Private Funds CFO

By: Robert Caporale, Guest Writer
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What exactly does 'in-house operations' mean?

As remote work becomes the norm, a new model for fund administration emerges, writes Robert Caporale of Gen II Fund Services.

As covid-19 grinds on, fund managers are seeing their teams adjust – and in some cases thrive. Meanwhile, their back-office operations are expected to maintain pre-pandemic levels of oversight and control with a new, highly-distributed labor model. In the process, what it means to have an "in-house" back office is materially changing.

Each GP is different and so is their strategy for evolving back-office operations to meet the challenges of this extended disruption. Some Zoom it, some share Excel files and some are installing point solution technologies. Others consider outsourcing. All approaches work to one degree or another, yet months into this disruption, outsourcing has emerged as one of the stronger and more enduring options.

Robert Caporale

Control freaks welcome

Most GPs have heard the third-party fund administrator pitch: "Gain specialized expertise! Scale efficiently! Leverage advanced technology!" The benefits are compelling, but the underlying concern is if you outsource you lose control. Truth is, the new pitch should be: "Gain control and visibility like never before."

Sophisticated private equity fund administrators have evolved considerably over the last 10 years, fueled by rapid advances in technology and cloud computing and the need to comply with increasingly complex and rigorous reporting requirements. As a result, the industry is now as much about data and analytics as offering core accounting and administrative functions. Fund administrators arm GPs with real-time dashboards and cloud-enabled flexibility, giving them the control they previously may have felt was lacking. As a result, leading third-party administrators can maintain peak performance with little-to-no adjustment while "future proofing" their back offices in the process.

This fundamentally alters the outsourcing equation. It may sound like semantics, but through technology and institutionalized processes, outsourcing is being re-imagined into an oversight – "trust but verify" – model, where PE sponsors leverage the capabilities and best practices of specialists while providing oversight and review over these tasks. Covid-19 has forced PE sponsors to pivot to this new reality.

The Ground Hog Day investment

Across private equity, a wide spectrum characterizes the back-office capabilities of fund managers. Many existing firms remain reliant on Excel to track and manage reference data, performance measurement and provide basic attribution analysis. Given the standing start for emerging managers beginning their journeys, outsourcing represents a logical option to get up to speed quickly.

Most larger firms, however, have built out back- and middle-office systems on the auspices that a customized technology stack, managed by internal resources, offered the most control to oversee and execute mission-critical workflows. When these investments were first conceived, however, many considered it a one-time expenditure they may have to revisit every seven to 10 years. They also did not realize how quickly the rest of the industry would catch up to them, necessitating continual investment as well escalating costs for talent and operations professionals that soon become fixed costs on management company income statements.

Wherever GPs fall along this continuum, they are discovering that the pace of innovation and change in the industry is demanding deep specialization that effectively mutes the previous competitive advantages of maintaining their proprietary technology. Moreover, they're finding that control is often an illusion, as "new" systems become obsolete as demands change. Consider, for instance, the evolving information appetite of institutional investors. As asset owners themselves become more sophisticated, many are seeking enhanced performance reporting with data-visualization capabilities, advanced risk analytics and customized benchmarking. The greater appreciation for ESG, too, is creating new data sets and reporting demands altogether.

Recognizing a GP's core competencies

To get a sense of the future, one only has to look at the mutual fund and hedge fund universe, where many of the largest managers have gone through their own digital transformations. Many invested in proprietary systems in the 1990s or 2000s. As new functionalities were added and as earlier technologies became obsolete, layers of workarounds were created to accommodate the new capabilities. Over time, and without realizing it, fund managers were creating an unwieldy and ineffective cost center, whose technology debt and complexity created business disruptions and amplified compliance and cybersecurity risks. Moreover, many of these proprietary technologies could not be integrated with front-office or downstream reporting systems, and the costs to continually upgrade and maintain their tech stack made the decision to outsource obvious. Today, the majority of mutual funds and hedge funds utilize third-party fund administration.

At the end of the day, though, it comes back to recognizing the mission for which GPs have been tasked. While technology has indeed become a bigger part of the equation, the most accomplished sponsors can trace their success back to deal sourcing and value creation and they leverage their outperformance through fundraising efforts that drive growth in new jurisdictions and complementary verticals.

Against this backdrop, forward-thinking managers are outsourcing their back-office function and re-allocating that spend toward capabilities that enhance their investment activities. This may take form as CRM and marketing automation systems that enhance and optimize deal pipelines or data science and analytic capabilities that augment and accelerate value creation efforts.

And for those that consider fundraising to be a core competency, outsourced fund administration – now enabled by tech – only adds further credibility and empowers IR teams to respond instantaneously to dynamic LP and regulator demands. Moreover, outsourced administration effectively allows management to "turn on" new capabilities to facilitate AUM growth. Again, this can take the form of new funds, new asset classes or new jurisdictions, such as Luxembourg, for US managers.

Technology, to be sure, is helping to automate key functions and provide more information and more access. But it is also facilitating a level of control required for the largest GPs to feel comfortable handing off these responsibilities to an experienced third party.

Covid-19 has proven to PE sponsors that an external fund administrator can provide exceptional service and specialized skillsets to fund managers during times of extreme stress. This discovery should be a catalyst that now allows PE sponsors to re-engineer their infrastructure to better meet the needs of their stakeholders. Even as investment in the back office has become the table stakes to compete in private equity today, specialized expertise and a modern technology underpinning are also becoming prerequisites to managing risk and facilitating growth.

Robert Caporale is head of strategic business development at Gen II Fund Services, LLC.