Bridging the gap

A view into the evolving relationship between institutional investors and private equity firms

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Building a better working world

A wake-up call for private equity firms

Superior investment returns are no longer shielding private equity (PE) managers from the transparency demands of the world's most influential investors. Considered a frontier asset class as recently as 20 years ago, private equity firms, or general partners (GPs), have enjoyed a period of limited scrutiny from regulators and investors. As a result, GPs have been able to provide investment, operational and financial data in formats of their choosing to limited partners (LPs), requiring these investors to spend a disproportionate amount of time processing and interpreting the information. The inherent complexities and nuances of fees and fund structures, coupled with lean operations, have made it difficult for GPs to commit the resources required to industrialize their operating models.

LPs had previously accepted this suboptimal system due to superior returns and intense competition among investors to commit funds to top-tier managers. As private equity becomes a more significant portion of LPs' portfolios, however, investors, led by public pensions, are demanding greater transparency into the investment and operational activities of their private equity managers. This is a call to action — GPs must formulate plans to seriously address these demands, while managing internal constraints resulting from typically lean operating models. Managers who effectively anticipate these requests by agreeing to a set of public or agreed upon standards with LPs will gain competitive advantage.

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LPs and regulators are demanding more access to information

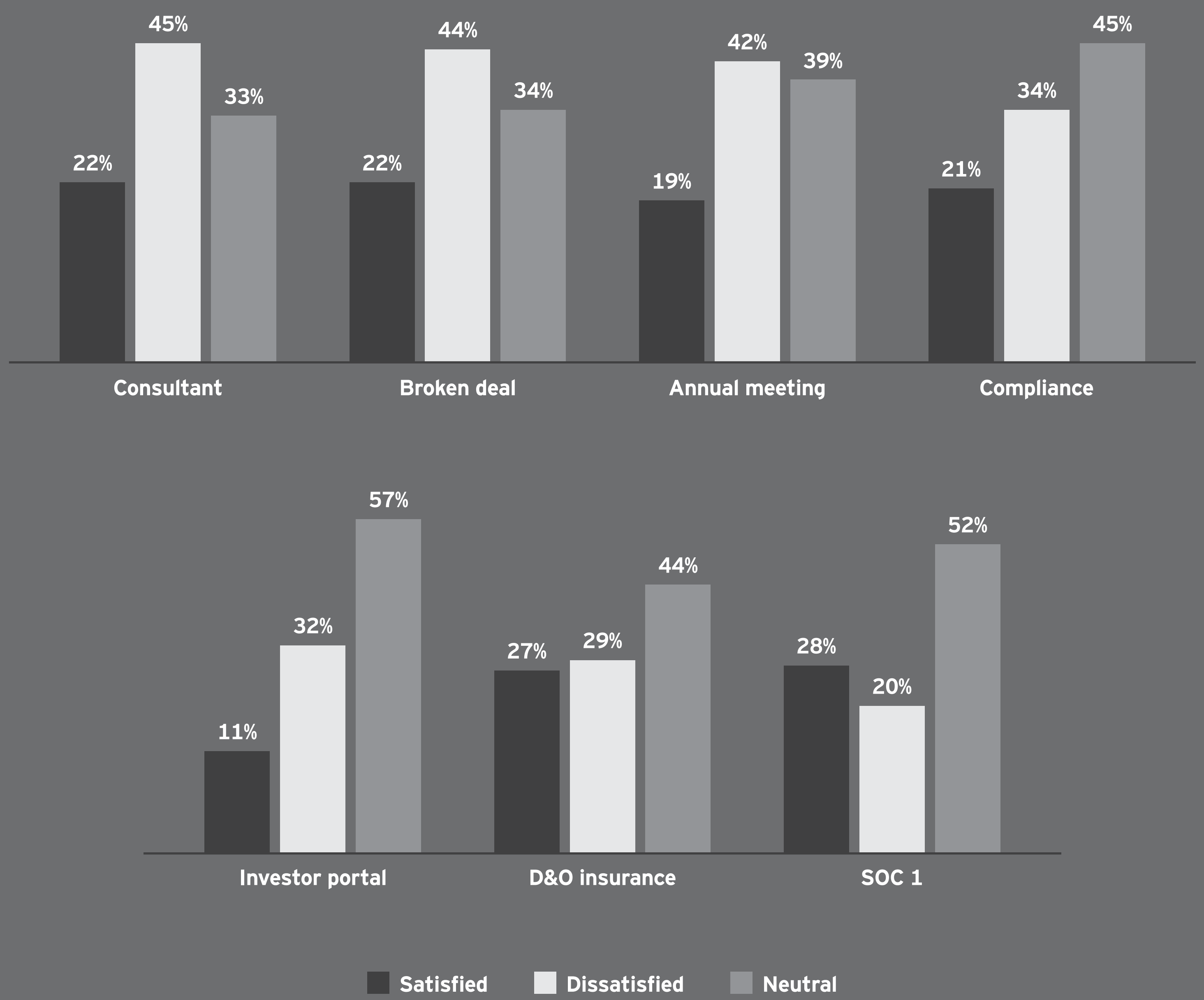
Fee and expense reporting has been the subject of much discussion among GPs and LPs as well as regulatory bodies. A recent EY study found that less than 30% of investors are satisfied with any category of expense allocation disclosures (with the majority feeling dissatisfied or neutral) from their invested private equity funds. Several private equity firms have been fined by the SEC for improperly disclosing fees or allocating expenses. As a result, an increasing number of investors are putting more focus on monitoring expense allocations and associated disclosures by PE firms. If GPs are not prepared to comply, some pension funds are considering denying new investments to or withdrawing capital from firms that lack full transparency around fees.

A joint study between CEM Benchmarking and the South Carolina Retirement System Investment Commission found that private equity fund quarterly reports did not clearly disclose fees such as carried interest, and often failed to explain expenses such as tax, legal and audit costs. Following this study, several other states conducted similar internal audits and found tens of millions of dollars in previously undisclosed fees, with some states reporting total costs 100% higher than what was originally disclosed. Frustrations around fee disclosure led to the state of California passing a bill, which requires Private Equity (PE) and other alternative investment firms to fully disclose fees and expenses for pensions and other retirement systems in California.

1. EY, Private Equity International, "Disruption: A Seismic Shift in the Private Equity Industry,"2016 Global Private Equity Survey, 2016 EYGM Limited.
2. CEM Benchmarking, "The Time Has Come For Standardized Total Cost Disclosure For Private Equity," June 2015.
3. Martin, Timothy, "Pensions' Private-Equity Mystery: The Full Cost," The Wall Street Journal, 22 November 2015.

Investors

How satisfied are you with the level of transparency related to expense allocations?



Source: EY, PEI: 2016 Global Private Equity Survey

Responding to complex investor requests often creates burdens due to immature operating models

While investment managers of all asset classes are facing similar pressures from investors and regulators, it is apparent that private equity firms in particular are often caught unprepared when customized requests flood in (e.g., other expense drilldowns, management fee/carried interest calculations, or historical data and activity requests). The prevailing industry opinion is not necessarily that private equity managers are unwilling to share such information with investors; rather, the lack of transparency is a consequence of the operational difficulties that private equity funds face in capturing, processing and tracking data across multiple sources and systems (or lack thereof). Many firms still rely heavily on spreadsheets to satisfy these reporting requests. This time-intensive data transfer requires GPs to compile data and LPs to consolidate, reconcile and analyze it, often using manual processes. Private equity (PE) managers have a culture of providing a reasonable amount of information to their investors; the need to enhance systems, processes and reporting may be all that stands between the GP and a satisfied investor.

The industry is slowly coalescing around industry standards

Compounding the challenges is the fact that there is no widely adopted industry standard for transparency reporting and allocation of fees; each firm is bound to unique limited partnership agreement terms. Organizations such as Institutional Limited Partners Association (ILPA) and AltExchange have released standard templates for data classification, financial reporting and operational due diligence, but these standards, so far, have not been consistently adopted across the industry.

That said, there is evidence that reporting and transparency standards are catching on — 53 institutional investors have endorsed the fee reporting template released by ILPA in January 2016, many of whom require their GPs to complete the template. This template provides a standard form for GPs to detail fees, expenses and carried interest. Several states have introduced legislation focused on fee disclosure for alternative investments, but the level of disclosure required continues to be a contentious issue. Hindering increased adoption is hesitation by several institutional investors who fear being shut of out of certain high-caliber investment offerings (by instilling compliance as a requirement).

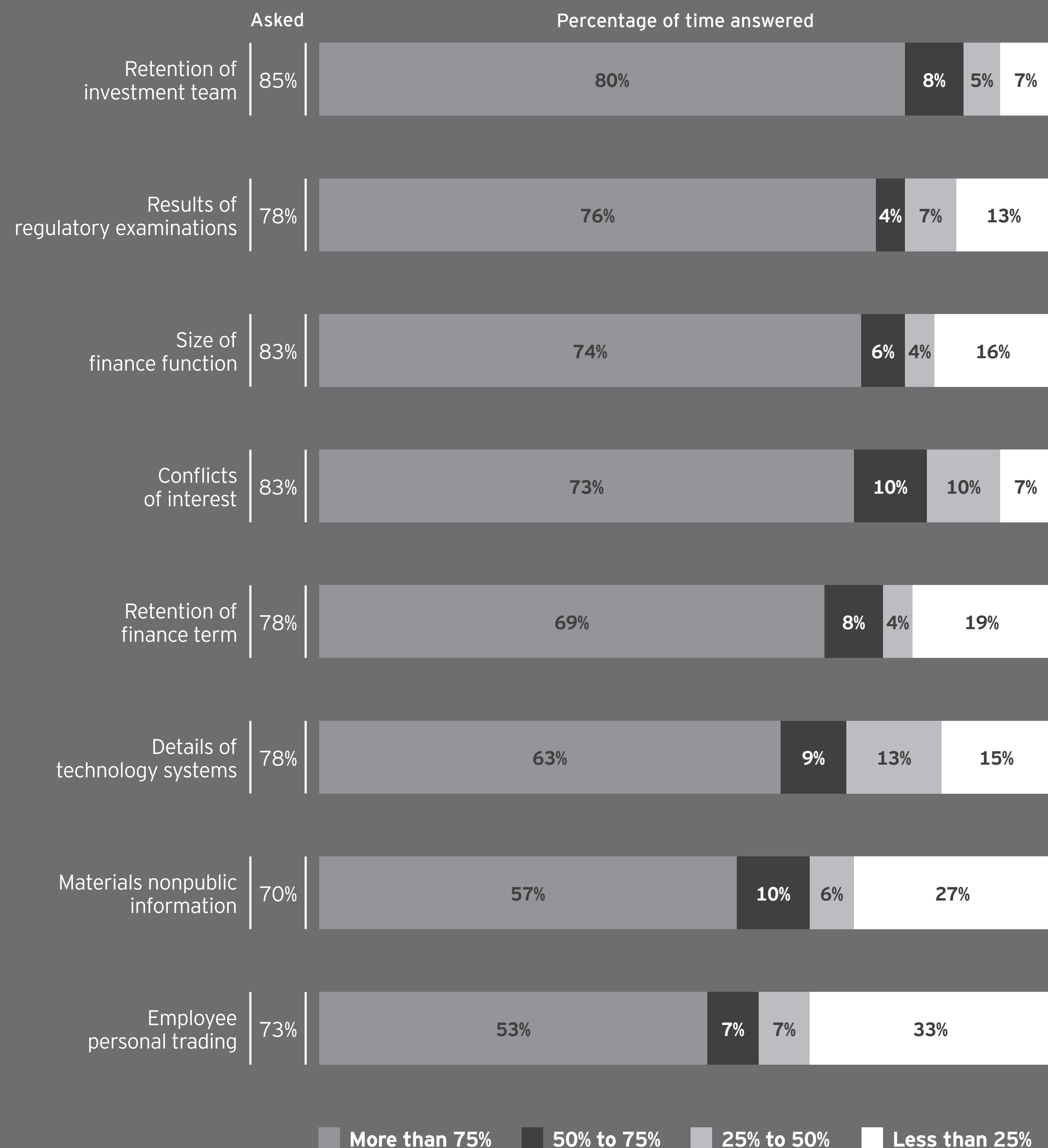
Whether the ILPA templates eventually become industry standard remains to be seen, but there is common belief among institutional investors that the call for enhanced reporting and disclosure standards will only intensify.

Some pension funds are considering denying new investments to or withdrawing capital from firms that lack full transparency around fees.

Figure 2

Private equity funds

What significant questions are asked during the due diligence process?
What percentage of these questions do you answer?



Source: EY, PEI: 2016 Global Private Equity Survey

Operational due diligence is an effective solution for LPs to increase understanding of operational risk of GPs' infrastructure environments

In seeking greater transparency around these performance and fee data points, investors are delving deeper into the operational policies and mechanisms inside of their investment managers. Investors are implementing formal operational due diligence (ODD) programs to evaluate and continuously monitor the operational risks of their GPs to quantify the potential impact of operational failures on their portfolios.

Until recently, ODD performed on private equity managers was often considered an afterthought for investors and performed as a "check-the-box" step within investment evaluation. Compared to most hedge funds, private equity transaction volumes are low, with fewer investments and much longer harvesting periods; why bother expending resources to examine (and periodically re-examine) the simple infrastructure and operational processes of private equity managers? Investors are realizing that private equity operations are more complicated than they seem on the surface, with increased risks of errors due to the many bespoke processes: multilayer tax structures, carried interest calculations, rebalancing for transfers and subsequent closes, expense allocations across funds, management fee waivers and offsets. Consequently, investors are committing resources to implement and execute robust operational due diligence programs over their private equity portfolios.

Industry-leading institutional investor LPs have developed scoring systems to measure operational risk against risk tolerance and investment objectives. A key objective of a scoring system is to mitigate the inherent subjectivity of operational reviews, thus complementing the rigorous quantitative analyses performed during investment due diligence. In these systems, LPs assign weights to specific criteria and thresholds across all operational areas of managers, including, but not limited to, the following:

- Valuation
- Performance and fee calculations
- Reporting
- Financial close processes
- Data management
- Vendor risk management
- Information security protocols (internally, portfolio companies and vendors)

As LPs continue to invest in more sophisticated techniques to identify and stratify existing and prospective GPs, they are elevating the authority of ODD teams. Many investors, for example, assign veto authority to ODD teams, thereby declining to allocate capital to firms that pose unacceptable operational risk. The inability (or unwillingness) of certain GPs to provide transparency into investments, fees and operations are clear warning signs of operational deficiencies.

While most GPs are willing to provide the level of transparency demanded by LPs, the sheer volume of requests and variances of procedures create significant operational burdens for managers, whose operating models are already stressed by rapid growth and regulatory change. Firms are relying heavily on personnel to carry the loads (by increasing workload/expanding roles), as most have traditionally underinvested in technology and other digital tools to create scale. PE has been spared many of the regulatory demands that have forced operational change on other industries, but it may be time to look to those solutions to meet the recent demands of their stakeholders. The cost may be too high to wait for legislation or regulatory fines before starting to move in that direction.

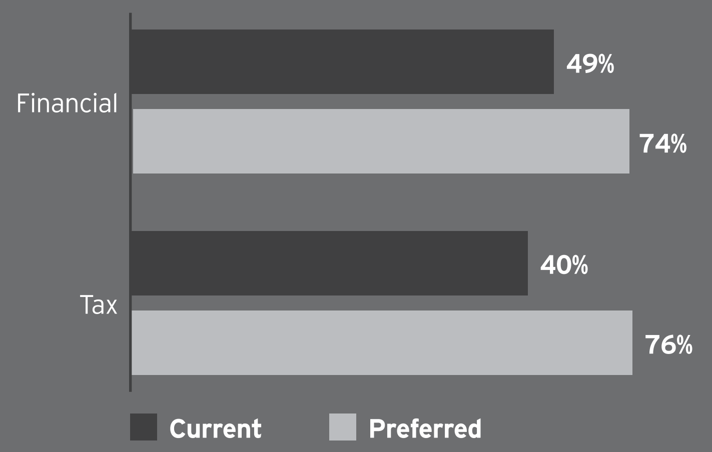
Reporting standardization is only part of the answer

With investor servicing and ODD programs becoming more arduous for both GPs and LPs alike, it is evident that the next step is an industry-standard framework for operational due diligence and reporting. A uniform process would reduce the time and resource hours required to evaluate each manager (initial evaluation and ongoing monitoring) during the due diligence process. Furthermore, an industry-standard framework would allow GPs to better anticipate data and information requests, while creating boundaries for investors and prospective investors.

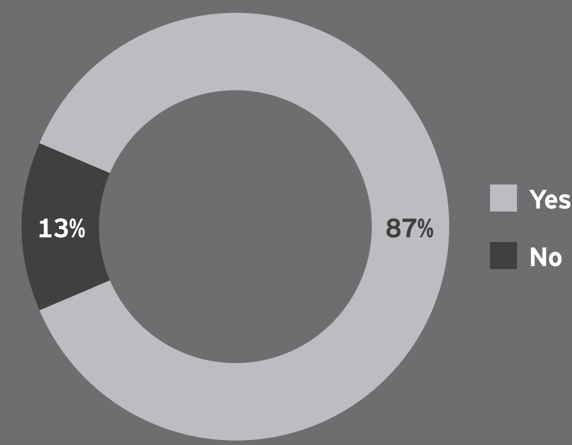
Although organizations such as ILPA have attempted to fill the void, there isn't a consistent golden standard applied among LPs and GPs due to the varying demands of each party and the fact that compliance with a specific standard is not required. Even if global standards such as ILPA and AltExchange are widely adopted, it still will not solve many of the aforementioned underlying operational challenges faced by GPs (data management, manual processing and tracking, etc.).

Figure 4

Investors
Are you currently, or would you prefer, to receive financial tax reports electronically?



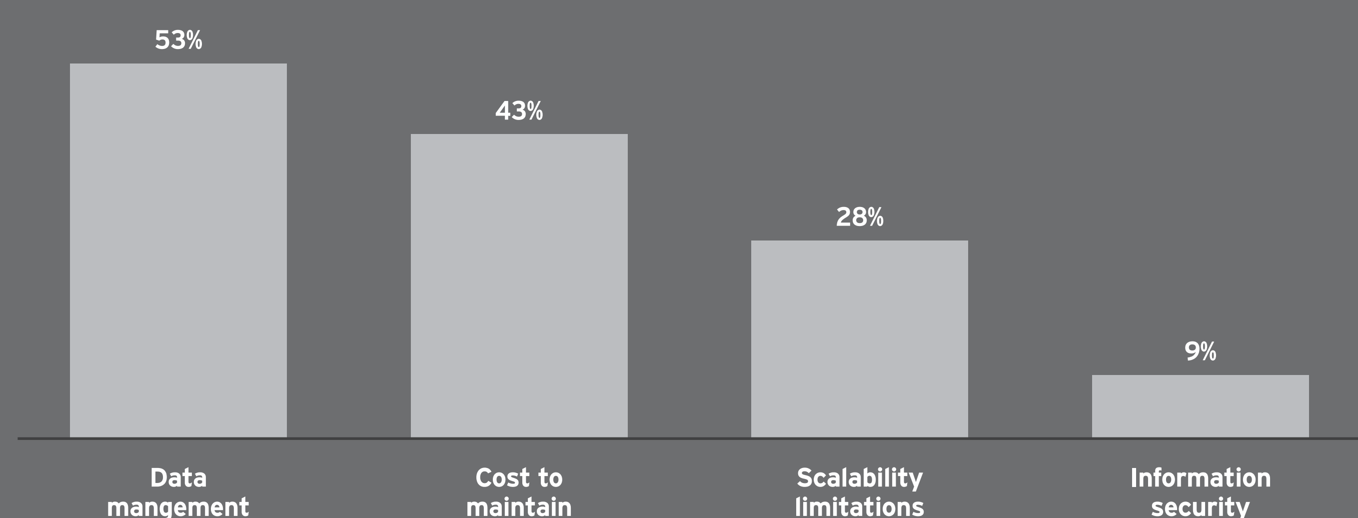
Investors
Would you like to receive reports through digital portals?



Source: EY, PEI: 2016 Global Private Equity Survey

Figure 5

Private equity funds
What do you foresee as the most significant constraint if you were to implement technology solutions?



Source: eSentire, Private Equity International, "Cybersecurity in Private Equity: How Prepared is the Industry?" January 2016 PEI.

Digital transformation is coming to a private equity firm near you

A recent EY study showed that 87% of investors prefer to access financial reports through investor portals; however, less than half of firms surveyed indicated that they currently receive financial and tax reports electronically. These figures tell only part of the story, though — delivering standard reports via secure online channels is an improvement over email, fax or traditional mail, but this scenario is still a one-way communication from GPs to LPs. From notification through final processing, there are still several manual steps performed by LPs that require disproportionate amounts of time from LP staff (relative to processing transactions for other asset classes).

Taking a cue from the wealth management industry, private equity firms and service providers are beginning to rethink how they communicate with investors and prospective investors. Some leading private equity firms and service providers have begun testing and releasing interactive portals that allow for better communication and access to data. These sophisticated solutions can tie reporting and communication processes together throughout all phases of the relationship. During the ODD process, for example, firms can create data rooms and workspaces to facilitate seamless document sharing and enable prospective investors to access portfolio and operational data, thereby reducing the frequency and volume of emails, calls and meetings during the due diligence process. For current investors, LPs can create customized landing pages with dashboards upon login, modify contact information and wire instructions, schedule automated downloads of customized reports (eliminating the need to email and populate individual data templates) and communicate with GPs efficiently and securely.

By expanding the functionality of investor portals to enable data delivery and investor self-service, GPs are able to address pain points cited by investors and internal personnel alike.

One major caveat to this automation, however, is the data management required to implement a digital solution. During a 2016 EY study of PE firms, 53% of firms cited system data management as the most significant constraint to implement technology solutions. For firms already far along the path, developing digital capabilities is a natural evolution; however, firms that are lagging in this area must mature their data management capabilities before making significant investments in sophisticated investor portals.

Additionally, cybersecurity is a key, under-recognized concern. Per a joint study by eSentire and Private Equity International, 54% of private equity companies have reported themselves as victims of cybercrimes, and there are undoubtedly countless more firms that have failed to detect attacks on their information systems. A digital investor portal would pose further risk by centralizing client and financial data. Thus with such an implementation, it would be necessary to monitor standard and privileged access and provide adequate information security training to employees and investors working with the system in order to keep private information out of the wrong hands.

There is common belief among institutional investors that the call for enhanced reporting and disclosure standards will only intensify.

Benefits of interactive, self-service investor portals

General partners	Limited partners
• Integrates front- and back-office data and processes to achieve higher levels of efficiency, transparency and control • Reduces dependence on headcount increases to achieve scale • Focuses staff time on analysis and client service, rather than report generation • Improves interactions with investors • Is able to measure touch points and user behavior (e.g., types of reporting, formats, frequency)	• Increases transparency • Access to raw data reduces time and effort to manually process reports • Streamlines communications — inquiries can be sent via portal or email • Enables robust monitoring of fund and investment performance through dashboards • Allows for customization of reports and data to suit individual needs

Firms that embrace the changing landscape stand to gain the most

Private equity firms must continue to find ways to address investors' increasing calls for transparency and operational excellence, it is clear that the status quo will not hold for much longer and poses a risk to the overall integrity of the industry. With investors and regulators heavily scrutinizing the transparency, operations and fees of private equity firms, the industry must dramatically change its perspective on leading practice reporting standards. GPs are finding it difficult to keep up with the ever-increasing demands for better data and reporting from all stakeholders, which further accelerates the business case for more sophisticated technology solutions, reducing reliance on headcount increases alone.

Interestingly, as GPs respond to these increasing requests, it is apparent that a proliferation of data is not the silver bullet, as most LPs are not equipped operationally to handle an increased flow of information. In addition to the sheer volume of data, other considerations such as varying accounting and reporting practices among GPs create additional barriers for LPs to process and understand the information being provided. If GPs comply, expecting that these demands will solve transparency issues, LPs will be obligated to understand, account for and integrate performance across investments. LPs must understand how they plan to receive this data, how they will interpret it and what downstream value they expect to receive. LPs must evaluate their processes and understand the implications of receiving all of the information they request; without an agreed-upon set of standards, these processes will continue to prove ineffective for both parties.

An effective method for firms to improve the investor experience and confidence, while reducing operational burden, is through the use of interactive investor portals, where LPs can obtain investment and operational data and generate reports to suit their customized needs. Eventually, as standards are embraced by both sides and digital becomes the norm, portal access should be replaced with direct data feeds from GPs to LPs; this "nirvana state" will offer massive operational improvements and cost reduction, as it will eliminate the need to manually log into individual GP portals for data collection. Although there are definite barriers to digital, such as implementation costs and data management and information security concerns, PE firms and LPs that embrace and support this changing technological landscape stand to gain the most in terms of scalability, regulatory preparedness and overall investor experience.

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