

Greasing the wheels

Fund administration providers offer a compelling service but their low penetration of the market suggests they still have much work to do to convince private equity firms of their benefits

By Nathan Williams

Fund administration is a key component of any successful private equity firm. From communicating with LPs, providing regulatory advice and assisting with the resolution of complex tax issues, the fund administration function is the oil in the engine of the private equity machine. In an age of increasing regulation and demands from LPs for ever-more detailed reporting, the way a private equity firm manages its back-office is set to grow in importance.

Private equity firms may be lean operations in comparison to their investment house counterparts in other areas of the financial sector but the majority still hold their fund administration functions in-house - it is estimated that only around 10% of private equity firms use a dedicated fund administration firm. This figure reflects the fact that a significant proportion of private equity firms are part of larger financial institutions and can rely on the in-house resource of the parent. A large swathe of the market may therefore be closed to third-party administrators, but a number of new private equity firms established over the past year, as well as newly independent private equity firms, are providing fund administrators with a steady stream of business. "More new firms are recognising that it is not always efficient to spend time and money establishing the infrastructure required

and to this end a number of senior private equity professionals are leaving their current firms to set up new funds (*see table*).

New private equity firms		
Firm	Founders	Former firm
Vespa Capital	Nigel Hammond, Denis Leroy	Montagu
Abris-EMP	George Swirski	Advent International
	Neil Milne	Copernicus Capital Partners
KP Capital	Jason Katz	UBS
Elysian Capital	Ken Terry	Doughty Hanson
	Edward Brett	Gresham

Private equity has been slow to catch the outsourcing bug, with dedicated fund administrators appearing only in recent years. The speed of growth in the private equity industry has outstripped the pace of development in the provider community which, until recently, compelled most private equity firms to handle their fund administration internally. "Five years ago no one could outsource the back office in private equity. If you look at what's gone on over the last ten years in the financial services sector all the major players have moved to outsource these functions," says

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David Bailey at Augustinus. Although the ninety percent of firms relying on an in-house function will not all move to outsource because some can utilise the resource of a larger parent, there is a significant number of firms not investing as an arm of a larger parent which choose to

manage the fund administration function in-house so they are looking to partner with a specialist fund administration provider," says Richard Harland at Mourant. The rash of new firms coming to market shows no signs of abating. Although most are forecasting the full brunt of recessionary pressures to hit the UK in 2009, demand for private equity remains robust

manage the fund in-house. The burden of managing the fund administration in-house is significant but with more providers now on the market, offering a range of services, this may lead to more independent firms contracting the services of a third-party administrator. "Outsourcing reduces the need for private equity firms to deal with areas such as recruitment, finding premises,

regulatory and compliance matters and other logistical factors associated with a multi-jurisdictional presence. We can locate ourselves where the business requires, so the client does not have to,” says Harland.

As funds have got larger and LPs more diverse, these pressures have increased, leading a number of firms towards the outsourcing route. A GP which has raised progressively larger funds comments that “just the words ‘fund administration’ make my eyes glaze over but it is an essential part of running a successful private equity firm. As our firm has grown the costs of fund admin have rocketed and it was becoming difficult to find quality people with private equity accountancy experience. Outsourcing solves this and at our size is now more cost effective.” The regulatory environment has also tightened up in the past few years and increasing compliance costs will continue to drive firms towards external providers. “Historically, private equity structures tended to be more straight-forward, with investors and regulators requiring less involved financial reporting. These structures are becoming more complex, investors more sophisticated, and regulatory environments are changing. As a result, private equity firms can mitigate a number of operational risks by outsourcing to a skilled provider,” says Harland.

Although compliance has tightened in light of the Walker report, the industry is still largely self-regulated and in this respect a specialist fund administrator has an important part to play. One LP says bluntly; “we have not had any major blow-ups in a private equity fund and everyone says it is all audited but the reality is that the hedge fund industry proves something else.” That we haven’t had any major private equity blow ups in the mould of US hedge fund LTCM is testament to the private equity reporting model. Indeed, the level of reporting from a private equity fund to its investors has often been praised by LPs and in his report on transparency and disclosure Sir David Walker commended the depth of information provided by a fund to its investors. However, one can see how a third-party administrator would provide an extra level of assurance for LPs, especially to those

who are familiar with the model of outsourced administration. “Most LPs that invest in hedge funds also invest in private equity and are used to third party administrators. Outsourcing is partly an insurance policy on the part of LPs,” says Bailey, who also believes LPs prefer a fund to outsource its administrative work for more practical reasons. “LPs would prefer that the private equity firm was not distracted from doing deals and managing the portfolio by looking after the back-office function,” he says. Harland agrees and says that third-party providers “are in a position to contribute to the increased requirement for transparency through a sound working knowledge of the regulatory frameworks and compliance requirements of the jurisdictions in which we operate.”

“It is not always efficient to spend time and money establishing the infrastructure required to manage the fund administration function”

Richard Harland, Mourant

As the recession worsens and private equity firms look at ways to streamline operations, those managing admin internally could also find switching to an outsourced model more cost-effective. “When you outsource back-office functions the admin costs are picked up by the fund not by the management fee. This is the same for many funds, including hedge funds and retail products such as unit trusts. When you have in-house functions the cost is picked up by the management fee,” explains Bailey.

A third-party administrator has many obvious benefits and their relative lack of penetration into the market so far is not a reflection of the value they can bring – in many respects it reflects the culture of a private equity firm. Many private equity firms are instinctively reluctant to relinquish any element of control over their business or investment processes and this extends to the back-office. However with recessionary pressures mounting, private equity firms may find that relinquishing some control is the most efficient way to ensure they remain on top of portfolio issues and new investment opportunities while reducing internal costs. ■

Fund administration in the UK

One of the curiosities of the fund administration business in the UK, according to Bailey, is the fact that “apart from JP Morgan, none of the other offshore providers have come to London to challenge us in any great strength. The majority are in Jersey and Guernsey although only a small percentage of private equity funds locate themselves in off-shore jurisdictions. We saw an opportunity to provide back-office accountancy

functions to London-based funds in addition to offshore funds.” The well-established investment management firms which provide fund administration may be missing a trick but it seems the large number not providing private equity fund services in London, such as Northern Trust, appear to have calculated that at present the volume of business is not at a level which would justify a private equity fund administration offering.