

EXPERT COMMENTARY **ERNST & YOUNG**

Shifting the back-office to the centre stage

*Providing insights and exploring emerging trends in private equity fund administration across Europe, by **Alain Kinsch, Olivier Coekelbergs and Martin Derfesser***

In a reshaping environment marked by a new regulatory era in Europe, the second Ernst & Young report on the European private equity fund administration industry provides insights into the main issues faced by leading fund administrators based in Luxembourg, Jersey, London and Guernsey, and identifies the emerging trends. Key questions for administrators are “Which organisational model fits best for my clients’ needs?” and “What type of services will I need to offer to my clients in order to stay competitive?”. The feedback from the survey participants provides guidance to answer these matters.

A new context for European fund administrators

Two years after the first survey was completed in 2009, Ernst & Young is pleased to note that our belief according to which the private equity model is robust has proven to be a true statement. Indeed, the private equity business model went through the crisis with limited damages as compared to other asset



Kinsch: the private equity model is robust

classes and we believe that, in spite of the challenges facing the industry, private equity will continue to play an important role in the post-crisis environment, as will the industry’s fund administrators.

Going forward, and according to the recent Ernst & Young 2011 Global Private Equity watch, tomorrow’s winners will be those who, apart from emphasising value creation in the portfolio and executing on a defined and clearly set investment strategy, also manage to create a professionalised back-office function. The increasing demand from limited partners for open communication and increased transparency, as well as strengthened due diligence procedures have resulted in moving the back-office to the centre stage.

As key service providers to the private equity fund industry, the fund administrators are impacted by these current changes, and the latter one in particular. Increased reporting, transparency and disclosure requirements will require fund administrators to expand their offering to meet the new needs of their

Main pricing drivers for administrators

Central administration	Accounting	Transfer agency	Reporting	Company secretarial
Number of investors	Frequency of NAV calculation	Number of investors	Number of reports to be produced	Volume of board meetings
Volume of investment transactions	Choice of GAAP used	Volume of capital calls / distributions	Type of reports to be produced	Volume of investment transactions
Volume of capital calls / distributions	Volume of investment transactions	Number of reports to be produced	Frequency of NAV calculation	Number of investors

EXPERT COMMENTARY ERNST & YOUNG

private equity clients. This will ultimately create both opportunities and threats for the fund administrator community.

In this new context, Ernst & Young has conducted its second European private equity fund administration survey, using the same geographical reach as for the first survey, and interviewing a total of 34 fund administrators.

What service offer to serve which clients?

Back in 2009, 53 percent of the survey participants announced that they wanted to expand geographically. Indeed two years later, 35 percent of survey participants have implemented new offices, which is considerably less than expected. This can be seen as a direct effect of the European-wide recession but should also be analysed as a desire to control costs, focus on core activities and concentrate on providing quality services to their existing client base. However, fund administrators have not fully abandoned their expansion plans as shown by 45 percent of participants anticipating obtaining additional regulatory approvals for undertaking fund administration activities in new jurisdictions, with Asia and the Far East as the most popular locations.

However, expansion can also be achieved through an expansion of current service offering. In this respect, and as was already the case in 2009, the vast majority of fund administrators provides central administration, accounting and reporting, transfer agent and company secretarial services, while those offering services in taxation remain an exception. The same applies to valuation and legal services, thus creating a differentiating factor with competitors.

Interestingly enough, the survey also reveals that participants developed new ways of sourcing business, through the use of thought leadership, for instance, to raise their profile and demonstrate their technical expertise, or by participating in private equity associations which increased from around 50 percent of respondents in 2009 to 76 percent in 2011.

Converting business to revenues: from desire to reality

Converting business to revenues remains a key topic for contributors to the survey.

While many survey respondents expressed a desire to reduce their exposure to a decrease



Coekelbergs: pricing pressure remains high

in Net Asset Values (NAVs) of underlying funds in 2009, none of the 2011 respondents reported having decreased the use of NAV linkage in their pricing strategies, while two had even expanded this approach.

If most administrators apply multiple pricing structures, the vast majority (80 percent) has revenues linked to assets under administration. In order to have some downside protection on the fees, 79 percent of participants apply minimum fees in their administration agreements.

When looking deeper into the details of the main pricing drivers per department of a fund administrator (Table 1), the biggest surprise, consistent with the 2009 survey, is the low weight given by respondents in any category to the number of portfolio lines and the nature of the investments, which indicates that the

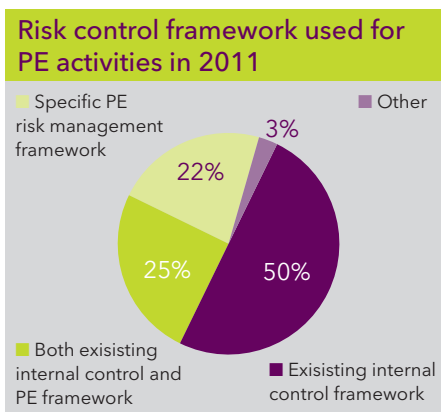
industry may not be overly concerned by valuation complexities.

Overall, pricing pressure remains high as noted by the survey respondents: only 6 percent reported a decrease in pricing pressure over the last months. This is fully in line with the increasing level of competition in the market. However, the competitive landscape may evolve in the near future, with 32 percent of respondents planning to acquire another administrator during the next 18 months.

This consolidation trend expected within the industry is also a clear answer to the expectations of private equity houses who want to deal with globally present service providers.

The role of risk management in the organisational model

The currently changing business environment and practices lead to one of the main issues for service providers at this time: "What should the organisational model of my company look like?" - meaning global vs. local approach and insourcing vs. outsourcing / offshoring. For a number of evident reasons, such as the demand from private equity houses to have more global service providers and cost control, fund administrators and other service providers will have no other choice but to become global or integrate with an existing global network. From the survey, it looks like this trend to globalisation will go beyond the geographic aspect to affect the internal organisation of



1 / 2 page ad

the fund administrator, switching to a business model organised around the client globally and not around the type of service actually contemplated by a number of fund administrators.

With the upcoming Alternative Investment Fund Manager Directive (AIFM), the private equity industry will have to cope with increased risk management requirements. As discussed above, the question is whether service providers employ a model where their internal risk teams are enforced or where support from outside is requested. Throughout the survey, we analysed the responses relating to the future plan in this context of risk management requirements and outsourcing of risk functions. The most noticeable trend is that nearly half (45 percent) of the survey sample was undecided regarding whether they will offer risk management services themselves, with a similar number keeping the option to collaborate with third parties open (47 percent).

But how does the current situation with regards to risk management look like? Half of the survey respondents confirmed the use of an existing internal control framework, 22 percent have a specific private equity risk management framework in place and 25 percent use both a general and a private equity specific model (Chart 1). In comparison to 2009 survey figures, the amount of administrators using a specific risk management framework almost doubled (2009: 26 percent).



Derfesser: administrators coping with increased regulation

Reasons for the increased application of such frameworks could lie in higher risk levels and upcoming new regulations for the private equity industry.

What's next for service providers?

The survey has overall demonstrated that the fund administrator community will have no choice but to accompany the private equity houses in their current and upcoming challenges. By positioning themselves more in the center of private equity business, fund administrators have now – in times of increased regulatory constraints - the chance to get closer to private equity houses' activities. Stricter reporting requirements and increased global operations are examples of such activities administrators have to cope with and turn into opportunities. Being able to grasp these in a consolidating market will be critical for the fund administrators willing to play a major and effective role in this post-crisis environment. ■

Alain Kinsch, EMEA Private Equity Fund Leader, Ernst & Young, Luxembourg*

Olivier Coekelbergs, Partner, Private Equity, Ernst & Young, Luxembourg

Martin Derfesser, Senior Consultant, Private Equity, Ernst & Young, Luxembourg

**EMEA: Europe, Middle-East, India and Africa*