HOW EMERGING GLOBAL STANDARDS ARE TRANSFORMING THE FUTURE FOR GPs AND LPs

Private Capital's Most Urgent Challenge

One of the greatest challenges for the private capital markets—and one of the greatest opportunities—centers on transparency. Investors and regulators alike are demanding new levels of disclosure, but investment firms have struggled to develop the processes required to meet those expectations. At a macro level, the private capital market as a whole is being held back by the lack of a consistent standard of reporting that makes it difficult for investors to compare performance and firms across liquid and illiquid asset classes.

But all of this is about to change, and the impact will be transformative for both General and Limited Partners.

Newly developed universal reporting standards are promising to take private capital's most urgent challenge—the lack of transparency—and solve it once and for all. And these standards are being released at a time when investor interest is soaring higher than ever before.

Consistently high returns and the potential for alpha are attracting a wider range of investors and elevating the reputation and visibility of the alternative asset class as a whole.

The convergence of highly motivated investors and a newly transparent illiquid investment landscape holds a promise of unprecedented growth. But to position themselves advantageously during this pivotal moment in the industry's development, investment firms need to take steps now to develop the processes, capabilities, and technologies required to adopt these new reporting standards. Those that do will see incredible growth opportunities.

This white paper examines the two most promising developments in the standardization of performance reporting and provides next steps that GPs and LPs can take in order to benefit from them in the future.

CREATING A CULTURE OF TRUST

28% of LPs rarely or never trust high level performance data provided by fund managers.

75% recalculate manager-provided performance data more often than not.

78% find it difficult to compare one fund manager's performance with another on a fair and consistent basis1

1 eVestment, Industry Survey: Private Equity Limited Partner Due Diligence Trends, 2016.

The Opportunity

In the decade following the global financial crisis, alternative credit assets emerged as a more stable, higher-yield alternative to public credit, and illiquid assets in general offered higher yields with comparably little extra risk.

As a result, this asset class has come into its own and is gaining wider recognition and attracting a wider range of investors than ever before. The next few years are likely to see even greater attention paid to alternative investments.

Based on data from Bloomberg, Cambridge Associates, NCREIF, HFRI, and KKR, private equity will deliver the highest returns of any asset class—including stocks, bonds, and commodities—between now and 2023.2

The investing community is well aware of the returns that private equity promises to deliver. According to McKinsey, fully 90 percent of LPs indicated that they believe it will continue to outperform public markets in the future.3

PwC predicts that assets allocated to private capital are expected to almost double by 2025, with assets under management (AUM) rising from US$84.9 trillion in 2016 to US$145.4 trillion in 2025.4

The availability of capital is set to increase dramatically in the near term, but not all GPs will see the benefit. Those in a position to capitalize on this massive influx of capital will be those that are capable of demonstrating the kind of transparency that investors are now demanding.

Across all investor types, transparency is one of the most important capabilities a firm can demonstrate. According to a global survey of asset managers and institutional investors conducted by the Economist Intelligence Unit, transparency was the top investment consideration, with 63% of alternative investors and 62% of traditional investors stating that transparency was "very important."5

For GPs, elevating and standardizing performance reporting will be the key to managing growth and staying competitive. For LPs, it will be essential to the ability to make better decisions, justify those decision to investment boards, and, ultimately, optimize returns.

EXPECTED INVESTMENT RETURNS BASED ON CAGR (2018 TO 2023)

Private equity - 10.6%

Real estate (unlevered) - 6.1%

S&P 500 - 5.4%

Hedge funds - 4.4%

U.S. 10-year treasury bond - 2.5%

Cash - 2.3% 6

2 Based on data collected on July 15, 2018 from Bloomberg, Cambridge Associates, NCREIF, HFRI Fund Weighted Composite Index, and KKR Global Macro & Asset Allocation

3 McKinsey, The Rise and Rise of Private Markets: McKinsey Global Private Markets Review 2018.

4 PwC, Asset & Wealth Management Revolution: Embracing Exponential Change, 2017

5 EIU and Northern Trust, The Rise of Transparency Considerations in Asset Allocation, 2017.

6 Bloomberg et. al.

The New Global Standards for Performance Reporting

Performance reporting has always been a challenge for illiquid alternative assets. With no universal guidelines for reporting requirements, investors have had to spend vast amounts of time comparing the performance of different investments, understanding and verifying the calculations, and identifying the metrics they needed to present to their boards. The lack of reporting standards has also created challenges for investment managers, who must spend excessive amounts of time responding to questions and requests for information.

In recent years, however, forward-thinking members of the alternative investment community have begun to explore solutions by developing and clarifying universal standards that enable LPs and GPs to speak a common language and create equivalencies between alternative and traditional investments.

The two standard bearers that have had the greatest impact on the ability of the alternative asset class to demonstrate greater clarity and reporting consistency are the Chartered Financial Analyst (CFA) Institute and the Institutional Limited Partners Association (ILPA).

CFA INSTITUTE: A NEW GLOBAL STANDARD FOR INVESTMENT PERFORMANCE

In 1999, the CFA Institute Board of Governors approved the Global Investment Performance Standards® (GIPS®) to replace regional performance standards with a single, international version capable of covering all asset classes worldwide. The most recent version is effective as of January 1, 2011, and is used globally by the majority of asset managers. A new version—GIPS 2020—was recently released and will go into effect on January 1, 2020.

The main goals of GIPS 2020 are to improve adoption (especially among alternative asset firms), simplify the standards, and reduce compliance costs. Its value to the alternative asset community is evident in the restructured standards that better represent the illiquid closed-end group of assets such as the use of pooled funds vs. composites. With this revision and broader use of the standards, advisors are now able to assess all types of investments—including real estate and private equity—against an appropriate benchmark.

GIPS COMPLIANCE CREATES OPPORTUNITIES

75% of consultants expect to require alternative asset managers to comply with the GIPS standards.

75% of consultants/investors exclude managers from searches some or all of the time if they do not claim compliance with the GIPS standard. 7

7 eVestment, The Value of GIPS Compliance: 2018 Manager and Consultant Survey.

The level of transparency supported by this common point of comparison enables fiduciaries to allocate to illiquid alternative assets with confidence, knowing that they will receive performance data they can understand and compare to other investments in their portfolios. It also enables investors to justify taking on the additional risk and illiquidity for additional returns.

And while GIPS is the standard used across all asset classes, there are many organizations that are promoting standards for illiquid alternative sub asset classes to help enhance transparency for investors.

More than one in three firms now use ILPA templates

The number of firms using ILPA templates increased from 31% to 35% between 2016 and 2018.8

ILPA: MORE DETAIL AND CLARITY AROUND REPORTING

The Institutional Limited Partner Association (ILPA) is a key player in the drive to create greater transparency and accountability in private capital markets. Formed in 2002, ILPA focuses on helping LPs maximize performance by ensuring that they can collect and use the data they need to make informed investment decisions.

To date, in addition to best practice guidelines, ILPA has launched three templates:

- Capital call and distribution notice (2012)
- Fee reporting (2016)
- Portfolio company metrics (2018)

8 pfm, Fees & Expenses 2018: A pfm Benchmarking Survey

REAL ESTATE STANDARDS

Reporting on the performance of non-listed real estate poses a unique set of challenges. As part of the real estate industry's efforts to align the non-listed real estate industry globally, INREV, ANREV, NCREIF, and PREA are working together to create and refine global standards. This convergence will significantly assist investment firms using these standards with their efforts to fold in other global standards. Most recently, the group has adapted the ILPA fee template for PERE funds (see the announcement here: bit.ly/2FEWBEh).

WHO SHOULD CONSIDER THE GIPS AND ILPA STANDARDS?

Compliance with GIPS is voluntary, as is the use of ILPA templates and best practices. Adherence to GIPS generally requires the adoption of a comprehensive framework that includes input data, calculation methodology, composite construction, disclosures, and presentation and reporting. Similarly, adherence to ILPA reporting requirements requires the collection and management of a broader range of investment data.

Greater transparency places a greater burden on the finance and operations teams, who must build new internal processes and allocate additional resources to ensure compliance. Many firms may find that they need to rely on third-party administrators and more sophisticated technology to achieve compliance with the new standards.

However, this additional layer of operational control is well worth the effort for illiquid alternative asset firms. As investors and regulators push for greater transparency, and as a growing number of firms choose to adopt higher standards of transparency, firms that continue with business as usual will find that the pool of investors attracted to their offerings begins to shrink, even as the overall interest in illiquid assets grows exponentially. While adoption of the GIPS standards was initially slow, the vast majority of the top 100 asset management firms worldwide—representing USD$50 trillion in assets under management (AUM)—now claim compliance with the GIPS standards. According to a 2018 eVestment survey, 84% of asset managers reported that their firms were GIPS compliant.[9]

Adhering to the GIPS standards delivers several advantages to investment managers:

- Demonstrates the use of accepted global performance calculation and presentation standards
- Fulfills a key due diligence criterion for many institutional investors
- Enables investors to objectively compare firms within strategies and across asset classes
- Facilitates the firm's ability to compete in global markets by providing a global standard
- Enables investment managers to gain exposure in databases that are used by investors and allocators

Following ILPA reporting best practices offers these benefits:

- Demonstrates a commitment to delivering valuable data in a useable format to investors
- Addresses concerns over management fees and carried interest calculations and their impact on net returns
- Ensures that the firm meets the standards of more than 450 ILPA members representing over $2 trillion in private equity AUM
- Fulfills a key due diligence criterion for many institutional investors

9 eVestment, The Value of GIPS Compliance, 2018 Manager and Consultant Survey.

WHERE TO START?

If your firm currently doesn't adhere to the GIPS or ILPA standards, consider beginning your journey by aligning your performance reporting with the GIPS standards. While ILPA provides in-depth guidance on reporting to investors, GIPS offers a baseline for reporting transparency that every investment manager should start working toward.

FIRST STEPS TOWARDS GIPS COMPLIANCE

(Courtesy of ACA Performance Services - acacompliancegroup.com)

The GIPS Standards (GIPS) are built on the framework of fair representation and full disclosure in an attempt to provide prospective investors with an apples-to-apples comparison when reviewing the investment performance of potential asset managers. Predominately illiquid asset managers will take the pooled fund report approach allowable under the updated guidance for GIPS 2020. These are standards, not laws, and there is no “right” or “wrong” way to work towards GIPS compliance. A good place to start is to understand the framework:

- Determine the GIPS firm definition.
- Determine existing marketed strategies within the firm definition.
- Define discretion per the GIPS standards.
- Define calculation methodologies for returns at the pooled fund (internal rates of return, both gross and net of fees).
- Develop prospective investor reporting (GIPS Report).
- Train the marketing and investor services teams on how to use the GIPS Report in conversation with prospective clients.
- Consider hiring a compliance specialist to test your policies and procedures and the accuracy of your calculations and to provide compliance training.

FIRST STEPS TOWARD ILPA COMPLIANCE

Achieving the levels of reporting transparency required by the various ILPA templates can be a challenging task. Investment firms that are exploring the option for the first time can use the checklist below to analyze the costs, identify potential benefits, and prepare for a smooth transition.

- Talk to your investors and determine whether more detailed reporting is a priority for them. This will help you determine how urgent it is for you to adopt a higher standard of reporting transparency.
- Determine whether the information that your investors need is in line with the information required by the ILPA templates. In some cases, investors are seeking less granular information; for example, they may need management fees broken out from expenses rather than requiring information to be broken out for all of the different types of expenses.
- Prepare a gap analysis. Review the ILPA templates for capital call and distribution and fees and expenses, and compare the account groupings and transaction types to the chart of accounts and other groupings used in your current accounting system.
- Evaluate whether or not your current accounting system will be able to track all of the required data points or if you will need to begin evaluating more sophisticated systems. Some data points, such as fee offsets, may not be transactions that appear on the fund’s general ledger, because they are paid to the management company. You may consider having these fees flow through the fund or recording memo entries so that the information is in the accounting ledger and can be included in fund reports.
- Decide whether it is feasible to convert data for existing funds to ILPA classifications and groupings. Depending on your current process, it may be more realistic to track the required details on a go-forward basis by beginning with your next fund.
- Consider phasing in ILPA standards gradually. Begin with these elements to avoid disruptions and administrative burden:
  - Start with the capital call and distribution template.
  - Use a modified version of the fee and expense template by providing a more detailed break-out of the profit and loss on your existing capital statement, especially including management fees and carried interest.
  - At a minimum, include quarter-to-date, year-to-date and inception-to-date information on each Limited Partner’s capital statement.
- Consider hiring a third-party fund administrator to reduce the operational burden on your internal staff of providing ILPA reporting.

TECHNOLOGY FOUNDATIONS FOR BETTER PERFORMANCE REPORTING

For investment firms whose accounting systems aren't configured to support the new performance reporting standards, and for those who rely on spreadsheets as their system of record, complying with the new transparency standards required by GIPS and ILPA can be costly and challenging. Spreadsheet-based processes are manual and time consuming, and they are difficult to scale in order to achieve the depth of reporting required.

According to a global Preqin survey, 46 percent of private capital fund managers still rely exclusively on Microsoft Excel to monitor their portfolios.10 While many already find it difficult to manage performance data in spreadsheets, for those that plan to adopt the new transparency standards, there are even greater challenges ahead.

For many firms, the solution is to invest in technology that supports greater detail and transparency, whether that technology is maintained on-site or provided as part of an outsourced fund administration solution. Transitioning from spreadsheet-based systems and investing in a structured, centralized platform that supports and automates the collection and distribution of data required by ILPA and GIPS standards is a common first step for a firm.

Whether you plan to keep the process in house or outsource it, look for technology platforms that support you in collecting the required metrics.

Look for platforms that support the collection and calculation of:

- DPI (distributions to paid-in capital), RVPI (residual value to paid-in capital), TVPI (total value to paid-in capital, which is also the combination of DPI and RVPI), and IRR at both gross and net levels.
- Details for capital calls, including the name of the investment, type of expense, and impact to unfunded commitment.
- Details for distributions, including breakout of interest on subsequent closings, income, realized gain, return of capital, and carried interest (if the distribution (or a portion thereof) is recallable, ensure that its impact to unfunded commitment can be recorded).
- Gross management fees, management fee offsets, waived management fees, and management fee rebates.
- Expense details, including (at minimum) advisory fees, broken deal expenses, director fees, monitoring fees, and placement fees.
- Carried interest (accrued and paid) and claw back (potential obligation and amounts returned).
- Fee and expense reimbursements.
- For fund of funds: management fees, including the details above, plus fees and expenses and carried interest (accrued and paid) for the underlying funds.

10 Preqin, Special Report: Digitization of Private Capital Operations, 2018.

NEW REPORTING STANDARDS CREATE NEW OPPORTUNITIES

As the illiquid alternative asset industry continues to mature as an asset class and gain increased attention from a wider range of investors, investment managers with the ability to demonstrate the highest levels of transparency will see significant opportunities for growth.

Investors have seen the returns that private equity and other alternatives are consistently capable of delivering. They are motivated to invest, but the attractiveness and visibility of these opportunities depends on the ability of the illiquid alternative asset class to align itself with traditional markets.

The transparency standards that are being set by GIPS and other industry reporting templates are the key to the future for private equity and other illiquid alternative asset firms, and the firms that prove themselves capable of adhering to those standards will surpass those that delay their journey toward compliance.

The future belongs to those who are able to not only generate alpha, but also demonstrate those returns clearly and position them within the full spectrum of investing options.