an alternatives investment team or a head of alternative investing. There also are situations where a single chief investment officer (CIO) and a few generalists maintain oversight over the entire portfolio. In this scenario, the internal staff generally focuses on asset manager diligence and oversight as opposed to investment screening and diligence. Flexibility is an important part of a separate account, and many investors are drawn to this model because the customisation allows them to best capitalise on the staff and resources already available to them.

The decision to utilise a separate account mandate brings with it a different cost profile than the advisory model, and is typically more expensive. Fees charged by external managers are represented in basis points per dollar of committed assets and can include a carried interest component. For a fund of one, the asset manager provides a financial commitment alongside the client as well. Again, legal and back office can be included in the fee structure.

Fund of funds model

The fund of funds model is the best example of the investor 'buying' the full suite of services required to build a private equity programme. Funds of funds are designed to provide investors with a diversified portfolio of private equity investments with minimal internal staffing resources as outlined in Table 7.2. A fund of funds is a pool of capital with a series of LPs and a single vehicle managed by the asset manager. Here, the asset manager is responsible for all investing and administrative activities on behalf of the partnership and has a shared economic interest in the form of a financial commitment and/or carried interest rights. LPs provide capital based on previously agreed commitments and receive a requisite share of the partnership. The fund of funds is a legal entity, so as commitments are sourced, screened and committed to, the structural relationship is between the partnership and the investment (similar to a fund of one). In contrast to the advisory and IMA separate account models, the original investor here has no legal connection to the underlying investments except through the partnership.

Funds of funds provide a contrast to the advisory approach where the investor is required to build an internal investment organisation. Staffing requirements for a fund of funds investor can be almost non-existent; an investment committee or CIO needs only the infrastructure to sign commitment documents and fulfil capital calls to utilise this approach. In practice, however, many investors maintain an active interest in the selection and ongoing diligence activities of the manager. While those investors lack direct oversight of investment decisions, they work to stay informed on the fund's progress towards its targets and understand the fund's performance and prospect for future value. A fund of funds investing strategy can be maintained by a diverse group of key personnel: finance officers, county clerks or treasurers, human resources staff, investment brokers and so forth.

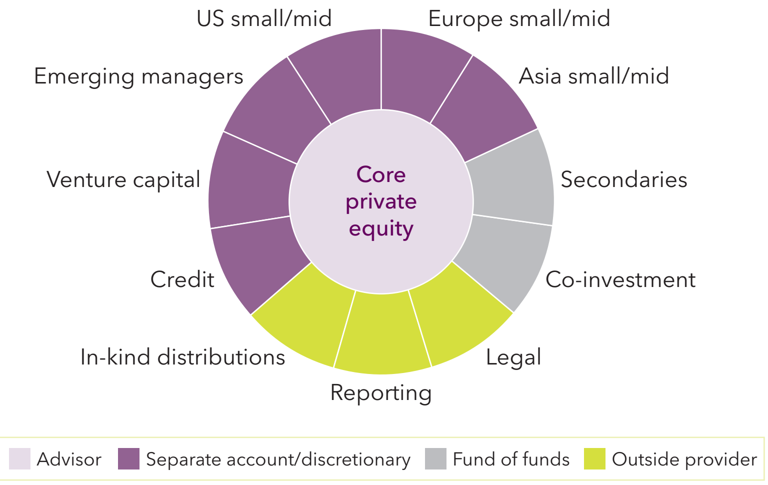
Of the models described in this chapter, funds of funds have the highest cost profile. A typical fund of funds has fees on committed capital and can include carried interest as an incentive fee. Since this model requires almost no internal investment staff and very limited ongoing legal or operational support, the incremental costs are very small by comparison. In today's private equity environment, funds of funds are a challenged approach to engaging in the asset class due to fees and lack of customisation; however, they remain the right solution for smaller investors without scale or those that cannot commit resources to staffing.

Hub-and-spoke model

As referenced previously, the concept of using the models listed above in different combinations is becoming prevalent as the private equity market matures and investors allocate broader bases of capital to the asset class. Further, we have seen a significant rise in specialised strategies in the asset class, including co-investments, secondaries, private credit, venture capital, rest of world and emerging managers, to name a few. With the rise of specialised strategies, investors are more often outsourcing specialised strategies to external managers who have the requisite resource and skill set to execute on these. Across all specialised strategies, it takes networks and access, diligence skills, investment judgement, appropriate technology and access to data, and disciplined processes to be successful.

The varied combinations available means that staffing and logistics requirements are just as varied. Trustees and overseers can mix and match internal and external expertise, as well as utilise technology in order to create a portfolio that seeks to match their plan objectives and risk tolerances. The most common example of the hub-and-spoke begins with the 'core' private equity component. This piece is implemented via an advisory approach with internal staff working alongside an external consultant to develop a strategy and execute commitments to the broadest sectors in the market (large or

Figure 7.3: **Hypothetical hub-and-spoke model**



Source: Hamilton Lane.

mega buyout funds). More specific sector mandates are then placed around the core in separate accounts or funds of funds. Often the same external party serving in an advisory role for the core portfolio manages one or more of these spoke strategies. This allows for a fully customised approach across the portfolio. Additionally, reporting, in-kind distributions and legal are crucial functions to a private equity programme that can be completed in-house or outsourced, also often to the same external party. Figure 7.3 provides a representation of one possible hub-and-spoke approach.

Investors utilising the hub-and-spoke approach will factor in all internal and external costs when deciding on this approach. On a total basis, the external costs of this model will likely fall between the advisory and separate account examples outlined above. This is a result of the combination of large amounts of capital in the core portfolio (advisory approach) coupled with smaller separate account mandates for targeted sectors. Internal costs are driven by the decisions made on the size and scope of the core portion of the portfolio and investments in technology, and can vary widely.

Conclusion

There are significant human capital needs associated with successfully creating, deploying and managing a private equity investment programme. Diverse backgrounds and skill sets are required to effectively manage a private equity portfolio, and establishing a global presence has become a necessity for investors in this asset class whether 'buying' or 'building' personnel and expertise to create and manage a programme. Further, the increased need and use of smart technology, and access to data, has become a necessary element in the asset class.

Given the complexity of private equity investing, several very different resourcing models have emerged over time. Each of the models allocates different functions between internal and external staff with, in some cases, certain functions being shared. As demonstrated by the increasing prevalence of the hub-and-spoke model, there is no doubt that as the asset class of private equity matures, new models will evolve. Each of the models discussed can be successful. For most investors, the most difficult decision point will be finding the right balance between 'buying' and 'building' the skills and resources needed to successfully invest in the maturing and evolving private equity asset class. □

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