Solving the cost conundrum

*GPs have an opportunity to simultaneously reduce overhead expenses and improve their business models write Samer Ojjeh and Manuel Villavicencio of Ernst & Young LLP.*

The costs of running a private equity firm are rising quickly. Limited partners and regulators are demanding more accurate, granular and timely data; and this often requires firms to redesign aspects of their operating models, hire additional staff and invest in new infrastructure. Getting these changes right can give a firm an advantage when it comes to competing for investors’ dollars. But, first, executives must satisfy regulators and investors without allowing costs to skyrocket.

One way to streamline the business is to closely examine a firm’s data requirements. LPs want information that enables them to track fund performance, monitor adherence to investment guidelines and manage portfolio risk. Regulators, meanwhile, acquired broad authority to collect data under the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank). Dodd-Frank required many private equity managers to register as Registered Investment Advisors (RIAs), meaning they must file the newly expanded Form ADV and the complicated Form PF. To do this requires accurate data about asset values and risks.

Becoming an RIA under Dodd-Frank also opens firms to on-site inspections by the Securities and Exchange Commission. Inspectors will look for sophisticated information management systems and technology, as well as strong corporate governance and compliance infrastructure.

Therefore, to succeed, it is crucial for private equity firms to meet investor and regulatory expectations by executing fiduciary and compliance duties efficiently. Firms that fall short find it difficult to attract new investments, and will waste time and resources dealing with regulatory inquiries.

Despite the scope and importance of this transformation, it is crucial to proceed in a cost-effective manner. A firm’s additional expenses will increase costs in the aggregate at the management company and the funds. To avoid this, leading private equity firms are focusing on building effective operating models, optimizing their technology and data management and maximizing the value of service providers, such as fund administrators.

Specifically, firms are establishing new functions, such as regulatory and portfolio reporting groups. In addition, firms are expanding the scope and autonomy of their investor relations, compliance and treasury functions. These groups work closely with one another to ensure consistency in the reports to LPs and regulators. They do this by ensuring accuracy of their data sources and building in numerous points where data from different sources are reconciled. These new functions effectively signal the establishment of a private equity firm’s middle office function. The middle office should work closely with the deal team and portfolio managers. The middle office should also leverage the sophisticated technology tools available in the market today to facilitate the gathering and consolidation of data from the deal team to support valuation and financial reporting for the firm. Accurate valuations are a priority for both LPs and regulators.

Firms are also leveraging existing data across the firm by integrating systems and technologies. For example, the systems used by the deal teams and the portfolio managers should either be the same or closely linked, and should be tied in with the accounting and management reporting systems. This can often be done by upgrading existing technology, rather than purchasing entirely new systems.

While these changes usually require a firm to increase its overhead given additional headcount and technology spend, overall costs can be contained in a number of ways.

Managers can achieve efficiencies through the automation of manual processes, the removal of redundant reconciliations and the elimination of duplication of efforts that do not add value.
Some private equity firms are also considering outsourcing functions that are far removed from the investment decision process to a fund administrator. Many administrators have developed the ability to take on functions that can benefit from economies of scale, so they can offer their clients those services at minimal costs.

Some of these include the generation of capital calls, distribution of investor communications and management of other reporting functions. However, firms considering outsourcing should be careful in order to retain the flexibility and responsiveness of in-house operations.

While the scope of these changes can seem large, they are nonetheless crucial in order to forge good relationships with regulators and align with LPs expectations to manage costs. Done in a thoughtful way, they can be executed in a cost effective manner that improves a private equity firm’s overall business model.

Samer Ojjeh and Manuel Villavicencio are a New York-based principal and executive respectively in the financial services office of Ernst & Young LLP. The views and opinions expressed herein are solely those of the authors, and do not necessarily reflect those of Ernst & Young LLP.

Samer Ojjeh
Principal, Financial Services, Ernst & Young LLP
+1 212 773 6486
samer.ojjeh@ey.com

Samer is a principal in the Asset Management Advisory Services practice based in New York. He has more than 17 years of experience and leads our advisory initiatives in the alternative investment marketplace. Samer has helped numerous hedge funds and fund administrators in improving and/or expanding the efficacy and effectiveness of their front-, middle- and back-office functions, redesigning operational processes to support changes in organizational structures, processes and technology platforms. He is an experienced advisor for trade capture portfolio management and portfolio accounting systems implementation, middle-office formation, and software vendor selection, as well as the infrastructure build-up related to the outsourcing of middle- and back-office functions. He has spoken at many domestic and international hedge fund industry conferences.

Manuel Villavicencio
Senior Manager, Financial Services, Ernst & Young LLP
+1 212 773 6983
manuel.villavicencio@ey.com

Manuel is a senior manager and leads the Private Equity Advisory Services within Ernst & Young’s Performance Improvement practice. He has eleven years of experience in private equity operations and technology and three years of experience in tax compliance. Manuel has assisted numerous private equity and alternative asset management clients including fund managers, fund administrators and fund-of-funds with operational and technological improvement and transformation efforts, evaluating service providers, and designing and implementing technology solutions in order to align with leading industry practices. Manuel has extensive knowledge of private equity operations and technologies, including partnership accounting, portfolio management, valuation and other key functions from both the fund manager and limited partner points of view.

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