A GUIDE TO EVALUATING THE OPTIONS AND MAKING THE RIGHT DECISION

The Outsourcing Revolution

Of all the duties the back office must perform, fund administration has changed the most over the past 10 or 15 years.

As the alternatives industry has matured, expectations among investors and regulators have grown, requiring General Partners to develop new capabilities and efficiencies in order to collect, manage, and report on a greater range of fund data than ever before. once a relatively simple task, fund administration has become a resource-intensive and complex activity requiring a higher headcount, greater expertise, and more sophisticated technologies than ever before.

As recently as two decades ago, few firms outside of the hedge fund market would have considered outsourcing fund administration. But as industry pressures have transformed this back-office function, outsourced fund administration has become a viable option for funds of every size and type, including venture, buyout, debt, real estate, SPVs, fund of funds, and more. As a result, and within a remarkably short time frame, outsourced fund administration has evolved from a small, niche industry to a business with $8.4 trillion in assets under administration (AUA).1

A few years ago, Preqin estimated that 30 per cent of all assets under management (AUM) were administered by a third party, and predicted that by 2018, it would rise to 45 percent.2 The latest numbers from Ernst & Young (EY) show that Preqin's ambitious prediction still fell short of the reality: in 2018, 55% of private equity managers outsourced the fund-accounting function and 71% outsourced compliance and regulatory reporting.3

This white paper examines some of the top considerations informing the decision to outsource fund administration, provides key criteria to apply to the task of selecting a fund administrator, and provides a useful checklist for evaluating the capabilities and cultural fit of shortlisted fund administration partners.

A FAST-RISING TREND

According to eVestment research, the size of alternative assets under the administration of a third party grew by $2.5B in five years.

2013 - $5.90T (↑20.2% YOY)
2014 - $6.90T (↑16.8% YOY)
2015 - $6.66T (↓2.92% YOY)
2016 - $7.64T (↑14.2% YOY)
2017 - $8.42T (↑10.2% YOY)

1 eVestment, Alternative Fund Administrator Survey, 2018.
2 Preqin, 2016 Preqin Global Private Equity & Venture Capital Report, 2016.
3 EY, At the Tipping Point: Disruption and the Pace of Change in the Alternative Asset Management Industry, 2018.

In House? Or Outsource?

To attract new investments, today's investment firms must not only deliver strong returns but also demonstrate an ability to navigate fast-changing regulatory requirements and deliver exceptional levels of service and transparency to their investors.

For CFOs who need to keep pace with the demands of regulators and investors, manage administrative costs, and carve out time for more strategic activities, outsourcing fund administration is an option worth exploring.

Many firms begin to consider outsourced solutions only when performance or resourcing issues begin to impact the firm negatively - an approach that can result in a decision made under pressure. Taking a proactive approach and recognizing emerging issues before they become critical gives General Partners time to evaluate their options thoroughly and make a more informed decision.

The decision to outsource fund administration is usually motivated by one of five key issues, each of which will be explored on the following pages.

Growth. Alternative investment firms see bigger opportunities on the horizon and are preparing to meet them.
Investors. Reporting capabilities have become the most important selection criterion for a growing number of investors.
Talent. Turnover can be high in the back office, and firms are seeking ways to mitigate the impact.
Competition. Fierce competition for investors has led firms to explore new ways to attract capital.
Complexity. As the demand for specialty investments grows, so does regulatory and reporting complexity.

GROWTH

Growth is perhaps the single biggest factor in the decision to outsource, yet many firms fail to recognize the point at which their growth trajectory exceeds the ability of their back office to keep pace.

The issue is all the more crucial today because opportunities for growth have never been so plentiful as alternative investing attracts a wider range of investors than ever before.

Virtually every firm will experience a pivotal point beyond which the firm's existing staff can no longer stretch to accommodate growth. An in-house team that has successfully supported Funds I and II may suddenly find themselves struggling to prepare for subsequent fund launches and support the ongoing administration and reporting requirements. Increasing the headcount can ease the pressure during the early years of a firm's growth, but as the firm continues to add to its portfolio, this option may no longer be financially viable.

There is a break-even point beyond which the cost of adding staff will exceed the cost of a third-party solution, especially when the expense of a private capital accounting platform (including staff training, IT support, infrastructure and integration) is factored into the equation. As the portfolio broadens, the in-house back-office team may also find themselves challenged to deliver specialized fund expertise across the full range of strategies, which is another area where a fund administrator can provide support.

Beyond alleviating back-office pressure, outsourcing fund administration enables the firm to put its in-house talents to more effective and profitable use. When the CFO and their team can leave the day-to-day details in the hands of an administration partner, they can focus on supporting key growth levers, including sourcing deals, fundraising, and building strong client relationships.

Outsourcing can also fuel growth by saving costs and freeing up resources, especially for firms in major metropolitan areas where business costs—including office space and staffing—are particularly high.

GROWTH PREDICTIONS

GP perspective: 55% of PE firms said they expect to raise a new fund this year, and most say it will be larger than the last fund raised.4

LP perspective: 39% of institutional investors expect their private equity allocations to increase.5

4 EY, Operational Excellence: One Path or Many? Key Findings from the 2018 Global Private Equity Survey.
5 EY, 2019 Global Private Equity Survey.

INVESTORS

For mid-tier and large investment firms alike, investor expectations around the flexibility, transparency, accuracy, and speed of reporting is placing a growing strain on back-office resources.

Firms of all sizes are struggling to keep pace as investors demand greater access to investment data than ever before. ILPA raised the bar considerably when it comes to the levels of communication and transparency required, the array of financial data expected, and the frequency with which it is expected, and those standards have transformed investor expectations and back-office workloads. The allocation and reporting of fees and expenses alone has become a complex and stressful exercise for many investment firms, even those with well-resourced back offices.

At the same time, the firm's ability to meet complex investor reporting requirements has become integral to the firm's ability to attract future investment. According to EY, between 2014 and 2015, there was a 400% increase in investors that rank a firm's ability to handle reporting requirements as the most important selection criteria.6 While these requirements are top-of-mind for firms of every size, the issue is compounded for mid-tier, middle-market investment firms that move upmarket and need to appeal to bigger, more sophisticated LPs. Upper-market investors have very different service and reporting expectations, which can place unexpected strain on the internal team—not just from the perspective of an increased workload, but in terms of the level of expertise required. In fact, for many large investors, third party fund administration is now a non-negotiable requirement.

A 2018 survey of institutional investors revealed that nearly two-thirds of investors (63%) consider operational improvements to be among the three most impactful things GPs can do to optimize returns.8

INVESTOR EXPECTATIONS ARE HIGHER THAN EVER

70% of investors are not satisfied with any category of allocation disclosure

29% of investors make frequent requests for specialized annual or quarterly reports

27% request customized templates

26% expect timely delivery of reports

18% expect a one- or two-day turnaround.

87% of investors want to receive reports through digital portals7

6 EY and Private Equity International, 2016 Global Private Equity Fund and Investor Survey.
7 EY and Private Equity International, 2016 Global Private Equity Fund and Investor Survey.
8 EMPEA, Global Limited Partners Survey: Investors' Views of Private Equity in Emerging Markets, 2018

TALENT

The attraction and retention of talent has emerged as a key concern for private equity firms. According to a recent EY report, 47% of CFOs rate talent management as a top strategic priority, making it an issue second only to asset growth, and more important than cost management or risk mitigation.9

As talent becomes an increasingly scarce commodity, back-office turnover can be one of the greatest threats to productivity and reputation and a significant point of vulnerability. Devastating at any time, the effects are heightened when a staff member leaves prior to a reporting period, resulting in not just a loss of capacity, but also of vital continuity. When a back-office employee walks out the door, irreplaceable institutional knowledge leaves with them, including a crucial understanding of the firm's history and processes, and an ability to locate key financial data. Backfilling and retraining is costly and disruptive, with institutional knowledge taking a long time—sometimes a year or more— to rebuild. And unfortunately, it is the most seasoned employees who are most likely to be lured away.

Outsourcing fund administration eliminates the cost and disruption caused by internal turnover because fund administration firms have processes in place to protect service consistency and retain institutional knowledge. In addition to distributing critical back-office knowledge across an extended team, most fund administrators maintain documented processes and procedures that accelerate onboarding and facilitate knowledge sharing. The technology platforms used by many fund administrators also contribute to stability and enhance continuity by providing a central repository for current and historical fund administration data.

In addition to mitigating the impact of turnover, outsourcing fund administration ensures that in-house talent can stay focused on more strategic areas, which not only makes better use of their skills, but can enhance retention efforts. According to the latest EY data, CFOs at private equity firms want their teams to spend **the least amount of time on fund** accounting and the greatest amount of time on high-value activities such as portfolio analytics, technology, and investor relations.10

9 EY, Operational Excellence: One Path or Many? 2018 Global Private Equity Survey.
10 EY, Operational Excellence: One Path or Many? 2018 Global Private Equity Survey.

COMPETITION

Across the board, and especially in the bulging middle market, firms are looking for ways to stand out and attract the capital they need. The competition for investor dollars is intense, and General Partners must cover all bases to appeal to investors. In a climate where fiduciary activities and regulatory oversight are top of mind, firm performance is now being evaluated in terms of back-office operational excellence as well as proven returns, and the integrity of the back office has become as important to the investment decision as the manager's track record and investment philosophy.

A 2018 survey of institutional investors revealed that they believe fund performance is connected to operational performance: nearly two-thirds of investors (63%) consider operational improvements to be among the three most impactful things GPs can do to optimize returns.11 Outsourcing fund administration sends a clear signal to investors that the GP is committed to operational excellence and supports the highest levels of transparency, diligence, accountability, and control.

FUND COMPLEXITY

When moving into a specialty fund area, even experienced firms can become overwhelmed by the added layer of regulatory and reporting complexity. While launching specialty funds such as debt funds, SBICs, or real estate funds can offer GPs an opportunity to attract investors with an advantageous and niche offering, these fund types often have complex structures or additional regulatory requirements.

That extra layer of complexity can significantly increase the amount of time and effort required to administer the fund, and it may also require specialized expertise that an in-house team doesn't possess. The right fund administrator can provide senior-level expertise for a specific fund strategy or situation, bringing years—or even decades—of experience to the table, and giving your firm access to guidance on demand.

SHRINKING MARGINS

Shrinking margins have become a reality for a growing number of firms. According to EY, margin erosion is affecting nearly 40% of private equity managers.12

Outsourcing has become part of the cost-management discussion for many private equity managers, with 37% reporting that they are increasing their reliance on outsourcing as a way to mitigate margin erosion of the management company.13 While not every back-office function lends itself to the outsourcing model, fund administration has emerged as one of the most valuable areas to outsource. In fact, more than two-thirds of CFOs (67%) consider fund accounting to be an area where outsourcing will add value.14

11 EMPEA, Global Limited Partners Survey: Investors' Views of Private Equity in Emerging Markets, 2018.
12 EY, 2019 Global Private Equity Survey.
13 EY, 2019 Global Private Equity Survey.
14 EY, Operational Excellence: One Path or Many? 2018 Global Private Equity Survey