

# SteelBridge

## Insights

*A management consulting view  
of private capital's evolution*

### **The Importance of Operational Due Diligence**

*Building a better Private Capital marketplace*

### Key Highlights:

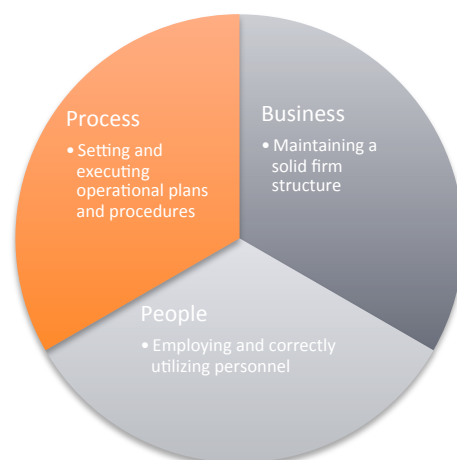
- Performance is no longer the sole measuring stick for investors
- The pillars of due diligence – business, people, and process – must be regularly evaluated to ensure fund manager success
- It's important to engage an objective third party to assess and help to improve operational capabilities

## The Importance of Operational Due Diligence (ODD)

Consistent outperformance of investment returns is one of the most critical to the success of fund managers. However, it is important for those managers to understand that, once an institutional investor is in the process of reviewing their fund, the criteria for measuring returns may have already been decided. In today's marketplace, institutional investors are looking beyond relative outperformance performance in determining which managers are most likely to consistently achieve and sustain returns.

Managers who demonstrate close attention to the full spectrum of operational due diligence position themselves better for attracting and retaining high-quality investors. Simply stated, institutional-class fund managers must be more than their investment returns to succeed in today's challenging capital raising environment.

"Chasing performance" is not an effective method of risk-adjusted portfolio construction for institutional investors. An in-depth understanding of the fund manager's business such as its goals and philosophy, the professionals who run it, and the firm's operational procedures, are also key drivers in manager selection process. As a result, a thorough examination of the operational integrity of the fund manager is of paramount concern to institutional investors. Sophisticated institutional investors are also seeking fund managers who recognize the importance of three areas of Operational Due Diligence (ODD):



These components are defined in the following sections. Combined, they frame a picture of how a fund manager will be compared and contrasted to peers in the industry.

## Business

The due diligence process starts with an overview of the firm's day-to-day operations. This allows managers to differentiate themselves by demonstrating their use of technology, resources, and operational procedures that other managers may not. The high-level components for evaluation of the business are:

The structure of the investment firm	Employee ownership, partnership structure, and fee structure are the most important aspects of this area of diligence. Institutional investors want to ensure alignment of interests between the limited partner and general partner. This is particularly evident with the creation and implementation of investor advocate groups such as the Institutional Limited Partner Association (ILPA).
The compliance of the firm	Investors must see that the business is on solid regulatory ground with registrations, licenses and compliance, and that stakeholder interests are aligned.
The financial strength of the firm	The firm must have the requisite financial reserves to weather tough times. Equally important is the origin of the income. The asset source, whether from friends and family, high net-worth individuals, or institutions plays an important role in the perceived stability of the firm in the marketplace.
Goals for growth of the firm	These are an important barometer for potential investors as there must be "buy-in" to the growth strategy and the plan for execution. This is especially important in the alternative space where fund size can impact future performance. Funds that attempt to grow too quickly can run short of quality deal flow and/or outsize their advantage in the marketplace.
The firm's third-party providers and vendors	These include, but are not limited to auditing, fund accounting, legal, brokerage, marketing, and technology providers. The higher the quality of the providers, the higher perceived quality of the firm itself. This is even more poignant in technology choices like software providers and business consultants. Institutional investors value managers who can outsource, improve, and grow using high quality, reputable providers.
The length of the firm's track record	Most institutional investors require a minimum of 3 years of audited returns as acceptable, however in the alternative space, if the partners can demonstrate prior attributable track record as an individual or team unit, that may suffice for new or first vintage funds.

## People

An equally important step in the due diligence process is the examination of the people who drive the fund managers business. Firms can expect an exhaustive inquiry into all areas of personnel, including:

Area of Inquiry	Description
Principals and Portfolio Managers	A detailed plan of who is accountable for what actions within the firm is extremely important. Past red flags must be addressed in a straightforward and proactive way to diminish the impact of any past action or track record irregularities that may exist.
Employee Compensation and Equity Ownership	This is weighted heavily in the minds of savvy investors. It is paramount that investors feel that the firm's key employees are invested, and that investor and firm/partners interests are aligned.
Back Office Support Staff	C-level executives must define the vision and lead the fund, but it is also necessary to employ the people and tools needed to execute that vision in a timely and responsible manner. The ability to analyse operational workflow and identify inefficiencies in the execution of the investment strategy specifically, as well as the business plan as a whole, is a necessary component of a successful firm. Smaller funds often tend to rely too heavily on their "star players" and may not effectively utilize the time and expertise of high level executives due to lack of proper support staff.
Command Structure	The identification of who the final decision makers are – and in what areas – is extremely important in determining where accountability lies. The investment process must be repeatable by the team as a whole so the firm is not relying solely on one or two individuals.
Succession and Contingency Planning	In addition to knowing the current chain of command structure, a succession and contingency plan must be in place. Often one or two individuals may carry the lion's share of the responsibility and, while this may be acceptable in the short-term, a long-term, realistic "what if" contingency plan must be properly documented and communicated.

## Process

If a firm has a solid business structure and quality people they will also be reviewed to demonstrate a quality investment process. Of utmost importance is a detailed, documented, and accountable investment process that describes how a firm executes its strategy in the real world. This concept is not simply the business philosophy, but the implementation of the process in ever-changing real world conditions. Primary factors of a firm's process are:

### The repeatability of the process

- A necessary component is a documented investment process that can be applied in varying market conditions with appropriate risk protection measures and growth projections. An investment process that is not repeatable may be viewed less favorably by institutional-class investors.

### The risk metrics a firm considers

- These can range from diversification of asset classes the number of investments in a fund. Effective due diligence identifies where risk is hiding and requires development of the concrete risk measures that the institutional marketplace requires.

### The appropriate growth pace

- The goals of the firm should be "smart growth," not growth at all costs. It can be equally dangerous for a small firm to grow too quickly, without backfilling support and technology along the way, as it is for a firm to lose or deny assets. Both scenarios, done too quickly, can be of equal detriment.

## Conclusion

Most importantly, understanding ODD means examining a firm and identifying the points in the process that add value as well as weaknesses that must be addressed to create a reliable and institutionally viable investment product. Our industry has evolved to require a fund manager to be much more than its relative performance.

## Partner with SteelBridge for Operations and Process Improvement

One of SteelBridge Consulting's greatest strengths is the ability to analyse operational workflow and identify inefficiencies in the execution of the investment strategy, business plan, people, and processes. This involves a comprehensive analysis of all aspects of the firm resulting in a detailed scorecard summarizing strengths and weaknesses of all ODD factors. SteelBridge is an industry leader in the evaluation and application of the most current technology and operational practices to ensure that our clients have the optimal infrastructure, operational guidance, and safeguards to back up their performance returns.

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## About SteelBridge

SteelBridge is a boutique advisory services firm with deep expertise in private capital. We have a passion for helping our clients identify and affect change to improve process and technology for more effective organizations. We help general partners, limited partners, third party administrators, software vendors, and portfolio companies. At SteelBridge, we hold ourselves to the highest standards by providing exemplary services for our clients.

To learn more call us at 646.737.7960 x1008, visit us at [www.steelbridgeconsulting.com](http://www.steelbridgeconsulting.com), or join us on our Facebook and LinkedIn pages for more information:



***Let us show you why we are the leading boutique advisory services firm in the Private Capital space.***

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