HAZIC INVESTMENTS

HOW FUND ADMINISTRATION CAN HELP GPs ENSURE STRONG RETURNS AND POSITIVE RESULTS FOR A FIRST-TIME FUND

Today's Emerging Managers Are Tomorrow's Hot Managers

The number of emerging managers has grown steadily over the past 20 years, and looking at their performance, it's easy to see why. Even in a high-performing asset class, emerging managers have earned a reputation for offering above-average returns, and many provide unique opportunities to those investors with a mandate to invest in underrepresented and emerging talent.

As a result, a growing number of LPs are exploring investment opportunities with emerging managers, including first-time funds and spin-offs.

But as motivated as they are to invest, LPs are unwilling to compromise on matters of transparency and compliance. And while most emerging managers excel at identifying investment opportunities and generating alpha, many are far less skilled at managing the back-office minutiae.

The situation, if left unaddressed, has the potential to significantly curb the amount of capital available to these less mature fund offerings. Today's emerging managers have the potential to become tomorrow's hot managers, but only if they can demonstrate both a strong, persuasive investment thesis and an ability to meet rigorous due-diligence requirements.

Fortunately, today's emerging managers don't have to hone their back-office skills or allocate scarce resources to building the kind of back office infrastructure capable of reassuring cautious investors. Outsourcing fund administration enables newer firms to focus on what they do best while benefiting from best-in-class fund accounting, compliance, and reporting.

This white paper touches and provides a set of key considerations and checklists to help them evaluate and select the right outsourcing partner.

Emerging Managers Defined

While there are a few variations, for the most part an emerging manager is defined as a firm that is raising institutional capital for funds one, two, or three in any strategy, including private equity, venture capital, real estate, growth equity, mezzanine, and debt. Emerging managers may also include diverse and female-operated firms, transition groups who've spun out of larger firms, fundless sponsors, and funds under $1 billion in size.

Why Outsource The Back-Office Function?

For an emerging manager focused on staying lean, outsourcing fund administration may seem like an extravagance. Why go to the expense of hiring a back-office specialist when you can do the work yourself?

In fact, an outsourced solution can actually help new fund managers lower their operational costs. Consider that taking fund administration in house includes not only the salaries of back-office staff and the associated overhead, but also the cost of implementing, maintaining, and troubleshooting the supporting technologies, including fund accounting software and an investor portal. When fund administration is outsourced, however, those technology costs are spread across multiple clients to deliver significant savings over self-managed platforms.

In addition to managing back-office costs, outsourcing offers other benefits:

ACCESS TO EXPERTISE

Because experienced fund administrators have worked with hundreds of funds across multiple strategies, they bring a higher level of expertise to the administration of your fund. For example, an experienced fund administrator will conduct a full review of the LPA to ensure that it conforms to LP expectations, industry best practices, and your firm's capabilities.

ABILITY TO SCALE

While emerging managers have more experience by the time they launch their second and third funds, there are no economies of scale when it comes to the administrative burden. A fund administrator enables your firm to expand without having to worry about back-office staffing, training, or turnover. In addition, as emerging managers begin to move upstream, having a third-party fund administrator in place can help them attract larger investors for whom outsourced fund administration is a non-negotiable requirement.

ACCESS TO CAPITAL

Investors are bringing a new level of due diligence to the evaluation process, and emerging managers must work harder than more mature funds to prove that they have the operational infrastructure in place to ensure compliance, manage the fund efficiently, and report to LPs in a timely and transparent way. Appointing a trusted, third-party fund administrator demonstrates that the firm is serious about meeting its regulatory and reporting obligations, and that can be the deciding factor.

"Investor groups are excited about committing to emerging managers, but then they look under the covers at the administration that supports the fund, and they realize that it's practically nonexistent. That puts them in a quandary. They want to commit, but they're concerned about the lack of infrastructure."
— Anne Anquillare, CEO & President, PEF Services

Choosing The Right Fund Administration Partner

The choice of fund administrator is important. Choose wisely, and it enhances your reputation, reduces risks, enables you to stay focused on sourcing and managing investments. Choose poorly, and it can impact investor relations, disrupt operations, jeopardize compliance, and hamper your firm's ability to scale.

Every GP, whether new or mature, needs to carefully evaluate their options, and the checklist provided at the end of this white paper includes a list of general considerations for any GP that is planning to partner with a fund administrator. However, emerging managers also have unique requirements related to their lack of a proven track record and lack of experience in setting up and maintaining the infrastructure required to administer a fund. And while spin-outs may be helmed by proven managers, they are still perceived as potentially lacking the internal resources or experience to adequately administer the fund.

With this in mind, emerging managers should prioritize these factors:

1. HIGH-TOUCH OR BOUTIQUE-STYLE SERVICE

Some fund administrators apply a one-size-fits-all approach, and this may not align with the needs of a new fund. Emerging managers are more likely to need a service-level agreement (SLA) that can be tailored to the firm's strengths and capabilities and that wraps around existing back-office preferences. When a generic approach is applied to a new fund, it can increase the workload and create friction, which in turn can impact the investor experience and take valuable time away from strategy and value creation.

2. ACCESS TO SENIOR-LEVEL EXPERTISE

Every GP will benefit by selecting a fund administrator that prioritizes extensive, industry-specific expertise, but emerging managers will see an even greater benefit from having a highly experienced team in place because their own administration experience may be more limited. In these cases, having direct access to a team with extensive experience in managing private capital fund structures can offer peace of mind.

3. INDUSTRY REPUTATION

The knowledge that a new fund will be administered by a third party gives investors confidence that the fund will not only deliver excellent returns but will be well run, meet regulatory requirements, and employ industry best practices. However, not every fund administrator has a trusted name and a recognizable presence in the investment community. For an emerging manager, choosing a fund administrator with a strong reputation will make the fund more attractive to investors and signal that the firm is serious about compliance, transparency, and operational efficiency.

4. INVESTOR COMMUNICATIONS

Both new and mature firms need to select fund administrators that integrate industry-leading technology into their service delivery because those solutions enhance service efficiency and transparency. For emerging managers, investor-facing technology is an especially important consideration. Choosing a fund administrator that uses an investor portal for investor communications offers tangible proof that your firm understands and is ready to support investor needs and expectations.

Ask these questions:

- Which technologies do you use?
- Can they be customized?
- Is your IT department in house?
- Do you offer investor support?

5. SERVICE PARTNERSHIPS

Because emerging managers are setting up fund infrastructure for the first time, they seldom have a trusted network of service providers in place. An experienced fund administrator can add value by providing introductions to auditors, placement agents, compliance firms, and tax reporting professionals whose services they can vouch for and with whom they have an existing working relationship.

6. NEW FUND EXPERIENCE

Look for a fund administrator that has experience working with emerging managers, because this demonstrates that they understand the unique requirements and are ready to provide the additional support your firm needs as it launches its first (or second, or third) fund. Make a point of speaking with at least one client that fits the profile so that you can hear first-hand what the experience has been like. Look for fund administrators that have been retained by emerging managers for the first fund and for subsequent funds, as this indicates that the administrator is capable of scaling up as the firm grows.

PRIORITY SERVICES FOR EMERGING MANAGERS

Core fund administration services include partnership accounting, capital call and distribution processing, financial reporting, investor capital account maintenance, audit and tax return support, and investor services. However, many fund administrators offer an extended range of services that can be particularly valuable for emerging managers.

CONSULTATION

Experienced fund administrators can provide targeted support and strategic consulting for the launch of a new fund, including the review of Private Placement Memorandums and Limited Partnership Agreements. Other consultative services include:

- Consultation on the administrative setup for new firms and fund launches
- Operational due-diligence assistance and consultation on operational best practices

MANAGEMENT COMPANY BOOKKEEPING

Outsourcing this back-office function can help emerging managers offload this time-intensive function and stay focused on growth and strategic operations. A fund administrator that offers this service can:

- Establish and maintain a general ledger for the management company entity 4 Record cash transactions from bank activity
- Reconcile bank accounts 4 Prepare checks 4 Monitor payables and receivables 4 Prepare portfolio company invoices 4 Record accrued/prepaid income/ expenses and other adjustments 4 Prepare financial statements including trial balance, balance sheet, and P&L 4 Prepare and distribute 1099s

TAX SERVICES

Many fund administrators have extensive experience in managing the tax complexities of cash flow, valuation, and distribution and achieving optimal tax efficiencies for funds and their investors. Services include:

- Prepare and process federal, state, and local tax returns
- Assist with the preparation for a federal or state audit
- Prepare Schedule K-1s
- Prepare tax estimates
- Advise investors on the tax implications of various decisions
- Prepare documentation for foreign reporting

THE DO'S AND DON'TS OF SELECTING A FUND ADMINISTRATOR

DON'T choose a fund administrator based on price alone. Make your selection based on factors such as the company's industry reputation and the years of experience they bring. While a good fund administrator may charge a premium, they will reduce your operational costs and enhance your ability to attract investors.

DO select your fund administrator before you begin fundraising. Partnering with a recognized fund administrator early will help your fund earn the consideration of LPs that may otherwise be hesitant to invest in a first-time fund, as well as those that will only invest in funds that are administered by a third party.

DO ask whether the fund administrator works with other emerging managers, especially those with similar strategies, and ask to speak to those clients about their experiences.

DON'T overlook the technology component of service delivery. Find out which platforms the fund administrator uses, how customizable they are, and pay particular attention to those that form part of the investor experience.

DO examine the fund administrator's service-delivery processes carefully. Do they adhere to a service-level agreement (SLA)? Do they conduct weekly or bimonthly status calls or meetings? Do they have a documented onboarding process?

DO ask whether they are audited for System and Organization Controls (SOC) Type 2 compliance. Fund administrators with this certification have been examined by an independent auditor to ensure that their internal operations protect the security, availability, processing integrity, confidentiality, and privacy of their clients' data.

OPPORTUNITIES ACCELERATE FOR EMERGING MANAGERS

In 2015, US-based emerging managers accounted for:

226 funds closed funds closed

$34.5 billion in aggregate capital

31% of funds raised

First-time funds outperformed non-first-time funds in almost every vintage year from 2000 to 2012.

61% Of LPs would consider investing in first-time funds or spin-outs.

ACCELERATE YOUR POTENTIAL

There is no question that the future is bright for today's emerging managers. Private equity has matured, and with an established track record of superior performance, more stringent regulatory controls, and a growing commitment to transparency, the asset class as a whole is attracting the attention of more investors than ever before. Spin-outs and first-time funds, once seen as too risky for cautious investors, are now considered a viable option by the majority of LPs.

Clearly, this represents an exciting turning point and a significant opportunity, but to take advantage of it, emerging managers need to demonstrate that they have not only a strong investment thesis, but also the infrastructure to support it. The back office has moved to front of mind as investors conduct thorough due diligence on every aspect of the firm's operations. How the fund is administered and how its performance is communicated back to LPs are key criteria for today's investors. Failure to adequately resource the back office can mean the difference between securing investors or failing to raise enough capital.

Spinning out, starting up, raising capital, and launching a new fund all require herculean effort. Emerging managers need to understand the expectations, be realistic about the requirements, and know what to delegate to service partners. For most, outsourcing the fund administration function enables them to focus on the strength areas that ensure success: investing, capital-raising, and producing attractive returns for their investors.