A matter of when

Research indicates that the use of third-party fund services is on the rise, so the operative question for many firms has become not if to outsource, but when?

The question of whether or not to outsource fund administration functions has been a hot topic within the private funds industry over the past few years. A combination of pressures on back office operations, including scrutiny from the US Securities and Exchange Commission (SEC) and investors alike, combined with the new culture of compliance around the industry has led many private equity firms to seriously consider the efficiencies of a third-party fund administrator.

Jeff Gendel and his partners at Gen II Fund Services have been witnessing this phenomenon firsthand. Gen II provides administrative, accounting, investor and reporting services across the private equity fund spectrum including buyout, energy, real estate, debt, venture, and infrastructure funds, reporting to over 6,000 LPs worldwide.

Gendel notes that there are some distinct points in a firm's development when the operational workload begins to mount and bringing on a third-party fund administrator just makes sense, such as when launching a new firm or when launching the next fund.

"If you're running a firm with highly paid, high value employees, you want them doing high level work," Gendel notes. "Most of our clients have CFOs and have found that by utilizing a third-party administrator the private equity firm's internal resources are freed up to focus on areas that will enhance the value of portfolio companies and/or the firm itself."

> **"Credibility in your operational infrastructure is crucial to investors entrusting you with their capital"**

A noted trend

Industry research indicates that investor and regulatory demands will result in a lasting change as to how the industry operates. For years, the hedge fund space has been a more prominent user of outsourcing, with nearly 100 percent adoption of the third party administrator model. While lagging hedge funds, the private equity community is quickly catching on.

In the US, approximately 30 percent of US private equity invested capital has been outsourced to a third-party administrator, according to a recent report from PwC. However, as back-office pressures continue to mount, outsourcing levels are expected to increase from 30 percent to 50 percent or more over the next five years, the report indicated. Gendel expects the private equity industry to migrate toward universal adoption of the third party model over time.

While there are still firms that choose to conduct most operational tasks in-house, GPs of all sizes including existing multi-billion dollar, as well as emerging managers are considering outsourcing at a record pace. The functions most likely to be outsourced are technology, tax and fund accounting, according to EY and PEI's *2014 Global Private Equity Survey*. The burdens continue to grow. Recent SEC demands for cybersecurity compliance have spurred investors to ask GPs of all sizes specifically to consider utilizing a qualified fund administrator to provide comfort on the security of investor information.

Gendel: when outsourcing, timing is key

Getting a head start

Not only are more firms reaching out to third party administrators, but those that do are contacting them earlier than one might think. Gen II has seen a significant change in the timing when new firms, including spinouts and startups, establish contact with an administrator. Previously, fund administrators would typically get involved at the end of a fundraising period or just prior to the first drawdown of LP capital, Gendel says. Now, however, GPs are reaching out even before raising their first dollar.

Interest in the operational side is driving this new focus on fund administration for both emerging managers and GPs going out to market their latest fund. Investors will regularly ask about a firm's operational infrastructure during due diligence, which is a relatively new practice. Gen II is seeing funds engaging with third party administrators before they have their private placement memoranda (PPM) finished, so that the fund administrator is included in the PPM right alongside the firm's counsel and independent auditors.

"Along with questions about your returns and your investment thesis, LPs and gatekeepers are increasingly asking GPs: 'Tell me about your operational infrastructure.' No one wants to fumble that question," says Gendel.

Aside from the standard administrative and accounting services that private equity funds usually desire when outsourcing, new firms might need more customized services to help them get off the ground and respond to those operational-level requests from LPs. This is helping to expand the role of third-party administrators, who are now becoming more involved in reviewing of organizational documents and structure of the firm, modeling GP sharing economics, liaising with legal counsel and advisers, providing benchmarks for transparency on operational tasks, and designing communication packages for investor notices and financial reporting.

Hiring a well-established third-party administrator can also help a newer firm to show operational credibility to the LP market. Gen II, for example, has worked indirectly with more than 6,000 LPs around the globe and the institutional grade infrastructure offered by a fund administrator allows an LP to check that important box.

"Credibility in your operational infrastructure is crucial to investors entrusting you with their capital," says Gendel. "It may not be a reason why you get their investment, but failing the operational credibility test would certainly be a reason why you may not win the mandate."

> "'Tell me about your operational infrastructure.' No one wants to fumble that question"

Growing opportunities

For private equity firms both new and old, the SEC is playing a key role in the future of a firm's operating infrastructure. The SEC is taking a much closer look at investment operations, the protection of investor data, and the transparency and accuracy of the fund information being provided to investors and regulators. Recent SEC actions suggest that they will not hesitate to bring enforcement actions against firms that are not following their limited partnership agreements to the letter.

These developments are concerning to any GP, but especially those returning to the fundraising environment having to face the realities of a new world.

"If your most recent fund was $500 million and your next fund is targeting $1 billion, you're adding a lot more LPs, potentially, in addition to the increased dollars you're overseeing," says Gendel. He notes that GPs will ask themselves: "Does my firm have a staff that can easily scale with this new fund? Am I structured to manage operations in the current regulatory and compliance environment that the SEC demands?"

"The last time the firm raised a fund, it's likely that these operational infrastructure questions did not come up," Gendel adds. "Now, in every single RFP there are questions about things like cybersecurity, protection of investor data, the ability for the team to respond to all types of requests and 24/7 access to information."

These information and technology concerns for GPs reentering the market coincide with the findings spanning the overall market in the EY report. Only 16 percent of respondents described their technology capability as "good to highly automated," while most have a combination of manual and automated systems. Building up current capabilities or implementing new systems is both costly and time consuming, leading most firms to outsource these functions to skilled fund administrators.

Whether catering to a new firm, helping an existing firm to reenter the market or working with a well-established firm that finds that outsourcing will better meet its operational needs, Gendel says this surge in the demand for third-party administration services is ultimately a reflection of the maturity in the private equity industry in recent years.

"Private equity's expected continued growth as an asset class bodes well for independent third-party administration. The bedrock of investing is based on trust and reliability of information; third party administration is a well-established part of this equation," notes Gendel. ■