private equity

How Outsourcing Can Enhance this Alternative

A growing number of institutional investors and private equity firms are learning that the most prudent way to succeed in the lucrative private equity space lies through outsourcing administration and operations. Here's why.

As private equity assets continue to play an ever-important role in institutional portfolios globally, and as private equity firms lure more capital, the growth opportunities the industry faces can present formidable administrative challenges to both private equity firms and institutional investors.

Growing Pains

"It's becoming increasingly difficult for private equity firms to hire fund accountants with relevant and sufficient experience. The skill set is increasingly more expensive and scarce," says Robert Caporale, head of JPMorgan's Private Equity Fund Services (PEFS), a newly launched division within WSS Alternative Investment Services (for more on PEFS, see jpmorgan.com/visit/PEFS).

This scarcity of talent, particularly when it comes to professionals who understand the unique finance and accounting needs of the asset class, has placed heavy burdens on private equity firms and institutional investors alike.

For private equity firms, "The cost to attract and retain the right talent can be considerable," says Jim Hutter, chief operating officer for JPMorgan PEFS, "this challenge applies to both new private equity firms or those established firms attempting to maintain an existing in-house staff."

In addition to the cost of hiring talent, there is also the time needed to train them. "Most of the qualified people are already part of an operating private equity firm, and since there is no broad training ground for private equity partnership and fund accounting, there's really no centralized place to find the talent," says Al Foreman, head of business development for JPMorgan PEFS. "Building the finance and accounting staff for a private equity entity is one of the greatest barriers to entry. The search alone can be very time consuming."

Since many new private equity firms are formed when a handful of investment professionals spin off from their previous firm and launch a new fund, the level of expertise across the front to back office can vary dramatically. "If those investment professionals were not previously focused on the finance and accounting processes and procedures, they are not going to have the expertise to know how to properly set up that infrastructure at their new venture," says Foreman.

For investors in those new firms, Foreman notes that, "It can mean the difference between investors receiving minimal, perfunctory reporting versus truly understanding the depth and complexity of returns generated by a private equity investment."

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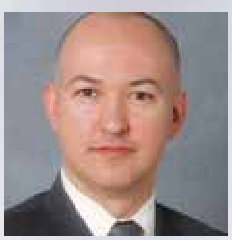
Robert Caporale

Albert Foreman

James Hutter



Cesar Estrada

The lack of a comprehensive industry standard on administration or reporting is another reason to consider outsourcing. “There is no single standard yet available to guide a new entity on the way your capital account statements should be delivered or the timing or framework for such reports,” says Hutter. “The fact that the business is still a bit non-standardized makes creating and maintaining a consistent process more challenging.”

The True “Alternative”: Outsourcing Private Equity Administration

While the number of domestic firms being serviced by private equity outsourcers (or servicers) is estimated by some industry experts to be roughly 10% to 15%, the benefits of outsourcing — as evidenced by its prominent role in the hedge fund industry — suggest that this percentage will grow.

Why Outsource What You Could Do In House?

From a foundational perspective, outsourcing can help clients focus on their strengths. While handling back office functions internally is an option, “Outsourcing helps clients focus on what’s important — maximizing investment returns,” says Caporale. “Effectively running private equity operations requires extensive internal processes and procedures, from both a risk management and efficiency perspective,” explains Foreman.

In spite of the increasing prominence of industry-related groups such as the Private Equity Industry Guidelines Group (PEIGG), the Institutional Limited Partner Association (ILPA) and the European Venture Capital Association, which aim to improve the consistency and transparency of information exchanged by participants in the private equity space, standards remain in the formative stages. “Because information is not as readily available in the private equity arena as it is in the public space, investors have to rely heavily on the private equity fund’s reporting to understand how their investments are performing,” says Hutter, who contributed to the recent PEIGG guidelines recommending private equity reporting and measurement standards. This is one of the most tangible benefits of outsourcing to, or partnering with, a high-quality administrative firm.

To address the need for a talented team, a solid set of procedures and an ironclad infrastructure, outsourcing presents a viable alternative. “Given the nascent stage of the outsourcing industry, it will prove to be the most prudent and profitable manner to manage private equity operations over the long term,” says Foreman.

How to Evaluate a Potential Partner

If outsourcing is the most efficient way to go, how should potential outsourcing partners be evaluated?

“When you think of the general risks of investing in private equity as an asset class, a major one is the lack of clarity in regard to information,” says Foreman. “As investors become more sophisticated, they are demanding greater and more comprehensive information. A firm cannot always create or develop the infrastructure necessary to provide that and finding the right outsourcer can be the most effective solution to that challenge.”

> **“Be wary of ‘team averages’** when it comes to years of experience.”

Foreman believes the key lies in incisive evaluation. “The key is targeting your evaluation to hit upon the three most important areas in private equity administration: the people, the processes and the technology,” he says. “So much of the success of the outsourcing relationship rests on the right infrastructure, and if you have that in place, outsourcing can prove to be the most profitable and prudent way to enter the private equity arena.”

People: Find Out Who’s Who

The teams of individuals who will service institutional limited partners or private equity firms are the most important element of the equation, and should be treated as such when evaluating potential outsourcers, according to Caporale. To begin with, clients should ask detailed questions about a private equity services entity’s staff. “They should clearly understand the number of years of experience of the servicing team,” says Foreman. “Be wary of ‘team averages’ when it comes to years of experience,” he warns.

Similarly, ask the potential outsourcing partner to identify exactly who will be assigned to handle your account. “Often, private equity service firms bring out their very best, most experienced people to handle queries in the initial stages of acquiring new business,” says Jim Hutter. “Then the client signs up, and finds out someone else, and typically more junior is going to be directly servicing the account.”

An offshoot of this concern relates to whether your service team will be learning on the job. “The people handling your portfolio should have specific private equity experience behind, not in front of them,” advises Hutter. Meeting the prospective team to learn about its personalities, structure and capabilities is also recommended.

Process: How Efficient is it?

“Private equity is, in large part, a combination of a professional service and a technology business,” says Jim Hutter. “The prospective client should think about what capabilities exist now and which platform in the future will deliver all the information needed and in the frequency required.” The right processes, he adds, can enhance the effectiveness and the efficiency of the outsourcing experience, but the key is knowing what to look for and what to ask.

Scott Kraemer, JPMorgan PEFS chief technology officer suggests, “Make sure that the majority of the information that is generated from the firm’s system is done via straight-through processing.” While there are a few instances where an extremely complex transaction might require some degree of manual intervention, straight-through processing for most transactions is preferable. Why? “To minimize human error and time delays,” agrees Hutter.

In addition, too much manual input or intervention could drive up the entity’s costs, which could inevitably be passed on to the client. “By not having made an adequate investment in technology, a firm could end up having to resort to a more expensive solution — adding bodies to the process, rather than state-of-the-art technology,” says Hutter. “The right platform can help reduce costs over the long term.”

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More Suggestions on evaluating a team include:

- Ask for evidence to demonstrate that client service is a value. How is the team structured?
- Find out if you’ll have a primary point of contact, and if that person has substantial private-equity-related experience, as well as a deep familiarity with private equity accounting.
- When learning about the team’s experience levels, have a direct dialogue with each member, if possible, says Jim Hutter. By asking specific questions about the private equity business, “You’ll be able to quickly ascertain whether they have the right experience,” he says.
- Inquire about turnover. High turnover at your administrator could prove to be disruptive to your long-term investment objectives.
- Be alert to any sign of single-person dependencies. The smaller the servicing firm, the more likely this will be a problem. Inquire about succession plans and each team member’s responsibilities.

why Private Equity?

Long considered one of the cornerstones of the alternative investment universe, private equity is growing in acceptance and popularity. According to the 2005–2006 Russell Survey on Alternative Investing, private equity has gained a foothold among institutional investors, particularly large endowments, foundations and pension plans. "Private equity is now truly a 'viable alternative'" among these client segments, according to the study.

Private equity experts agree. "Pension funds and other large institutional investors have typically allocated most of their portfolio to more traditional investments (e.g. fixed income and equity securities), but now they're allocating increasingly larger portions of their assets to alternative investments," says Robert Caporale, head of JPMorgan's Private Equity Fund Services (PEFS).

Meanwhile, private equity firms themselves are capturing a bigger slice of the marketplace's available investment capital. Fundraising increased dramatically in 2005; with 92 new funds formed and new commitments totaling $53.7 billion in the second quarter alone, up from 46 funds and $13.7 billion in the first quarter of 2005. By mid-2005, fundraising for private equity ventures had reached a run rate that put it on track for well over $100 billion in commitments for the year. Through October 2005, more than $137 billion had been invested in private-equity-related ventures, an amount that outpaces those of prior years.

In the United States, private-equity-backed IPOs accounted for 53% of the deals priced through mid-October 2005, compared with 30% in the year earlier, according to Dealogic. In large part, the influx of new companies that are owned by private equity firms has to do with the availability of low-interest debt in recent years, which has made buying large companies easier and cheaper than in the past.

It's All About Performance

Why the surge in interest and demand? The answer is simple: top private equity firms continue to deliver better returns than more traditional, publicly traded investments. According to the Russell study and other findings by the global investment group, most institutional investors believe that the annualized returns from top private equity managers will eclipse those of their public equity investments over the next two to five years. "The top quartile venture and buyout funds are delivering returns that are outpacing the public markets, and doing so in a consistent manner," says Al Foreman, head of business development for JPMorgan PEFS.

The lure of superior returns is not exclusive to the United States, either. Private equity investing in Europe has become a major trend, thanks in large part to the strong returns from European investments during and after the U.S. recession. As a result, more and more U.S. private equity firms have brought sizable vehicles specifically targeting Europe to market. Commitments to private equity are forecasted to reach record levels by 2007, with markets that have traditionally had lower allocations to private equity, such as Europe and Japan, showing the largest expected increases. "These trends reflect the increasing appetite of institutional investors to seek out the higher returns that private equity has historically provided, as well as signaling a greater acceptance of the liquidity and risk profile of the asset class," says one Russell Group executive. Al Foreman of JPMorgan agrees. "We're seeing an increase in the globalization of the private equity industry."

Other factors come into play, as well, making private equity more attractive to investors. Above all, investors remember the three-year equity market downturn from 2000 to 2002 all too well, and their subsequent wariness of stocks lingers. In addition, the prospect of higher interest rates has prompted some to look past bonds for more promising returns, while others are concerned that the return premium for stocks over bonds in the next decade might be as low as 3%. Finally, greater confidence in hedge fund managers' ability to successfully extract alpha from inefficient markets globally has added to the lure of private equity. Combined, these factors seem to boil down to a simple ingredient for potentially successful investing: diversification. "It's simple — the historically higher returns and the additional level of diversification it [private equity] can offer are driving the trend," says JPMorgan's Robert Caporale.

The future looks bright for private equity, as foundations and endowments report they plan to continue to increase their allocations to the asset class. Clearly, what was once marked as "alternative" is becoming an essential component in a fully diversified portfolio for many institutional investors.

JPMorgan Private Equity Fund Services

pefs

Building on Long-term Experience and Success

In November 2005, JPMorgan Worldwide Securities Services (WSS), a leading global provider of fund services, announced the launch of JPMorgan Private Equity Fund Services (PEFS). The new business unit offers a full suite of high-quality outsourced private equity administration services to both private equity firms and institutional limited partners.

While JPMorgan PEFS is officially deemed new, the enterprise stems from a long-term, highly experienced and established entity, JPMorgan Partners, which operated for more than 20 years. “JPMorgan Private Equity Fund Services emerges from an existing private equity finance and technology operation that has built a strong track record in serving clients in this space,” states Robert Caporale, head of JPMorgan PEFS.

The new entity includes more than 130 professionals with decades of experience in private equity accounting and operations. With the enviable capital base supporting JPMorgan PEFS, it enters the private equity services universe among the top private equity firms in regard to assets under administration. Caporale adds that JPMorgan PEFS makes its debut as “one of the few fully integrated sources of fund administration and banking services,” due to the multifaceted nature of the JPMorgan enterprise itself.

Private equity is a hugely important business to JPMorgan, as indicated by its investment banking revenues from private equity, commanding 8.5% of the overall sponsor market, according to Financial Times.

“JPMorgan’s extensive experience in private equity, our proven accounting and operations expertise, and best-in-class technology positions us as the pre-eminent provider of outsourced private equity services,” says Al Foreman, head of business development for JPMorgan PEFS. “We have the industry’s best people, proven processes and superior technology. These are the three most important pillars of strength for any private equity outsourcer or servicing entity. We have the very best resources needed to develop and effectively manage high-quality outsourcing relationships with both general partners and institutional limited partners.”

This track record combined with a world-class infrastructure point to JPMorgan’s competitive lead. “Due to the work we’ve already done across the variety of funds that were raised and managed by

JPMorgan Partners, we have what I would consider the broadest experience in fund administration worldwide," adds Foreman.

JPMorgan PEFS offers a comprehensive and detailed list of the benefits to potential outsourcing clients, be they private equity firms or institutional limited partners.

Size: With a staff of more than 130 people, the risk of "single-person dependencies" is virtually eradicated for clients.

Support: JPMorgan's capital base is expansive enough to ensure business continuation, capital expansion and improvements, longevity and the resources to attract, train and retain the industry's best and brightest professionals.

Structure: JPMorgan PEFS is founded on long-term (20+ years) experience, and has proven processes that were developed through many years of experience interacting with CFOs. "Our teams are structured such that the CFO will have a primary point of contact with a subject matter expert," says Jim Hutter, chief operations officer of JPMorgan PEFS. "The primary client contact will be an accounting professional (CPA) with 10 or more years of private equity experience and a client service mentality." Surrounding that point of contact is a support team of fund managers and fund accountants. "Behind the scenes in our organization, there is more depth, because we offer a broader array of services than do many of our competitors, such as cash management, treasury, FX, and hedging services," says Hutter.

Technology: An integrated technological platform that serves as a comprehensive general ledger package; a solid, dependable master file system and a flexible reporting tool.

JPMorgan PEFS clients can also access the following reporting features through a Web-based facility:

- Balance sheet reports
- Income statement reports
- All supporting documentation for an audit
- Compliance and regulatory reporting support
- Investment roll-forwards
- Custody holdings and certificate numbers

For private equity firms, "We offer a full suite of established outsourced services," says Caporale. "Prior to the launch of JPMorgan PEFS, we had well over 100 people handling fund accounting, administration, investor tracking and reporting, as well as all the tax preparation."

For institutional investors, JPMorgan PEFS positions itself as an extension of the client's investment arm "Its not uncommon that an institutional investor might have commitments to 300 different funds," explains Caporale. "Today, that investor would get a statement from each of those 300 funds, and they need to figure out their concentration in certain segments, funds, regions, industries, exposure, etc., and where the risk lies. This streamlined analysis and reporting service is what we offer to institutional investors. This capability existed in WSS, but has now been repositioned to focus exclusively on the institutional limited partner market through JPMorgan PEFS."

An array of competencies, deep experience, as well as a track record of reliability and success, are all qualities that JPMorgan PEFS brings to market that help distinguish the entity from the bulk of the surrounding market. "Whether it is our global reach, our breadth of product, our capital base, our extensive experience or our people, we believe we offer the best-in-class outsourced administration service worldwide," says Caporale.

"If you are going to outsource, you want a provider who can respond to the rapidly changing private equity landscape. JPMorgan is well positioned to be the premier, one-stop firm for high-quality private equity administration. Our services enable private equity managers and institutional investors to focus on what they do best — building wealth."

> “Outsourcing can prove to be **the most profitable and prudent way** to enter the private equity arena.”

More Suggestions

for evaluating a potential partner’s technology:

- Look for a company that has a definitive, step-by-step transaction process, and some standardization of reporting and financial records.
- Ask how detailed, or granular, reporting will be. Overviews are fine, but if a CFO needs an answer quickly on issues such as compliance status or sources of performance, the platform should be able to deliver such information on a timely basis.
- Ask for a demonstration of the integration of the outsourcer’s platform. “Private equity is a self-contained, multifaceted process,” says Kraemer. “You have to make the investments, service them and report on them. A prospective client should make sure all those functions are cohesive and integrated. If there are too many ‘creases’ between functions, that could be a red flag, signaling the outsourcer faces impediments to doing a thorough, proper job.”
- Evaluate the technology experts in the firm as you do the service team. Can technology experts in the firm explain or demonstrate that they understand the private equity business?
- Find out if information is being transferred and transmitted in a safe and secure manner. Ask whether the firm understands how to transmit information in a way that protects you as an investor or fund.
- Are communications encrypted? Because of the rapid growth in private equity, spreadsheet programs and e-mail are often still used to transport confidential information. “This inherently puts investors at higher degrees of risk,” says Kraemer.

Another red flag: if the outsourcer has what seems to be an archaic or overly manual process, it may be unwilling or unable to make the necessary capital investment to bring its current platform up to speed. This can signal another, perhaps deeper problem, which is the capital base that stands behind the private equity services company itself.

“Look to evaluate the capital base of the outsourcer, as it can divulge their potential success for years to come,” says Kraemer, who says this factor can determine whether the servicing firm will have the willingness and ability to make critical technological improvements over the long term. If they claim to have invested in their infrastructure, inquire about what specific capital improvements they’ve made, and how these developments relate to the reporting and accounting foundation.

If a private equity services firm is linked to a strong capital base, it will likely have a lifeline and a pipeline of capital to keep technology current. “This is essential,” says Hutter, “for when regulatory, market, tax and accounting issues evolve, as they inevitably will.”

Technology: A Critical Component of Private Equity Administration

While technology plays a prominent role in the mutual fund or separate account arenas, it has an even more critical hold on private equity. For one, there’s the complexity of the business, which even a merely adequate private equity systems platform needs to address. Additionally, there’s the issue of tax. “Private equity processes and platforms are driven by tax — and soon enough, regulatory — requirements,” says Kraemer.

For private equity entities and institutional investors, outsourcing can translate into a myriad of opportunities to improve their platforms and systems, and can lead to additional benefits. “Having a third party handling the accounting function will open the door for greater transparency,” points out Kraemer.

The other issue that comes into play is the current age and stage of the industry itself. Unlike in the mutual fund or global custody areas, “Technology in the marketplace has not universally caught up to the processing requirements of the private equity business,” notes Kraemer. Private equity technology and software systems are expensive, he says, because it remains a somewhat complex, niche part of the financial services business. “Make sure to consider technology when evaluating an outsourcer,” says Kraemer. Also, he recommends that clients “factor into the equation that you’ll be able to avoid the substantial capital outlay it would require to do it yourself.”

While current platforms are paramount, Kraemer recommends that prospective clients talk to the entity about its longer-term technology strategy. “Because the industry is changing so rapidly and poised for even greater growth, what are the firm’s plans for capital improvements to existing systems?” he asks. “As the industry changes and evolves, you want to be sure your outsourcer’s systems will, too.” ○○○