Hamilton Lane
Research

ODD: SOUNDBITES FROM THE FRONTLINE

By Matt Barbato, Head of Operational Due Diligence

"His palms are sweaty, knees weak, arms are heavy..."

There was a time when those opening lines from Eminem's hit, "Lose Yourself," might have reflected how managers reacted when undergoing a rigorous operational due diligence (ODD) review. But, similar to how B-Rabbit improved his confidence and flow throughout the movie *8 Mile*, I am happy to say that GPs also have embraced their ODD reviews and are now more prepared, and seemingly more comfortable, than ever with discussing their operational organizations, structures and even challenges.

It is obvious to us that the best managers care deeply about all aspects of their businesses. Frequently, at the end of our onsite meetings, we engage in an active dialog discussing our views on their operational preparedness. To us, this conversation is a sign that managers take their operational procedures and setup very seriously, and are constantly trying to improve.

At the end of the day, our goal in working with managers is to effect change that alleviates the risks we've identified, both for the benefit of our investors, as you would assume, but also for the manager. Investing in the private markets asset class generally is a long-term relationship, and one where both parties have a very vested interest.

ODD OTR (on the rise)

It should be clear to all that ODD reviews are most certainly here to stay and will continue to evolve in their depth and complexity. Thus, a growing number of allocators are now hiring dedicated professionals to do this work. These teams are being staffed with individuals who have diverse backgrounds, ranging from audit, accounting or operations to even regulatory and legal. And, firms are empowering these teams, generally through the conveyance of a veto right over investments, with a very real and loud voice in the investment decision-making process. I suspect these two forces will continue to drive operational changes across the industry going forward.

While managers often do a great job of building and fixing other businesses, it is interesting to us that their own level of operational preparedness can vary greatly. This makes some sense when we consider how many GPs there are throughout the global private markets and how diverse their respective backgrounds can be. Some GPs start as small, two- or three-person operations, where they build the business from the ground up. Others, maybe spinouts from larger organizations, have knowledge of and experience with what constitutes a well-developed level of infrastructure, and they simply decide to maintain that level of process. And to be fair, historically, there has not been a wealth of opportunity for managers to have easy access to information relating to best practices operationally on an industry-wide basis (*Shameless Plug*: HL's Back Office Best Practices forums are great resources for this!). It is against this backdrop that we see a rigorous ODD process being a force driving meaningful and worthwhile change for all constituents. We can and want to help GPs implement and understand ODD best practices for the protection of all investors.

Dot Your I's and Cross Your T's

A good place to start taking stock of where GPs stand is to look at what's actually covered in ODD reviews. Managers can generally expect the following:

- Receiving an ODD questionnaire
- Hosting an onsite meeting to discuss initial findings from the questionnaire responses and to walk through their operational processes
- Undergoing background checks on key investment and non-investment professionals

Throughout this process, managers can expect to cover everything from their accounting and valuation processes and compliance oversight, all the way to their data and cybersecurity postures. As you might expect, this can be a long process with multiple teams involved in discussions lasting several hours.

We'd say that's pretty thorough. Gone are the days when we'd often get the distinct feeling that we may be the first firm to ever inquire about a GP's operations. More frequently, we get the very welcome question of "How did we do?" This question allows us to engage in a dialog with managers to help them understand our areas of concern (if any), while giving them the opportunity to offer some constructive feedback or counterarguments about our points. Then, we all return to our respective offices to allow each manager to consider changes that address our concerns while we decide our level of risk tolerance. Not every matter that we note is something that absolutely must change, but it does help to inform our investment decision-making process when we determine our level of interest in committing capital.

To be clear, the broader industry focus on ODD over the past few years doesn't mean that all managers are just now starting to examine their operations. In fact, many firms have been focused on this for a while and are executing quite well. But, it does mean that this is an area that managers today must address meaningfully. Those who have not been investing properly in their own infrastructure are starting to stand out and will continue to face more questions about their processes. We think that's great news for both investors, and the asset class.

Trending ODD Topic: Independence & Oversight

So, what is one of the latest trending topics in ODD today?

One of the most common trends we see is a call for independence between the manager and the fund to ensure proper fund governance and oversight. In general, we see LPs push for the manager to engage a third-party administrator to maintain the fund's books and records under the assumption (which we would argue is a false one) that they're providing this independence. The real question is whether they actually are getting the level of independence that they perceive they are, and at what cost?

If you look under the hood a bit further you'll see that many times, fund administrators are effectively taking direction from the manager and providing bookkeeping services. While there's a certain level of independence that comes with bookkeeping, it's not much, probably less independence than an LP would actually want. The fund administrator may also participate in the fund's cash control processes as part of their service, but it's generally not a regulatory requirement to do so.

Another area of perceived independence would be the administrator's role in the valuation process. However, most managers do not have fund administrators participating in this step; they most likely only receive the values from the manager each quarter. So, we leave it to you to decide if this makes administrators more independent of managers, or just an extension of them.

Hamilton Lane Research

Final Musings

The increasing focus on managers' operational processes and service providers is here to stay and will continue to evolve. We view this as an extremely positive development for LPs and GPs alike. LPs will continue to benefit by ensuring that their managers have taken the time to think through, and have invested the appropriate amount of dollars in, their infrastructure needs in order to protect LP capital. On the flipside, managers will benefit by having more robust protections in place for their franchises, which should enable them to continue to grow and develop their businesses.

To our GP readers, we hope this inspires you to continue taking steps in the right direction with a thorough, honest review of your organization's operations. After all, in the words of Eminem…

"You only get one shot, do not miss your chance to blow. This opportunity comes once in a lifetime…"