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## THE PEI FUND ADMINISTRATION & TECHNOLOGY COMPENDIUM

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## EXPERT COMMENTARY J.P. MORGAN

# Why outsource now?

*Dodd-Frank is causing some blue chip private equity firms to re-think the hidden costs of in-house fund administration. By **Cesar Estrada** and **Georges Archibald***

Increased scrutiny and a host of new issues raised by regulation under Dodd-Frank are causing major private equity firms to seriously consider working with third party fund administrators. For some firms heretofore committed to administering their funds in-house, this is a historic first.

Vast changes in the regulatory landscape are prompting widespread re-thinking about the real costs of in-house fund administration. Under Dodd-Frank, private equity firms managing \$150 million or more have been scrambling to meet the SEC registration deadline of 21 July 2011.

And, irrespective of where regulations ultimately land, institutional limited partnerships are getting increasingly organised to demand more transparency, better reporting and tighter controls.

All of this means new concerns about the operating model for fund administration currently in use by major players. CFOs face higher risk in many key areas. Funds must understand and comply with a host of regulations regarding trading and document retention, and cope with how these will affect their employees. Additionally, private equity firms will have to contend with the custody rule and its application to their respective businesses.

As leading private equity firms re-think these concerns regarding their in-house fund administration, many are coming to the conclusion that now is the right time to outsource.

This represents a paradigm shift for major funds' CFOs, who acknowledge that it requires a significant leap of faith to partner with an outside fund administrator. When thinking about outsourcing, CFOs naturally consider execution risk and control concerns. In addition, deep discussions with many CFOs reveal that they are mindful of the fact that not all fund administrators are created equal. Most are keenly aware that a fund administrator with a blue chip name and a high level of experience sends the right signals to both regulators and clients.

## Outsourcing: The value proposition

For private equity firms, the value proposition for outsourcing involves avoiding both present and future costs related to back office functions, while enabling fund managers to focus on their core capabilities -- executing fund strategy and increasing investor returns.

For many major funds, Dodd-Frank presents them with a decision point. Bearing in mind the new compliance and reporting burden, should they keep fund administration under their roof? Doing so means hiring new in-house people and investing in new technological infrastructure today -- as well as committing the firm to the necessary future expenditures involved with keeping current in this rapidly developing field.

Fund administration is a business of specialists. J.P. Morgan, for example, is in the business of attracting, training and retaining the best people in the field. Retention is key -- and it is often a matter of career opportunities. Accordingly, fund administrators are in the best position to offer career growth opportunities for the best people.

In the face of all of these developments, it's important to understand the magnitude of the stakes involved. History shows us that the pitfalls of many hedge funds who kept fund administration in-house may be instructional for private equity firms.

Fully 50 percent of all hedge fund failures to date have been due to operational risk. With this in mind, the time spent on a careful cost/benefit analysis is well worth the time in terms of quantifying the true cost for your private equity firm.

Outsourcing fund administration gets private equity firms out of the expensive, time-consuming business of back office management, including the

worries involved with technology investment. In effect, they pay a fund administrator to keep up with the evolving technology of the marketplace.

Here are the key questions and criteria to consider about people, technology and processes when re-thinking outsourcing. ➔

## KEY CFO QUESTIONS:

- What tasks or burdens are preventing you from focusing on value-added functions?
- How agile is your firm in terms of launching new funds, closing deals and assessing market opportunities?
- Are you equipped to respond to market conditions in navigating the complex regulatory landscape?
- What challenges has your firm faced regarding staffing, hiring or replacing key fund administration employees?

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*“Some managers only feel the sting of these people-related costs when they’re hiring – and then only consider pay and benefits”*

### → The cost of people

When a key employee departs, CFOs often find themselves in a time-consuming rush to recruit, train and retain a skilled fund administrator. And the pain isn’t limited to the CFO. Filling a senior position often involves the commitment of significant executive time from a number of busy people on the CFO’s staff.

Some managers only feel the sting of these people-related costs when they’re hiring – and then only consider pay and benefits. However, both cost accountants and human resources professionals point out that CFOs with this mindset are ignoring significant hidden costs.

Some people-related tasks and costs are straightforward and transparent, such as hiring a recruiter or providing the necessary technology and connectivity and/or physical workspace. Others, by their very nature, are voracious consumers of managerial time, and difficult to extract from a cost/benefit analysis.

### The costs of internal processing and reporting

Private equity funds’ monthly and quarterly processes are designed to ensure efficient operations, meaning a whole host of protracted, cyclical administrative tasks for the CFO, including:

- Capital call and distribution processing: Massive Excel workbooks with no defined workflow or controls, linked together by custom formulas engineered on a one-off basis, are a particular concern in the area of distribution waterfalls and carried interest calculations.
- Managing cash receipt and distribution requires efficient cash management, and CFOs can effectively leverage bank services that support these processes.
- Costly quarterly and annual audits: Non-audit trail tools such as Excel spreadsheets used as a main calculation engine can raise audit concerns.
- Investment valuation and fund returns requires maintaining a clean record of periodic valuation integrated with core →

**Table 1: Hidden costs of internal staff**

*When hiring new employees, general partners need to consider more than just pay and benefits – not just the time spent in sourcing and hiring talent but also in training and managing staff*

Task	Hidden Costs	Important Considerations
Sourcing/Hiring	<b>Interviewing time:</b> Four to eight hours for each candidate means between 32 hours to 64 hours per hire <b>Administrative time:</b> debrief, reference and background checks, drafting the offer letter	<b>Rule of thumb:</b> On average, managers interview eight people in order to hire one
Training	<b>Managerial time:</b> Five hours a week per employee for coaching	<b>Training time:</b> Employees need to get up to speed and become independent, taking a minimum of six to nine months, with a larger organization, and years before determining if hiring cycle must begin again
Pay	Time spent evaluating competitive pay	Existing employee pay in a normal market with two percent cost of living adjustment annually – employers can expect a five to ten percent annual increase in total compensation for performing employees
Benefits	Managerial time spent negotiating benefits with provider and enrolling new employees	Cost of benefits in the future
Managing	Managerial time averages 15 percent of total working hours per week	Personal coaching, directing and maintaining priorities



## Complex Issues. Clear Solutions. Leadership in Private Equity Administration

As investments in private equity increase, so do the challenges. New staffing, reporting, and administration requirements are just some of the demands facing today's private equity firms.

At J.P. Morgan, we are uniquely positioned to help investors meet these new complexities. We deliver innovative outsourced fund administration and infrastructure solutions to support private equity funds around the globe. Our services enable our clients to focus on the core activities of investment management – maximizing returns for investors, while keeping business process streamlined and efficient.

To learn more about Private Equity & Real Estate Services, visit us today at [www.jpmorgan.com/visit/pefs](http://www.jpmorgan.com/visit/pefs)

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For more information, please contact your relationship manager or:

Americas **John Weeda** at [john.weeda@jpmorgan.com](mailto:john.weeda@jpmorgan.com) or +212 552 4553

Asia **Sam Lam** at [sam.lam@jpmorgan.com](mailto:sam.lam@jpmorgan.com) or +852 2800 0780

Australia **Nick Paparo** at [nick.x.paparo@jpmorgan.com](mailto:nick.x.paparo@jpmorgan.com) or +612 9250 4712

Europe **Patrick McCullagh** at [patrick.h.mccullagh@jpmorgan.com](mailto:patrick.h.mccullagh@jpmorgan.com) or +44 0 207 3259566

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- accounting processes, and a detailed awareness of assumptions which vary between regions and asset types.
- Quarterly financial reporting involves accumulating all the data necessary to create financial statements, including investment books and records for fund consolidation and delivery to investors.
  - Sustaining investor confidence can be an ongoing challenge for CFOs who are not supported by state-of-the-art processing and reporting and can raise concerns during annual audits, prolonging the costly, time-consuming audit process.

Designing, managing and re-engineering these critical processes requires substantial commitments of management time and attention – thereby incurring real, if hidden, opportunity costs.

### The cost of technology

Technology heightens your efficiency, but comes with some significant costs of its own. Establishing repeated processes and acquiring, managing and upgrading the technology to support them may well be the biggest challenge that private equity funds face today.

Funds' typical technology investment is likely to be in the six-to-seven figure range. This includes an all-encompassing fund

accounting, administration and reporting platform, and an investor communication portal. Maintaining, keeping current, upgrading and training people on new technology is an ongoing cost that must be considered, as well.

To properly assess the costs for each of these investments every single time they occur, you should identify the hidden expenses in addition to the outright costs of purchasing the hardware and software and maintaining the system. A similar approach should be used for those separate costs of maintaining adequate disaster recovery for all of your books and records.

### A new level of thinking

Today, the benefits of outsourcing are clear:

- Increased focus on core capabilities: In an increasingly competitive market, outsourcing enhances managerial focus, allowing C-level executives and their staffs to focus on what they do best -- investing money.
- Flexibility and speed: The ability to quickly alter investment and portfolio strategy based on rapidly changing market conditions.
- Enhanced control: Provides a level of continuity in operations to the firm while reducing the risk in an ever-changing business environment.

**Table 2: Hidden costs of fund administration technology**

*In identifying the costs of introducing an all-encompassing fund administration programme, CFOs should also consider the hidden costs of buying technology, including time spent on evaluating systems, implementation, maintenance and upgrades*

Task	Hidden Costs	Important Considerations
Evaluation	<i>Time:</i> Requirements, RFP review, demonstrations, vendor visits, scorecards.	Do you know requirements?
Implementation	<i>Time:</i> Scoping, project management, parallel processing of old and new system/process, process re-engineering, un-met expectations  <i>Economics:</i> Customisation, scope creep, sub-par implementation	What if the implementation is unsuccessful?  Can you assure continuity of resources on implementation, both internally and for your vendors?
Software	<i>Time:</i> Negotiating contract  <i>Economic:</i> Legal fees, unforeseen maintenance fees, further customisation	Do you have external counsel with technology background?
Hardware*	<i>Economic:</i> Additional network/IT resource time, periodic server replacement and maintenance	Do you have in-depth knowledge of complex hardware requirements?
Business Continuity*	<i>Time:</i> Designing plan, testing, failure to execute	What if your plan doesn't work? What happens to your data?

\*Assumes hosting technology in-house

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For CFOs of major private equity funds, a cost/benefit exercise such as we have described here should also be the start of a tantalising new line of thinking:

- “What would happen if I took steps to alleviate some operational burdens?”
- “What if I focused more time on developing an exceptional executive team, attracting investor capital or identifying investments that we can use to maximize return?”
- “What would my IRR look like in such a brave new world?”

In order to get to this new level, however, private equity firms must partner with outside fund administrators who tailor their offerings to their firm’s very specific needs – no small task, indeed, for some providers. Such a high level of expertise and careful attention requires an experienced partner.

At J.P. Morgan, we are uniquely positioned to help investors meet the new challenges they face. We deliver innovative outsourced fund administration and infrastructure solutions to support private equity funds around the globe, helping them enhance their control environment and increase transparency for their investors.

We can help your private equity fund by providing the tailored, scalable solutions you need as your fund grows. Contact us to learn how your firm can thrive in today’s challenging markets. ■

Checklist: **Can your fund administrator do this?**

Not all providers are created equal. Be sure to ask any potential providers whether they offer these important capabilities:

- Provide a one stop shop for all your back office needs as you continue to expand your business and develop new strategies
- Service closed end fund structures which have investment styles that rival hedge fund complexes
- Deliver aggregated reporting across all your fund products
- Provide full disaster recovery for all books and records, supported in an offsite, secure environment, stored and backed up against any eventuality
- Constantly look to the future, evaluating the best options for sourcing and implementing the next new technology
- Focus on innovation and offer products to meet your growing fund, portfolio, organisational and market needs

**Automating waterfalls***J.P. Morgan’s approach is deliberate and methodical*

Our experienced, centralised waterfall team has developed these industry-leading best practices:

- **Gathering requirements:** We seek a detailed understanding of waterfall requirements through discussions with our clients, in order to understand the interpretations of the limited partnership agreements and other documents. Waterfall requirements for each fund are documented before a waterfall is developed. Process and expectations are clearly documented before moving forward.
- **Development:** During development, we consider all potential scenarios that could possibly impact the portfolio with the aim of limiting any need for manual interaction with the model.
- **Automation:** We automate the waterfall calculation at an investor level, which includes pulling data directly from the general ledger system. The result is a more controlled process with full insight into the source data and calculations.

**Cesar Estrada** is head of product management for private equity and real estate services and **Georges Archibald** is head of strategy for alternative investment services for J.P. Morgan Worldwide Securities Services. J.P. Morgan supports the world's leading private investors, complex portfolios and global fund structures through innovative outsourced private equity, real estate and infrastructure solutions which leverage our extensive expertise, powerful technology platform and proven processes. With more than \$300 billion assets under administration and a staff of over 350 professionals operating from offices in Chicago, Dallas, New York, San Francisco, Bermuda, London, Guernsey and Jersey (Channel Islands), Luxembourg and Sydney, J.P. Morgan is one of the largest and fastest growing service providers, earning top ranking in the 2007-2010 Global Custodian Private Equity Fund Administration Surveys. Our decades of experience, reputation for superior quality of service, and breadth of capabilities — waterfall and carry administration, financial calculations oversight, and complete banking services — have earned the trust of the world’s leading private equity CFOs, COOs and institutional investors. For more information, please visit us at [www.jpmmorgan.com/visit/pefs](http://www.jpmmorgan.com/visit/pefs)