Private equity: evolution of the operating model

By Samer Ojjeh and Manuel Villavicencio

Executive summary

A barrage of investor, regulatory and economic pressures means that private equity firms can no longer afford to solely rely on deal-making prowess while overlooking investments in the back and middle offices. The private equity (PE) industry is at a critical point of maturity and many firms are making significant decisions with regard to their long-term operating infrastructure. Many of these decisions share a common objective: adding value to the business via effective production, management and deployment of information across the enterprise.

Now more than ever, private equity firms have started to take a serious look at the state of their operating infrastructure. These firms have recognized that they can no longer rely on manually-intensive spreadsheets and small-business software to manage billions of dollars of investor assets. Over the past decade, many of the leading hedge fund managers have evolved rapidly in response to calls from institutional investors to develop more sophisticated, consistent and mature operating practices along the lines of traditional Securities and Exchange Commission (SEC)-registered asset managers such as mutual funds. In order to preserve and expand their share of institutional asset allocation over the coming years, private equity firms will be compelled to continue developing and evolving their operating model to keep pace with the rest of the asset management industry.

Pressures to change

Recently promulgated standards by the Institutional Limited Partners Association (ILPA) are a reflection of the need by select investors for more transparency, quality and consistency of information from their General Partners (GPs). Although these standards continue to be refined as firms and investors attempt to reach a mutual definition of best practices, what is certain is that, as evidenced historically by other asset classes, funds will flow to the firms that combine solid investment returns with sound risk management practices and client service standards. In addition to the ILPA standards, other regulatory measures such as the Foreign Account Tax Compliance Act (FATCA), the Alternative Investment Fund Managers (AIFM) Directive in Europe, and the SEC’s Form PF filing requirement represent the new, more demanding reporting environment that private equity firms face.
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In a market increasingly characterized by competition for the best assets, a solid operating infrastructure is a precondition for success. When money was pouring into ever-larger private equity funds during the pre-2008 boom, managers could afford to defer major operational improvements. However, since the global financial crisis, private equity fundraising has been challenging. Given investors’ liquidity concerns and generally more sober view of alternative investments in the post-crisis environment, private equity firms are finding that having a robust and well-coordinated operating infrastructure is increasingly a prerequisite for attracting capital.

These issues take on more importance — and difficulty — as firms diversify their business models, either organically or through strategic acquisition, away from traditional leveraged buyouts and into other markets, such as credit, bank debt, distressed debt, traditional asset management and advisory, in order to smooth revenue streams and broaden their earnings and returns.

This is especially true for firms seeking to follow the lead of private equity companies that are going or have gone public. IPO aspirants will need rock-solid operational infrastructure to satisfy regulators, exchanges and shareholders. Even if accessing the public market is not an immediate goal, it is important to have sound processes and data to address the increased reporting demands of key stakeholders.

Since the financial crisis, competition for deals and credit to finance acquisitions has increased alongside competition for investors’ funds. There is far more weakness in the debt markets, resulting in more equity being put into deals, challenging overall returns. This, along with the changing regulatory environment, has put pressure on fees and given investors the ability to make other demands, such as for more transparency and customized reporting.

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<th>Key drivers</th>
<th>What is happening in the private equity industry?</th>
<th>What is the impact on private equity firms?</th>
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<td>Regulatory reform</td>
<td>• Regulatory reform in the wake of the recent economic downturn impacting private equity firms, including Dodd-Frank, FATCA and self-regulation initiatives such as ILPA reporting guidelines</td>
<td>• Stricter regulatory environment and disclosure requirements driving firmwide process improvement and data management initiatives</td>
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<td>Shifts in business model</td>
<td>• Firms diversifying their business models away from traditional leveraged buyouts and diversifying into other businesses, such as credit funds, bank debt, distressed debt, traditional asset management and advisory in order to smooth revenue streams and broaden their earnings and returns</td>
<td>• Shifts to new, unfamiliar and complex asset classes result in significant challenges in the ability to scale adequately and provide needed expertise</td>
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<td>Fundraising environment</td>
<td>• Institutional investor concerns around liquidity, fraud and reduced appetite for risk posing significant challenges to firms’ continued ability to raise funds</td>
<td>• Increased LP focus on operational due diligence, including processes and internal controls seen as a key factor in fundraising success</td>
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<td>Investor demands</td>
<td>• New and increasingly stringent reporting requirements for many investment managers with PE holdings resulting in pressures for greater transparency from PE funds</td>
<td>• Overall greater demand by PE firms for technology vendors and fund administration service providers in order to provide timely and accurate data to LPs</td>
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From ad hoc to best practice

The days of the back office serving as a factory for capital calls and financial statements are over. The modern objective of the private equity operating model is to support the business of deal-making and value creation, and ultimately to enable the firm to provide timely and relevant information to stakeholders. In order to achieve this level of value creation, operations must be able to provide accurate, timely and useful information but, most critically, in reusable forms to avoid the deployment of costly resources in activities that essentially reinvent the wheel every time information is collected and analysis is performed.

A maturity model for private equity technology demonstrates the increasing benefits gained as firms progress from an entirely manual environment towards a more advanced level of maturity and automation in which they are able to use technology strategically to extract valuable information that can be used to analyze trends, determine root causes and make predictions. (See diagram.) Leading PE firms have identified the need to move rapidly up the development pyramid in order to carve out a competitive advantage.

The typical path of development in terms of operations and technology is highly consistent among firms. In early stages, firms often start out with small-business software packages for fund accounting and financial statements. Other common activities, including capital accounts allocations, performance analysis and financial reporting, are performed using Excel spreadsheets. As these functions become ineffective in supporting increasing volume and complexity, firms develop in-house tools or purchase off-the-shelf systems to handle activities such as fund accounting, management company accounting, contact management and investor correspondence. Their decisions are based on immediate, short-term needs. Some of these off-the-shelf systems have gained significant traction in the market and have become mission-critical to many firms. However, since few product or data standards have been developed, the opportunities for integrating these platforms to achieve reporting efficiencies have been limited. Hence, firms’ systems and tools for accounting, CRM, portfolio management, investor reporting and other key functions developed along decidedly separate paths.

Information management maturity model for PE firms

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<tr>
<th>Stage</th>
<th>Description</th>
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<tr>
<td>Basic</td>
<td>Manual environment. Basic transaction processing for fund and management company activities. Use of spreadsheets for allocations, performance, and other ad-hoc financial analysis. No technology to capture and retrieve data, resulting in limited reporting ability.</td>
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<tr>
<td>Developing</td>
<td>Partial system automation. Core processing tools, such as fund accounting systems implemented but not integrated or used by other business areas. Data definitions and standards not in place, resulting in inability to use information for business decisions or stakeholder reporting.</td>
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<tr>
<td>Established</td>
<td>Multi-system environment. Technology platform encompasses majority of core business processes, however, inflexible use of data to drive management actions due to the overhead of metrics and post-translation. Multiple versions of the truth require excessive use of spreadsheets and offline analysis to deliver accurate information.</td>
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<tr>
<td>Advanced</td>
<td>Tactical integration. Technology is being implemented to integrate data from core processing systems in order to drive key metrics. For management decisions including capital allocation strategies, portfolio construction and waterfall analysis. Data sources are being rationalized and standardized; redundant and duplicate metrics are being eliminated.</td>
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<tr>
<td>Leading</td>
<td>Full integration. Core processing tools, such as fund and management company accounting and reporting systems implemented but not integrated or used by other business areas. Data definitions and standards in place, resulting in ability to use information for business decisions or stakeholder reporting.</td>
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Data from core processing systems is standardized and integrated into a common information repository, allowing advanced querying and drill down capability to deliver accounting, performance and key portfolio metrics to management, investors and other stakeholders.
The result can be seen in many organizations’ current operating model – multiple, disparate systems, multiple points of entry for the same data, time-consuming reconciliation processes; IT strain due to the storage space and processing power needed to run old, inefficient systems, and information that is subject to error due to manual processes.

Today, leading firms are reaching the level of maturity where they are evaluating ways to address their lack of automation and patchwork of systems. They are discovering the need for improving their processes and systems as part of a cohesive and coordinated framework to provide internal and client-facing advantages. These leading firms are adopting a pragmatic approach by leveraging tactical initiatives, such as ILPA reporting and compliance with regulatory requirements such as Form PF, to introduce strategic changes to the production and deployment of information to create competitive advantages in deal-making, portfolio analysis and investor reporting.

Perhaps the next phase of development is reflected in the growing momentum of information management initiatives among leading private equity firms. Data warehousing efforts, for instance, establish platforms that are specialized and dedicated to capturing, aggregating and presenting information from any underlying source. The benefit of this approach is that it is independent of the source of the data – be it a vendor package, a third-party fund administrator or a spreadsheet file. Traditional asset managers, institutional investors, as well as a growing number of hedge funds have implemented data warehouses to overcome the dilemma of disparate systems and manual processing. However, this is an emerging area for private equity practitioners, and significant time, effort and expertise is involved in standardizing and indexing data to make it consistent and in converting the data into relevant and valuable information to drive strategic business decisions.

### Objectives and benefits

Regulatory mandates such as FATCA and Form PF, along with industry principles being promulgated by ILPA, are often the drivers of operations and technology enhancements. However, there are a number of analytical exercises unique to private equity firms where opportunities to derive value from operations and technology are just beginning to be explored:

- **Financial modeling** – firm-level modeling and projections for cash needs, profitability and risk levels given changing performance assumptions, growth projections, and fee structures.
- **Portfolio construction** – analysis of risk and return contributions of individual deals as well as the impact of current or prospective industry and sector concentrations to the firm.
- **Deal flow analytics** – tracking and analysis of deal flow to understand trends, patterns and relationships among successful deals as well as deals that were lost or rejected.
- **Value driver analysis** – analysis of drivers of value creation within individual portfolio companies, including quantitative financial and nonfinancial measures as well as economic indicators and the application of statistical approaches.
- **Valuation modeling** – valuation of portfolio companies under various scenarios and valuation methodologies, e.g., industry comparables analysis, discounted cash flow method, liquidation value.
- **Waterfall and GP carry** – calculation and projection of investor and GP cash distribution values under various scenarios, applying waterfall allocation rules as governed by the ILPA and individual carry plan provisions.

The above reflect a number of examples of areas where firms are looking to operations and technology resources to increase their level of automation and responsiveness. A gradually burgeoning sector of vendors and service providers has emerged to attempt to plug the gap between the inefficiency of spreadsheet-based analysis and a more strategic approach to information production and management.

### The ways forward

Firms that wish to keep their operating infrastructure strictly internal face a number of challenges. There are the high initial costs of licensing and implementing applications and of training employees. The exercise requires a major change of roles, responsibilities and daily activities. It requires efforts from resources that are outside of their normal activities and capabilities. Workload as well as resource development and hiring can become an issue. However, if integration and change management are handled competently, costs are likely to fall over time as the new operating infrastructure becomes part of the way of doing business. Firms that have made investment in technology an organization-wide priority and managed such investments carefully have reaped the benefits in terms of asset growth and overall efficiency and scalability.

Another option is to outsource information requirements to a third-party fund administrator. Typically, private equity firms have seen outsourcing as a useful temporary solution to support the addition of a new investment strategy or a change in business model. However, outsourcing non-core, less complex activities has become an increasingly attractive alternative in light of the economies of scale that allow administrators to make large infrastructure investments and spread them among many clients. Competitive pressure among PE fund administrators has promoted highly customized service models and willingness to work with their private equity clients in
advancing technology integration efforts. However, many PE firms are reluctant to relinquish a degree of control and flexibility that often characterizes the outsourcing model. While operations outsourcing by PE firms has increased in prevalence over the past few years, it has not yet been established as an industry standard in the way that it has for hedge funds and mutual funds.

By taking a diligent and comprehensive approach to the costs and benefits of transforming their operating infrastructure, PE firms can not only prepare for greater regulatory and investor scrutiny, they can also improve their chances of attracting increasingly scarce institutional investor capital. This type of strategic thinking can help transform infrastructure projects involving significant investment and heavy lifting from must-haves into game-changing competitive moves.

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