

Opportunities Presented by Change

thought

2013 sees the private equity industry continuing to embrace significant change and having to reconsider how it can operate within a more regulated landscape. Kevin Luck, Executive Director and Head of Private Equity and Real Estate Sales, Investor Services at J.P. Morgan, explains how this presents opportunities for private equity firms to reassess their business models, create greater efficiencies and deliver results that benefit both private equity investors as well as the industry.

Regulatory and market change

Regulatory reform is fundamentally changing the way in which the global private equity industry is operating. Many private equity houses are experiencing significant pressure from a host of regulation.

The Dodd-Frank Act and the Foreign Account Tax Compliance Act (FATCA) in the US, European Markets Infrastructure Regulation (EMIR) and the Alternative Investment Fund Managers Directive (AIFMD) in Europe, are designed to provide greater investor protection and enhanced, transparent reporting with tighter accounting controls. In the post-financial crisis environment, more sophisticated investors are also seeking increased granularity of data and rigorous risk management controls.

Restructuring operations

However, private equity firms can find it extremely time consuming and expensive to establish the necessary in-house administrative resources to meet these regulatory and market demands. Maintaining and scaling up their infrastructure is likely to result in a step change in fixed costs.

This is also the case if private equity managers decide to change their business strategy, for example, by introducing new funds with increasingly complex structures or new investment strategies, such as debt funds, to offset the financing gap left by historical lenders to their portfolio companies.

More importantly, overseeing these new arrangements demands extensive management time, diverting precious resources that private equity firms might otherwise channel towards the sourcing of capital and executing their investment strategies.

Outsourcing trends

Given these challenges, private equity firms are reviewing their operations and exploring whether outsourcing their administrative functions to a specialist provider could offer a more effective solution. In this way, private equity firms can benefit from robust, scalable technology and resources which provide transparent reporting whilst mitigating risk. Outsourced solutions can also facilitate a transition from a fixed to a variable cost base, potentially aligning fund-related costs to the fund itself.

Similarly, the mandatory AIFMD requirement to appoint an independent depositary, which applies in many instances to private equity firms, makes their choice of depositary increasingly important.

Under the new AIFMD rules, depositaries will also be responsible for: verifying the ownership of assets, record keeping, cash flow monitoring and oversight duties. Private equity firms that are subject to this requirement therefore need to ensure that the depositary they select has the right skills, technology and reach to conduct their extended depositary functions effectively.

As the operational complexity and counterparty risk involved in adapting to the new market environment mounts, many private equity firms are also considering partnering with a single service provider that is capable of delivering more nimble, flexible and comprehensive services tailored to their bespoke operations needs.

Summary

In summary, new regulation is creating structural change within the private equity world, revolutionizing the way that many private equity firms approach their resources. Given the operational complexity and increased costs involved in meeting the new regulatory requirements, many private equity firms are re-evaluating which of their operations they would be better outsourcing to external providers.

Ultimately, whilst the latest regulatory and market changes are challenging, they also present real opportunities for private equity firms to emerge with more flexible, scalable and cost-efficient operations. By partnering with a single trusted service provider, private equity firms can also benefit from an increased focus on their core investment capabilities.

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