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# Private Equity Operational Due Diligence

*Tools to Evaluate  
Liquidity, Valuation, and Documentation*



*with* **WEBSITE**

JASON SCHARFMAN



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Valuation, and Documentation*

JASON A. SCHARFMAN



WILEY

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*I dedicate this book to my wife, Rachel, for her endless support, to my brother, Barry, to my parents, Gloria and Michael, and to my entire family for their never-ending encouragement.*





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# Preface

**P**eople tend to not take operational due diligence in the field of private equity very seriously. The risk category that operational due diligence is supposed to evaluate—operational risk—is not as narrowly defined as other related types of risks, such as credit risk, counterparty risk, currency risk, and so forth. Depending on the context, the implications of the term *operational risk* can change. In part, the broadness of the field and subsequent confusion about exactly what is meant when discussing operational risk and operational due diligence are likely contributing factors to the lack of attention paid to this risk category.

When an investor first decides to take the plunge into private equity investing, it is often an anticlimactic choice. In some cases, hundreds of millions of dollars are committed by institutional Limited Partners (LPs) to private equity funds, but the money may not generate returns for years. Yet, with such a long-term commitment of capital into a traditionally illiquid and complex asset class, it would seem only logical that LPs would seek to perform at least as rigorous a due diligence analysis on a private equity fund as they perform on other asset classes, such as hedge funds. In investing arenas outside of private equity, operational due diligence has slowly gained acceptance over the years. Within the alternative investment arena in general and hedge funds in particular, a key driver of increased focus is the losses that have been caused by fraudulent activity, which in turn was facilitated by weak operations. In recent memory, investors have seen a number of headlines and articles about the hundreds of millions in losses associated with names such as Bernard Madoff, R. Allen Stanford, Jerome Kerviel, Tom Petters, and Samuel Israel III, which help to explain the meteoric rise in interest in operational due diligence in the alternative space. Even as this book is being written, alleged UBS rogue trader Kewku Adoboli has been charged with fraud that resulted in a loss of over \$2 billion. Because of a series of similar private equity frauds, LPs and, however begrudgingly, General Partners (GPs) have begun to respect the need for private equity operational due diligence.

But operational due diligence involves a great deal more than fraud detection. Sometimes honest GPs and LPs simply do not have the requisite skills, resources, or foresight to avoid underperformance or losses due

primarily to operational concerns. Proper operational risk management within a fund is not simply a matter of throwing experience or money at the problem. Rather, operational risk evolves within a fund organization over time. To effectively manage its own internal operational risk exposure, a fund's management must be actively involved in all aspects of operations oversight. At different times and during different types of market events, private equity funds may react differently and the ensuing consequences may not be uniform for their internal fund operations.

Operational due diligence is an ongoing diagnostic process. Much like private equity investing itself, however, operational due diligence on private equity investments requires a measured dose of patience. Due diligence can be more art than science, and a thorough analysis will allow investors to detect funds that will have an increased likelihood for underperformance or for failure in the event of unexpected stresses.

This book seeks to accomplish several goals, but in particular the author wishes to convince LPs of the benefits of designing, performing, and maintaining a robust operational due diligence program for private equity funds. To support this cause, I have outlined a brief history of operational risk coupled with an introduction to the unique aspects of operational due diligence on private equity funds.

The second aim of this book is to provide LPs with the tools necessary to execute detailed comprehensive operational due diligence reviews of private equity funds. To accomplish this, I have outlined the elements of core and expanded operational due diligence reviews. I have provided comprehensive chapters dedicated to analyzing approaches to valuation, legal, and financial statement risks. In Chapters 3 and 4 you will see a red flag icon (like the one set next to this paragraph) that indicates key operational risk areas in which deficiencies have historically tended to signal larger problems.



I also offer a summary of historical private equity frauds and hypothetical case studies to familiarize LPs with the scenarios they may encounter when performing operational due diligence. This discussion also includes a review of the key considerations LPs should take into account when reviewing real estate funds.

Additionally, this book seeks to broaden the discussion surrounding operational risk assessment in private equity funds beyond the notions of “pass” or “fail.” To accomplish this, I have provided an introduction to incorporating the results of operational due diligence reviews into the asset allocation process. This book also includes discussions regarding ongoing



operational monitoring techniques and the role of advisory boards in due diligence.

Finally, one of the other goals of this book is to foster an increased understanding among investors in the private equity community about the rights of LPs to perform comprehensive operational due diligence reviews and the ways in which GPs approach operational risk management. It is likely that there will be readers who disagree with some of the opinions and conclusions presented in this book. Debates are welcomed, and I encourage all those interested in private equity to throw their hats into the arena, to join in and discuss the issues and enhance the larger community's understanding and focus in the field of operational risk.

A detailed, comprehensive operational due diligence program for private equity funds requires time, resources, and skill to develop and refine over time. The benefits of implementing such a program with discipline, uniformity, and caution are that it will allow Limited Partners to weed out managers with weaker operations, make investment decisions with stronger convictions, facilitate ongoing monitoring, and avoid losses associated with operational risks. It is my hope that the techniques and advice in this book are taken up by LPs and more risk-conscious GPs. Perhaps Ben Franklin's saying best sums up the importance of operational due diligence in the illiquid, complex, and often opaque field of private equity investing: "An ounce of prevention is worth a pound of cure."

JASON SCHARFMAN  
*March 2012*



# **Private Equity Operational Due Diligence**



# Introduction to Private Equity Operational Risk

**P**rivate equity investing is a unique asset class that can offer a number of attractive benefits to investors. Compared to more traditional investments, some of the benefits associated with private equity investing can include the ability to focus on long-term capital growth with higher uncorrelated returns. Despite these benefits, as is the case with any asset class, private equity investing is also fraught with a number of unique risk sets and challenges that investors must consider. These risks can include traditional investment-related risks such as style drift, excessive risk taking, and overall poor performance. When investing in private equity, investors are also exposed to a series of what may be thought of as risks that are not purely related to investments. These risks have become commonly grouped together under the moniker of operational risks. But what exactly is this mysterious risk category known as operational risk?

## **INTRODUCTION TO OPERATIONAL RISK**

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Noninvestment-related risks can be often grouped into different categories due to certain shared similarities. These noninvestment risks also go by many names depending on with whom you are speaking. Some may refer to these noninvestment related risks as fat-tail risks. The term *fat-tail risks* is used due to the severe effects that these risk may have, coupled with the perceived infrequency with which they actually cause damage. Others may use the terms *business risk* or *organizational risk*. The term that most individuals who focus on analyzing and monitoring these risks have settled on in recent years is *operational risk*.

The concept of operational risk is not unique to the world of private equity. Indeed, it is not even unique to asset management or the financial

industry in general. Concerns related to risk management falling under the heading of operational risk are present across a number of industries that have nothing whatsoever to do with the business of investing or managing money. The FAA System Safety Handbook for pilots has a section dedicated to Operational Risk Management (ORM) and defines the goals of ORM as “protecting people, equipment, and other resources, while making the most effective use of them.”<sup>1</sup> In the medical field, surgeons have procedures in place to mitigate literal operational risk, to prevent mistakes such as wrong-side surgery when conducting actual operations on patients.<sup>2</sup>

With such a well-developed field spanning multiple disciplines, why in recent years has there been a flurry of interest in a subject that is supposedly so well fleshed out? After all, with a large body of research on operational risk in other fields not related to asset management or private equity, could a discussion of operational risk and due diligence in a private equity context actually yield anything new? While the field of private equity investing has continued to increase in complexity and specialization, the issues of operational risk and due diligence areas applicable to private equity as they are in other fields. This ambivalent situation can perhaps be best summed up by a comment that Pablo Picasso is rumored to have made following a viewing at Lascaux Cave of some of the earliest prehistoric cave paintings ever discovered: “We have invented nothing.”

Regardless of the field or context in which operational risk is being discussed, often times it seems both practitioners and academics alike have a difficult time pinning down an appropriate definition of this broad topic. Part of this problem perhaps stems from the typically broad number of topics and disciplines that operational risk generally encompasses. Within the financial and specifically asset management world, defining operational risk is often a contentious exercise at best. Indeed, as Chapter 2 discusses in more depth, many in the asset management world and private equity communities in particular, may not even see a real need to devote material resources toward analyzing operational risk in private equity funds.

Indeed, why bother attempting to develop a definition of something if there is a commonly held belief that the very thing attempting to be defined is not itself of any consequence? Stated plainly, as the reader may be able to gather from the title of this book, operational risk not only matters but should be of paramount importance to any investor even considering investing in private equity. As an aside, for those in the private equity community who may disagree with this statement, I invite them to read this book, fully consider the benefits of developing a private equity operational risk assessment program and ultimately think about whether or not they would find making a more informed decision (e.g., a decision based on an understanding of not only the investment risks of a particular private equity investment, but the operational risks as well) to be the most prudent course

**EXHIBIT 1.1** Common Private Equity Operational Risk Categories

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**Risk Category**

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Cash controls  
Trade life cycle processing  
Valuation  
Transparency and fund reporting  
Liquidity management  
Technology and systems  
Legal and compliance  
Counterparty oversight  
Quality and roles of service providers  
Business continuity and disaster recovery

---

by which to proceed. Ultimately, more informed investors tend to make better investment decisions and realize fewer losses due to operational risks.

Within the private equity world, there are any number of factors that can fall into the category of operational risks. Common operational risks are outlined in Exhibit 1.1.

The list of common private equity operational risks in Exhibit 1.1 are the general risks that come to most individuals' minds when they first hear the term *operational risk*. As this chapter discusses in more detail, the operational risk category lacks a true universal definition. Within the private equity world, there is no operational risk rule book. Furthermore, no private equity legislation, regulatory guidance, or other laws describe what falls under the term *operational risk* and it is therefore usually defined by what is covered by the operational due diligence process. As such, in a private equity context, *operational risk* is very much a term whose definition is driven by the market. Investors, fund managers, and private equity service providers alike are effectively left to their own devices in some regards to come to terms with this concept. That being said there are certain risk factors, as discussed throughout this book, which most in the private equity community would group into the category of operational risk. It is upon this foundation that we will begin to place the building blocks of the discussion of the operational due diligence process.

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**OPERATIONAL RISK COMPARED TO OPERATIONAL DUE DILIGENCE**

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Now that we have introduced a basic understanding of what is commonly meant by operational risk we can next focus on operational due diligence. The two terms are occasionally used synonymously in practice; however,

there is a distinction between the two. The term *operational due diligence* is correctly utilized when employed to refer to the processes of gathering data about a particular private equity fund. The type of data collected during the operational due diligence process is operational risk data. After this data has been collected during the operational due diligence process, an investor then can perform an analysis of this data to come to a determination as to the amount of operational risk present at a particular private equity fund. This analysis stage, as compared to the data collection stage, is also typically considered to be a part of the operational due diligence process.

Operational due diligence can be thought of as the process of performing due diligence on these operational risks. But this definition does not really tell us much. So, what exactly do those in the private equity community mean when they refer to operational risk and operational due diligence?

## **WHAT IS OPERATIONAL DUE DILIGENCE?**

With the basic understanding now in place we can now begin to think about what exactly operational due diligence actually entails within a private equity context. Operational due diligence is a peculiar subject. Indeed the acronym that is commonly used in the industry is “ODD,” although this book will use “ops dd.” Many investors and fund managers may have a general idea about what operational due diligence encompasses. Some investors may even think operational due diligence to be limited to the seemingly easy-to-diagnose areas such as post-trade analysis and other back-office processes. Any such risks would certainly be obvious to detect for anyone who devoted the time to take a look—they are hiding in plain sight. While these statements are certainly overgeneralizations, they definitely contribute to the understanding of what encompasses operational due diligence.

What is less obvious perhaps is that while each individual’s exact notions of what is meant by operational due diligence may vary, the range of variations can be quite wide. This is one of the reasons why operational due diligence is a multifaceted and fairly deep field of due diligence and lacks one universal definition that would sum up all of these aspects into one unique package. The lack of a universal definition is brought even more into focus in the complex work of alternative investments.

Under the broad umbrella category of alternative investments, it is even more difficult for investors and fund managers to explain how operational due diligence processes may vary among different types of investments such as hedge funds and private equity investing. It is the latter category, private equity, upon which this book will focus. By introducing the various related concepts, due diligence techniques and approaches, as well as trends in



this field, this book attempts to provide guidance toward fostering a more complete understanding for the parties involved in private equity investing, including investors, fund managers, and private equity service providers of what the field of a robust operational due diligence program entails. Perhaps this will foster a more universal definition of the term among members of the private equity community.

But perhaps we are getting ahead of ourselves. As intimated earlier, the world of private equity is a category of alternative investing unique unto itself, replete with its own series of challenges and opportunities. This uniqueness and the general ways in which investors and fund managers may have approached the concept in the past have developed into a situation in which, among most individuals in the private equity community, operational due diligence in the private equity world tends to be an amorphous concept.

### **Focus on Fraud Detection**

When many private equity investors first hear the term operational due diligence, they may immediately begin to focus on fraud detection. Indeed, when first beginning to think about the subject of items that may influence the ultimate investment decision other than purely investment-related concerns, there is a strong temptation for investors to focus on concerns related to fraud in the management of a private equity fund. Certainly, this is understandable for several reasons.

Due to the fat-tailed risks associated with fraud it is certainly reasonable, and from a pragmatic standpoint logically prudent, that due diligence surrounding potential issues of fraud should be of penultimate concern during every stage of the entire due diligence process. Private equity investors logically want to avoid all losses, but losses due to fraud can leave a particular sting and any potential recovery from such losses is often a sticky business. When an asset management fraud occurs it can generally lead to total losses with little hope for recovery. Indeed if recovery by defrauded investors does occur it is often only after a long extended process steeped in legal costs. Moreover, any recovery process typically only results in partial recovery because the capital “pie” to be divided does not meet the needs of all investors. Of course, there are rare exceptions in which investors recoup the entire amount of their initial investment.

Additionally, in the wake of a series of frauds, Ponzi schemes, and the like, in the alternative investment arena concerns related to fraud are still at the relative forefront of the general investment collective consciousness. Furthermore, regardless of whether a private equity fund manager has a long track record of stellar performance, coupled with experienced well credentialed professionals and a highly compelling investment thesis for a

fund—if the entire thing is a fraud—none of the other due diligence that may have been performed regarding the merits of the investment strategy (i.e., investment due diligence) and the quality of the managers' reputation (i.e., reputational due diligence) matters very much.

In the context of fraud detection, the distinction matters little whether an investor is performing investment due diligence, operational due diligence, or any other subcategory of the two. Stated plainly, if the due diligence process fails to detect fraud, it has failed.

Now of course there are different levels of fraud. There is the complete and total fraud often employed under the model of the Ponzi scheme (e.g., Madoff) and then there are other types of fraud that may not be so apparent or so completely ruinous to an organization (e.g., a private equity manager claiming that they have 80 percent of the portfolio independently valued when in actuality it is more like 70 percent). In the latter example, the fraud may not result in any losses at all, however, the private equity fund manager is still committing a fraud in the broadest sense of the word by misrepresenting the truth of the facts and circumstances relevant to their particular organization. So if a due diligence process fails to detect these "white lie" lesser frauds, has it failed?

It would be easy perhaps to give into the temptation to state, quite directly, yes. However, this seeks to impose black-letter bright-line pedagogy on a mutable subject matter. In fact, one approach toward reaching an answer to this question relates to issues of the weights with which a particular areas of the underlying items queried by the due diligence process both matter to an investor and directly relate to the potential severity with which overlooking such an item could create losses or future liabilities (i.e., clawback) for investors via fraud.

So, for example, there may be little potential for investor losses due to fraud solely related to the fact that a private equity firm may claim to use the more well respected, and expensive, Fund Accounting System A while in fact they utilize the cheaper and less robust Fund Accounting System B. Certainly this is an important misrepresentation that would raise red flags, lead investors to consider what else a fund manager may be lying about, and ultimately affect an investor's determination whether or not to invest with a particular private equity manager. However, if the private equity manager utilizes the accounting system in only a limited capacity and accomplishes all the necessary accounting tasks with Fund Accounting System B, then the potential for direct investor losses due to fraud (i.e., perhaps that the fund's accounts were not properly maintained) is minimal as related to the fund manager's misrepresentation of accounting systems utilized.

Therefore, in the overall scheme of things certain instances of fraud may be more or less deadly to a particular investor in terms of their

ultimate consequences to generate losses. However, the opportunity for fraud is still prevalent throughout multiple areas of a private equity organization at both the management company and fund level. As such, investors' sometimes seemingly zealous focus on fraud detection and prevention is certainly reasonable. Fraud concerns however, should not overshadow other goals of the operational due diligence process. After all, an organization can be run with the best of intentions in a nonfraudulent manner but still be a complete operational disaster. In such cases, whether a private equity fund fails due to fraud or a weak operational infrastructure, regardless of the potential recovery options when a fraud occurs, both situations have the same initial destructive effects.

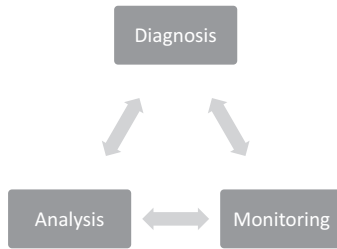
### **Universal Definition of Operational Due Diligence**

Depending on who you talk to and what their general role is (e.g., investor, fund manager, fund operations personnel, service provider, etc.), you will likely receive a multitude of answers to questions regarding the meaning of operational due diligence. From the investor's perspective, the author has heard the head of an alternative investment allocation platform describing the work of their operational due diligence team along the following lines, *"Sure we do comprehensive work. These operational due diligence guys go in and make sure that the fund manager doesn't have two different driver's licenses or has never spent time in jail."*

If you talk to someone with an accounting background they may interpret the term literally to mean due diligence on the operational aspects of a firm, such as the back-office accounting work. They would be correct. Others, as our example illustrates, may consider operational due diligence to consist of fraud detection and background investigations (e.g., making sure that their private equity manager is not the next Bernard Madoff). They, too, would be correct.

Others with a focus on controls might describe operational due diligence as focusing on the flow of cash throughout an organization.

Still others might describe operational due diligence as making sure that the fund manager is properly valuing securities and not stealing from the firm. Still others may consider operational due diligence to be all of the leftovers from the rest of investment due diligence process (e.g., things that don't quite fit neatly into the parts of due diligence that are used to determine the merits of a particular private equity fund and whether it will be profitable or not). These opinions are also correct. We could go on with this list but by now the reader should have the idea that operational due diligence is viewed by some to be a catch-all hodgepodge of different disciplines and subjects cobbled together into a developing field with its own unique moniker.



**EXHIBIT 1.2** Functions of a Core Operational Due Diligence Process

### **Core Operational Due Diligence Process Functionality**

Within this potpourri of concepts and terminology, as with all areas of due diligence, be they operational investment or otherwise, are a series of basic processes, techniques, and risk factors that can be found. It is these areas that are the core of operational due diligence, and should be the bedrock upon which a larger due operational diligence process is founded. As outlined in Exhibit 1.2, by diagnosing, analyzing, and monitoring operational risk in private equity investments, investors can foster a deeper understanding of any operational risk exposures, mitigate those exposures, and avoid taking unnecessary operational risks when investing in private equity.

### **OPERATIONAL DUE DILIGENCE IN THE FIELD OF PRIVATE EQUITY**

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Many investors will not be directly managing their own private equity funds but instead entrusting capital to a third party to manage on their behalf in a commingled investment vehicle also known as a private equity fund. There are several categories of private equity fund strategies including:

- Venture capital (VC) funds
- Leveraged buyout (LBO) funds
- Mezzanine financing funds
- Distressed debt investing funds
- Crossover funds
- PIPE transactions
- Interval funds
- Real estate funds

In addition to these strategies there also exist private equity fund of funds, which are private equity funds that invest with other private equity funds. This book will provide an overview of the general universal elements of operational due diligence for private equity funds in general and will also pay particular attention to certain of the specific risks associated with different classes of funds just referenced including real estate funds. With an understanding of the basic landscape of private equity fund strategies, we can begin to discuss in greater detail the investor's role in the private equity process.

To begin with, despite all of the benefits that an investment in private equity funds may offer, the asset class does have its detractors. It is an asset class that has been referred to as having "lottery-like characteristics."<sup>3</sup> Private equity groups have been called "amoral asset strippers" and "casino capitalists."<sup>4</sup> Franz Müntefering, former vice-chancellor of Germany, referred to private equity firms as "Heuschrecke," or locusts, and went so far as to publish a so-called locust list that included such firms as Carlyle, Goldman Sachs, KKR, and Deutsche Bank.<sup>5</sup> Others have referred to private equity investors as vultures or buzzards.<sup>6</sup> Groups such as the Service Employees International Union have criticized the tax advantages enjoyed by many private equity firms as compared to the employees of the portfolio companies that they manage.<sup>7</sup>

Putting the rhetoric aside, private equity can indeed be classified as one of the alternative investment asset classes in which manager selection plays the most crucial role in all asset classes.<sup>8</sup> Therefore, one of the key considerations in assessing the potential benefits and risks that will be factored into an investor's decision making process to invest in private equity will not only be related to the scope of the underlying investments and/or portfolio companies that will be held in the private equity fund, but also to the competency, skill, and quality of the operational infrastructure of the private equity fund manager themselves.

## **OPERATIONAL DUE DILIGENCE AS DISTINGUISHED FROM OPERATIONAL MANAGEMENT OF PORTFOLIO COMPANIES**

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As is the case in many disciplines and particularly in finance, the terms and concepts associated with operational risk and operational due diligence can have more than one interpretation, particularly in a private equity context. As such it is important to clarify the specific context within private equity in which the term is being used here. For the purposes of this book, operational due diligence refers to the due diligence on operational risks that investors will perform on *private equity funds*.

This is to be distinguished from any operational planning or management assessment that a private equity fund manager would perform on underlying portfolio investment companies. While many of the core operational concepts and techniques that will be discussed in this book are certainly relevant, those types of operational reviews fall more into the context of investment management than they would operational due diligence and are therefore best left for other texts focused more exclusively on such subject.

Before we proceed, so that all readers are on the same page it is worth pausing for a moment to define some basic terminology that will be used throughout this book:

- **Private equity firm.** For the purposes of this text, a *private equity firm* will refer to the management company of a private equity organization. A private equity firm will typically manage several private equity funds.
- **Private equity fund.** The term *private equity* fund refers to a private equity investment vehicle that adheres to a particular strategy. A particular private equity fund may be offered in a variety of different investment vehicle formats so that investors from different jurisdictions can invest in a particular investment strategy. Motivations for such different investment vehicles can include jurisdictional and tax concerns.
- **General Partner or GP.** The *general partner*, commonly referred to as a GP, is the managing partner of a private equity company. To clarify the General Partner is not typically a single individual but rather a legal entity that is organized by the private equity firm's principals to oversee the management of a private equity fund. These entities are commonly organized as a limited liability companies.
- **Manager or Investment Adviser.** In many cases, a private equity fund will have an intermediary level entity known as the *Manager* or *Investment* Advisor between the general partner and investors, which technically may serve as the manager of a particular private equity fund.
- **Limited Partners or LPs.** Investors in a private equity fund are commonly referred to as *Limited Partners* or *LPs*. This term comes from the fact that many private equity funds are organized as limited partnerships and, therefore, the investors that subscribe (i.e., invest) in those funds are limited partners.

## **TIMING OF OPERATIONAL DUE DILIGENCE IN THE INVESTING PROCESS**

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During the initial private equity fund assessment process investors are faced by a series of due diligence challenges. These challenges often broach the due