Evolving Efficiencies: Outsourcing Administration of Private Equity Funds

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Recovering from the 2008 financial crisis and subsequent economic downturn, a slowly rebounding private equity industry must also struggle with more strident demands for transparency from investors and vastly increased regulatory requirements. Maintaining the industry's traditional self-governance approach is no longer acceptable and future regulatory, compliance and tax issues are expected to continue to impact the industry. Additionally, many private equity managers have modified their investment strategies, entering new markets and new geographies.

As a result, chief financial officers (CFOs) are faced with managing an exponential growth in data and reporting requirements. Creating and maintaining effective controls in this new environment has increased the operational costs of private equity firms and placed significant time constraints on senior level managers and CFOs. This is true for all private equity firms. However, the boutique, specialty investment firms have been particularly hard hit by the increased regulatory burden and the need to manage and report data more quickly to investors and deal team professionals. This is because boutique investment firms tend to have leaner operating models even though they may have billions of dollars under management and complex fund structures.

Most private equity managers, especially boutique firms who have managed their operations internally, are being forced to assess their current administrative capabilities. This includes evaluating the skills of employees handling their back-office and middle-office operations, as well as, researching vastly improved technology offerings specifically designed for private equity operations. These firms must quickly improve their operating capabilities and many have already turned to third-party fund administrators to boost their operating performance and efficiency.

Many boutique investment firms that have turned to or are considering outsourced solutions are finding that large fund administrators, who currently dominate the market, are structured to best serve far larger clients. The boutique firms, generally with limited administrative resources, can greatly benefit from a responsive administrative partner to handle their back-office functions and assist with complex issues and new regulatory matters.

According to recent research from alternatives specialist Preqin, there are approximately 3,400 private equity and venture capital firms headquartered in the United States alone. The vast majority of these firms are specialized boutiques. Typically, they do not require custody or other ancillary services offered by the large administrative firms. Without these cross-sell opportunities, large administrators struggle to profitably service the boutique firms. These are the private equity firms that have a clear need for a knowledgeable, responsive administrative partner who will enable them to focus their time and energy on the functions that add value to their firm and their investors.

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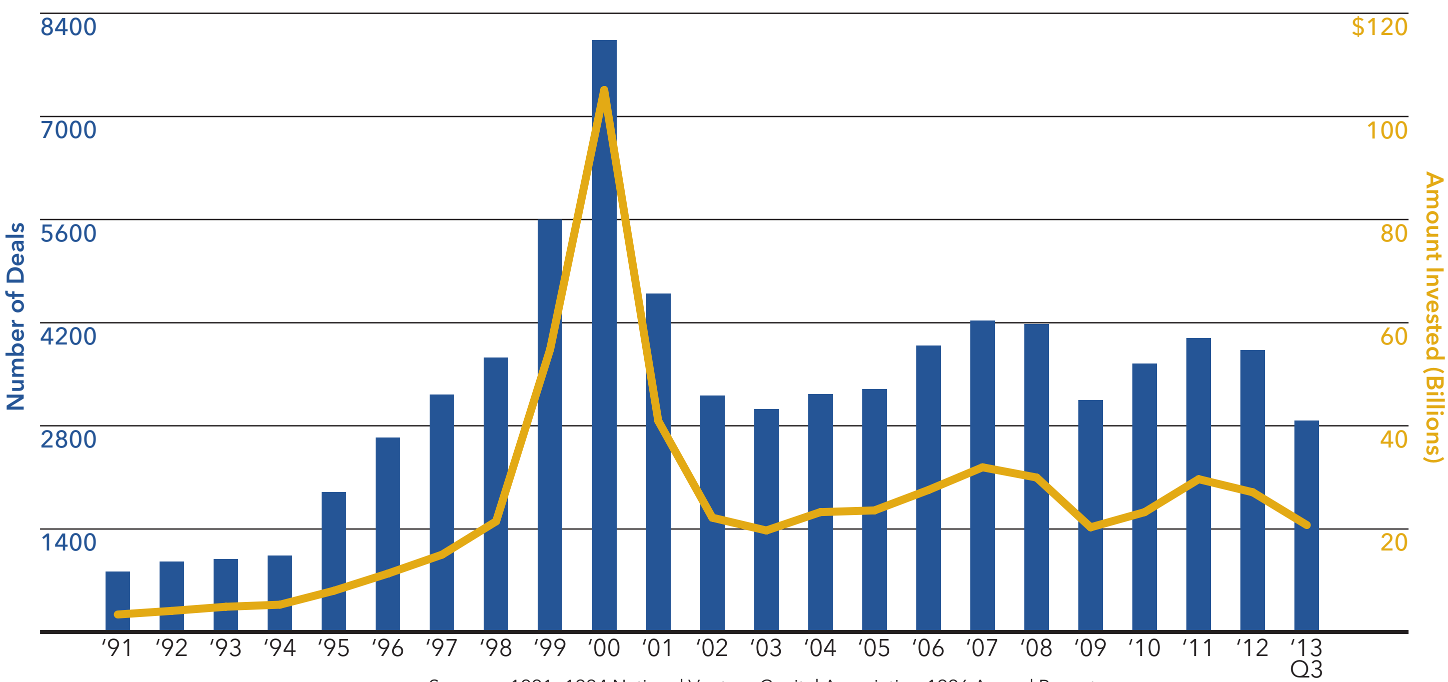
The Genesis of Private Equity Administration Outsourcing

While private equity and venture capital funds have existed since the mid-1940s, the industry experienced its first dramatic expansion in the 1980s. With financial deregulation, a rapidly growing group of entrepreneurs entered the field, many of whom pursued leveraged buyout strategies. Few of these entrepreneurs even considered outsourcing their fund administration. Over time, however many began to struggle with the complexities of handling their expanding administrative responsibilities.

In the late 1980s, I recognized the need for a third-party administrative offering dedicated to the private equity industry. In 1991, I launched Palmeri Fund Administrators, Inc. (PFA). PFA was the first independent firm to offer full-service fund administration exclusively to the private equity industry. Offering a classic outsourcing value proposition, PFA bundled technology, talent and expertise to handle a burdensome series of tasks that lay outside the core competencies of its clients, typically at a lower overall cost than could be achieved in-house. Beginning in the early 1990s and continuing through the end of the decade, the private equity industry once again experienced a tremendous boom as a result of the dot-com bubble and the emergence of brand-name firms managing multi-billion dollar funds.

As a point of reference, the chart below shows the tremendous growth in just venture capital investments made during the 1990s.



Sources: 1991–1994 National Venture Capital Association 1996 Annual Report;
1995–2013 PricewaterhouseCoopers/National Venture Capital Association MoneyTree™ Report,
Data: Thomson Reuters

Throughout the expansion cycles of the ’80s and ’90s, a growing number of investment professionals launched an increasingly diverse range of offerings. It was during this period that outsourcing private equity fund administration began to take hold. Before long, PFA administered client funds globally. The firm expanded rapidly throughout the 1990s and, by the mid-2000s, PFA was growing at an annual rate of approximately 35%. The firm’s client list comprised a diverse group of private equity firms managing venture capital, leveraged buyouts, fund-of-funds, real estate, infrastructure, energy, financial services and other specialty funds. This growth and the emergence of other competitive fund administration offerings validated the outsource service model for the private equity industry.

Consolidation and Transformation

As the alternative investment industry progressed through the boom and bust cycles of the 1990s and early 2000s, the independent fund administration industry began to consolidate. Large institutions entered the fray, in many cases acquiring independent fund administrators and packaging their offering with custody and other services. PFA became part of this consolidation when the firm was acquired in 2007. Hedge fund administrators also began offering private equity fund administration, primarily to existing hedge fund clients expanding their operations into private equity and real estate.

Given their high cost structures, internal regulations and functionalized service models, large institutions offering fund administration services soon began to recognize the difficulties involved in adequately servicing boutique firms profitably. Many large institutions are beginning to focus their efforts on large independent private equity firms and private equity divisions of major financial companies. As more and more independent fund administrators were acquired, fewer and fewer administrators remained with the expertise and operating model required to adequately service boutique private equity firms.

The Current Case for Outsourced Administration

The case for outsourcing the administration of private equity funds is quite similar to the proposition first offered in the early 1990s. However, significant enhancements in accounting databases, customer relationship management (CRM), Web-based reporting and automated waterfall models are available today. Customizing and maintaining these systems to provide reliable, accurate reporting can be arduous and time-consuming, leaving CFOs less time to focus on high-level operational issues. These tasks require specialized expertise, flexible technology and the perspective of professionals who understand the latest market demands and regulatory requirements.

CFOs must adjust to keep pace with expanding regulatory and investor demands while managing increasingly complex investment strategies in new investment areas and new geographies with unfamiliar regulatory requirements. In the United States alone, Securities and Exchange Commission registration and Form PF (resulting from Dodd-Frank), the Foreign Account Tax Compliance Act (FATCA) and increased investor scrutiny of internal operating models and back-office infrastructures are just the current challenges — with more on the horizon. Firms using manual processes, which are still prevalent in the industry, are quickly looking to leverage the skills and technology available by partnering with a strong third-party administrator. The current environment has only intensified the need to improve back-office functions, making a strong back-office operating model a competitive advantage for boutique firms.

Selecting the right administrator will catapult firms to a new level of operating efficiency and cost savings. The need for a dedicated, knowledgeable third-party administrator is greater than ever. As a result, we expect a significant shift from in-house to outsourcing back-office administration over the next few years. The boutique firms require high-quality service from an administrative partner focused on responsiveness, reliability, dependability and accuracy – provided by knowledgeable industry experts who are engaged in their daily workflow and who are easily accessible. That's why we established Broadscope: to provide a superior service offering exclusively for the private equity industry based on direct access to senior management, robust quality controls and flexible state-of-the-art technology.

Case in Point

A private equity group operating inside a privately owned corporation recently transitioned from investing only family money to accepting investments from third-party investors. As the operation expanded, they hired a CFO who was charged with improving their financial controls and processes. After careful analysis, the CFO determined that implementing a private equity administration system with existing staff would be overly time-consuming and expensive. Based on the CFO's recommendation, the group decided to outsource their administration and selected Broadscope Fund Administrators.

After a smooth conversion to our technology platform, the CFO was able to redeploy administrative staff while streamlining financial controls, business workflows and investor deliverables in a timely manner. The firm now provides real-time data to its clients through a customizable Web interface. Once the conversion was complete, Broadscope was asked to discuss FATCA regulations with regards to both a new fund under consideration and the firm's existing funds. We took them through the finer points of the legislation and discussed how Broadscope assists with these compliance issues utilizing an automated solution.

Instead of adding staff, grappling with installing and customizing complex software and devoting a substantial amount of time and resources to administrative services, the private equity group saved money, improved their controls and added the perspective of seasoned industry experts to their team. Pleased with the results, Broadscope was also awarded the administration of the wider corporate and family private equity portfolios.

About Broadscope Fund Administrators

Broadscope uses a high touch, boutique style model to provide full-service fund administration to private equity fund managers. Broadscope's mission is to deliver a premium service model based on direct access to senior management, robust quality controls and innovative technology. The Company's founders and senior employees have significant industry-specific experience and knowledge of a broad range of private equity fund types and structures. The Company prides itself on the experience of its senior team, which forms the basis of its personalized service offering.

Contact Us

If you want to free up time to focus on important strategic issues, please contact us.

We have a lot to offer.

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