

# Yearbook 2019

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**WILL AI TAKE  
OVER MY JOB?**

**WHAT DO I  
NEED TO KNOW  
ABOUT GP-LED  
SECONDARIES?**

**HOW CAN I STOP  
A TECH PROJECT  
RUNNING OUT OF  
CONTROL?**

**SHOULD I BE  
WORRIED ABOUT  
DATA SECURITY?**

**HOW DO WE  
SELL A PIECE  
OF OUR FIRM?**

**What keeps  
a CFO awake  
at night?**

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## 2019 Yearbook

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# Insight

**2019 in review** Private equity has had to manage political and regulatory pressures, as technology becomes a preoccupation for CFOs

1

## SEC gets tough

The Securities and Exchange Commission appeared to take a more lenient stance towards enforcement in the first years of the Trump administration. But the regulator swung back into action in fiscal year

2019, bringing 191 cases against investment advisors and investment companies.

This represents a 77 percent increase on the previous year, **writes Ben Payton.**

The SEC is most likely to target private funds over their misallocation of fees and expenses. Several firms settled enforcement actions in the past year,

including two cases where firms paid close to \$3 million to the SEC. The need for firms to ensure proper compliance structures and procedures are in place has never been greater, with the SEC particularly active in targeting firms where the chief compliance officer wears one or more hats. Meanwhile, the fallout from the Abraaj scandal continued in 2019. Founder Arif Naqvi is now facing criminal charges.

And the enforcement landscape will get even more interesting if the SEC pursues its plans to open private markets to retail investors. For the plan to work, regulators will have to be ever more rigorous in scrutinizing managers to ensure individual retirement funds are adequately protected.

**COULD WE BE  
TARGETED BY  
THE SEC?**

## Wary of Warren

Politics has not always been kind to private equity in 2019. Things could get more difficult in 2020, especially if a more radical candidate such as Elizabeth Warren wins the Democratic nomination for president.

The Massachusetts senator has been at the forefront of raising concerns about the way the industry operates, following a series of business failures at PE-owned companies. Her Stop Wall Street Looting Act proposes reforms that would drastically alter the regulatory ecosystem. Carried interest would count as regular income for tax purposes and fund managers would be financially liable for failed investments.

The chances of the Warren bill becoming law are effectively zero in 2020, given that Republicans control both the Senate and the White House. Even if Warren (or another progressive candidate such as Bernie Sanders) wins the presidency, they are unlikely have the votes to push the legislation through Congress. Even so, the danger of public opinion turning against the industry is a long-term concern for private equity.

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**HOW LIKELY IS  
WARREN TO  
GET HER WAY?**

3

#### Don't be afraid of AI - yet

Many fear that the anticipated AI revolution will result in massive job losses. But artificial intelligence and robotic process automation are only just beginning to make an impact in the private equity industry. And we found in our June issue that technologies that can be readily applied should allow professionals to devote more time to creative and client-facing tasks. We heard from a PE firm that

had automated its invoice processing function. This saved 2-3 hours a week - and far from making someone redundant, it freed up time consumed by a low-value task.

Relatively few firms have seriously engaged with AI. Our annual *Private Funds CFO Insights Survey* shows that 70 percent have not even reviewed its application. Part of the challenge is that AI requires a major investment in acquiring and restructuring data, when the payback may not be felt for years.

HOW MUCH  
WILL IT COST  
TO JOIN THE AI  
REVOLUTION?

“The enforcement landscape will get even more interesting if the SEC pursues its plans to open private markets to retail investors”

**\$7,500**

Maximum possible fine  
per violation of CCPA

4

#### Planning key to tech success

The potential for private funds to reduce costs and improve processes through automation means the CFO is increasingly focused on tech projects.

Our case studies of three firms that have implemented new technologies reveal a number of common themes. While it is routine for firms to outsource technology functions, a successful project relies on the firm knowing what it wants to achieve before turning to an external partner. Staying focused on

the problem and the solution is crucial if you are to avoid being distracted by fashionable technology.

CFOs also face dilemmas in how to strike a balance between pushing projects forward while also achieving widespread adoption throughout the firm. Restricting a project team to a few individuals may help rapid implementation; but can come at the expense of widespread buy-in.

HOW DO I ENSURE  
THE TEAM BUYS IN  
TO NEW TECH?

#### Privacy privations

The GDPR, the EU's data protection behemoth, has become a notorious compliance burden. Private funds (especially those headquartered outside Europe) are still confused over whether they are subject to the regulation and, if so, what they need to do to comply.

The looming introduction of data privacy measures in California, the CCPA, will further complicate the picture.

It appears the US is heading toward state-by-state data privacy regulation, a model that is inconvenient to private funds (and countless other industries) that have customers across many states. In practice, complying with the strictest state requirements is the most viable strategy to ensure firms do not fall foul of regulatory standards.

Although private equity firms do not typically collect huge amounts of customer data, protecting the data they do hold is of paramount importance. This is causing firms to focus intently on their cybersecurity infrastructure. Indeed, the CCPA imposes fines of up to \$7,500 per violation - so if a database containing thousands of pieces of personal data was hacked, the firm could face fines running into millions of dollars.

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IS THE US  
HEADED  
TOWARDS  
GDPR?

**77%**

Increase in enforcement actions  
against investment advisors and  
investment companies

**70%**

Of firms have  
not reviewed AI  
application

“ Artificial intelligence and robotic process automation are only just beginning to make an impact ”

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### Secondaries boom

GP-led secondaries deals are becoming increasingly popular. Out of \$42 billion in secondaries transactions that closed in the first half of 2019, GP-led deals accounted for some

\$14 billion. This might be

surprising to those who remember the days when a GP-led

secondaries deal was

normally a last-ditch

attempt to resuscitate a

fund that had gone badly wrong.

But in recent years, as PE firms have looked for ways to efficiently manage an investment that still has room to grow beyond the 10-plus-two-years period, they have found that a GP-led secondaries deal can be the ideal solution.

The biggest challenge is to manage conflicts of interest. The SEC takes a dim view of firms that do not adhere to the highest standards of transparency when in the delicate position of being responsible for selling assets, managing a transaction and possibly even buying a share in the same assets.

**WILL  
SECONDARIES  
GENERATE  
CONFLICTS OF  
INTEREST?**

**\$14bn**

Value of GP-led secondaries deals in H1 2019

“ Much of Luxembourg’s growth has come at the expense of the UK and Channel Islands ”

### Selling makes sense

What do you do when your firm needs a capital injection to power the next phase of growth?

Very few are now finding that the answer lies in issuing shares on the public markets. It is far more common to enter into a private transaction, often with the biggest players in the industry.

Typically, a firm will sell

a minority stake of no more than 20 percent.

In some cases, the founding partners look to monetize their shares in the firm, allowing a leadership transition to take place. But in the majority of these deals, the bulk of the capital is reinvested into the firm. This can often fuel new strategies and power expansion into new markets.

Undertaking the transaction itself is far from straightforward. Many industry insiders doubt there is a ‘typical’ way to structure a deal. Methods of valuing private equity firms are shrouded in opacity, although a best guess suggests that a firm may be worth around 10 percent of its AUM.

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**SHOULD  
WE SELL A  
MINORITY STAKE  
TO GENERATE  
CAPITAL?**

### Luxembourg rising

Our domicile survey revealed, unsurprisingly, that Delaware retains its status as the heartland of private equity. Some 45 percent of survey respondents said it was one of the jurisdictions they would select for their next fund launch.

Next on the list, level with the Cayman Islands, is Luxembourg. Both jurisdictions were the choice of 36 percent of respondents. The Grand Duchy is highly rated for its tax and regulatory frameworks and its business environment.

Much of Luxembourg’s growth has come at the expense of the UK and Channel Islands, as investors seek a European domicile post-Brexit and LPs express concern over offshore funds. Luxembourg has also been proactive in establishing limited partnership regulations that mirror those in Delaware or the UK, thereby offering reassurance to investors. This has given it an edge in its quest to be a hub for funds seeking to comply with the AIFMD.

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**WILL BREXIT  
FORCE US TO  
RELOCATE OUR  
EUROPEAN  
DOMICILE?**



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## Editor's letter

# Face the strange changes

Two weeks into the new gig, and I've already been asked, jokingly, if my professional jump from liquid capital markets to private funds journalism might have something to do with the direction public markets are headed. I certainly appear to have come to *Private Funds CFO* at a particularly exciting, and crucial, point in its history. Net asset value in private equity alone has grown twice as fast as public markets since 2002, according to McKinsey's 2019 review. Ever since Dodd-Frank, the SEC has increasingly scrutinized large, private investment managers, and even with the purported death of its 'broken windows' approach to enforcement, there's no sign it plans to loosen up.

The traditional image of private equity as corporate raiders, à la *Barbarians at the Gate*, somewhat subsided before coming back with a vengeance during the current presidential debate cycle.

As this publication heads to the printers, we are busy unpicking the punches thrown in a House Financial Services Committee hearing on the industry, titled "America for sale? An Examination of the Practices of Private Funds." It seems to have cemented private equity as a main battleground for a proxy war between the right and left over economic and financial policy (that said, fears that the hearing would represent an all-out public thrashing of the industry proved to be overblown). As the industry continues to grow, and potentially even open up to retail investors under the current SEC administration, increasing scrutiny and public attention are all but inevitable, for better or worse.

This is a publication about best practices. That's a rich topic, because, for all intents and purposes, 'best practices' are still being negotiated. LPs are pushing for more transparency and even greater interest alignment, the regulatory environment continues to evolve, and new technologies, structures and market segments – take ESG, for example – provide additional challenges and opportunities.

That is to say, half a century into the life of the private equity market, in many ways, it is yet in its nascency. We aim to help you navigate its growing pains and grasp its even brighter future. I hope our *2019 Yearbook* will give you a taste of what's to come.

Graham Bippart,  
Editor, *Private Funds CFO*

**“ I certainly appear to have come to *Private Funds CFO* at a particularly exciting, and crucial, point in its history ”**



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## Ask the CFO Give outsourcers 'narrowly defined tasks or the project won't work out'

# Q+A

With **Dimitri Korvyakov**  
Sandton Capital Partners

Dimitri Korvyakov is CFO of Sandton Capital Partners, a mid-market firm with \$900 million in assets under management, which raised its fourth fund in 2016 with committed capital of \$600 million. **Philippa Kent** spoke to him about the outsourcing lessons he's learned, his tips for fellow CFOs and his predictions about the future of outsourcing.



### Q What is your biggest outsourcing regret?

We were looking into investing in agriculture in France and we hired a research company based in India to research the market to see whether the investment would be appropriate for us. They did produce a high-level review of the French agricultural market, but not to the level for us to make any conclusions with regards to whether we could invest or not. Projects where you're not giving the outsourcer clearly defined tasks don't usually work out that well. Because they don't know your internal culture, your internal dynamics and your constraints, the results of that are fine, but not necessarily useful.

### Q What was your most important lesson learned?

The most successful projects are those when you do not leave much freedom of interpretation to the outsourcing firm, but give them very narrowly defined tasks, clear instructions and very clear expectations as to what you want them to deliver. It gives clarity to the outsourcing firm in terms of what needs to be done, it enables them to staff the project better

and we know exactly what we will get as a result.

### Q What three tips would you give to other CFOs about outsourcing?

Provide outsourcers with very specific, well-defined tasks and deliverables. Be specific about the process you want them to carry out to achieve the results. Spend time getting to know the outsourcing team and explain to them what you do and the role the outsourcing team will play in your internal process.

### Q What would you love to outsource but can't?

The perception in the industry is that valuation has to be outsourced because it requires a level of experience that you may not have in-house, but we haven't found that experience to be helpful. With small to mid-sized private companies, the use of standard valuation techniques is necessary but not sufficient to provide a good valuation analysis. It probably would work for a larger private equity firm, but for our size - and we are looking at investments between \$10 million and

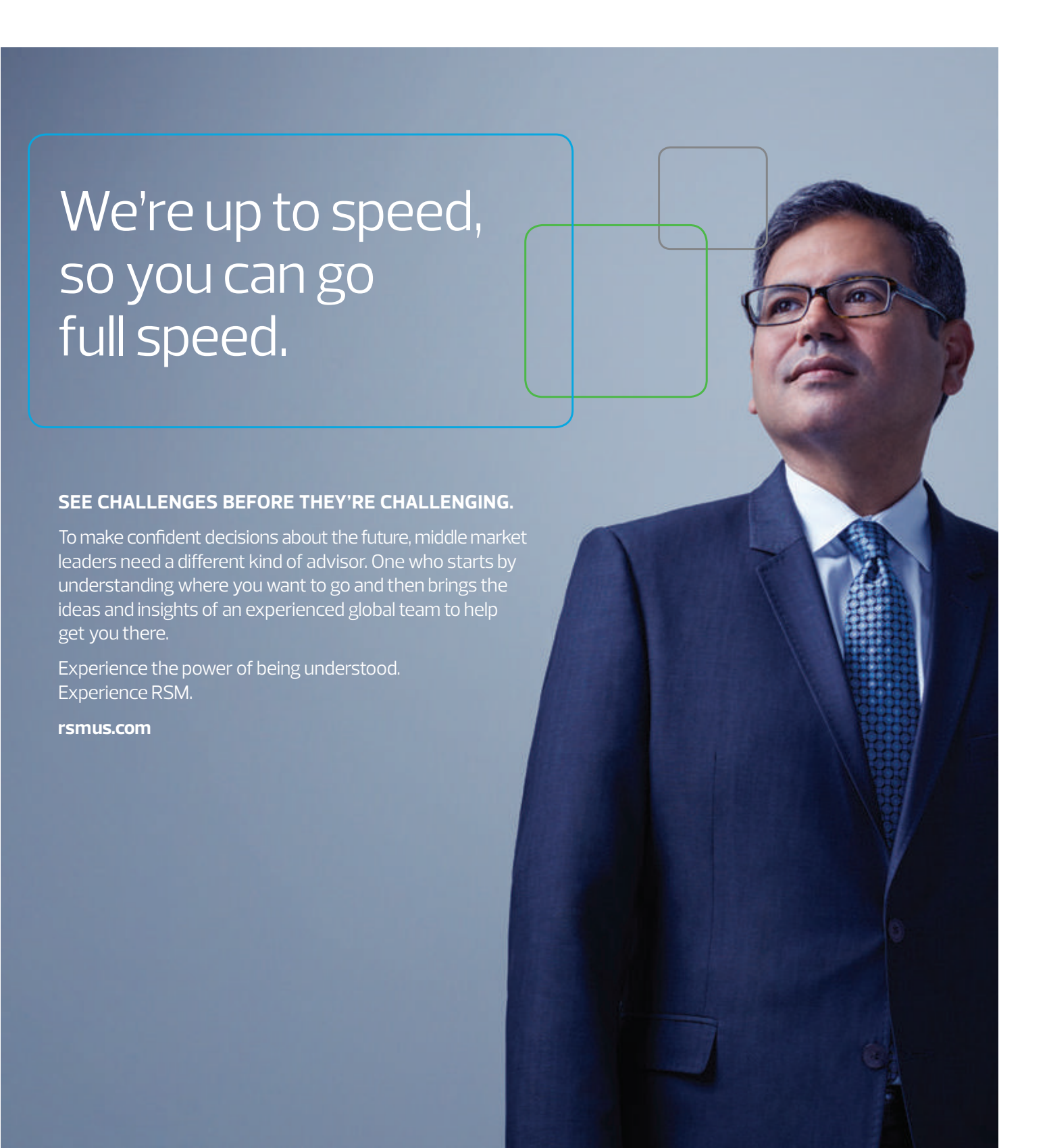
\$20 million on average - we haven't found that the value of the work justifies the cost.

### Q What do you wish outsourcing firms would do better?

You could call it a customer service issue, but to go a step deeper; companies tend to spend less time on the client - with the desire to make a profit on the project. It takes time for an outsourcing firm to get to know their clients and two or three years to generate profit from a project. Many outsourcing firms are trying to speed up this period in order to get into the green by spending less time trying to get to know who we are and what we do. It seems to me, to ensure the quality of future projects, outsourcers must start by spending a considerable amount of time getting to know their clients on a personal level, and as a business - what the investment strategy is, what the thesis is and what previous investments they have made.

### Q What do you predict for the future of outsourcing?

I've been in this industry for 15 years, and I do clearly see that the degree of outsourcing has been increasing, and I believe that the future is in more outsourcing. Eventually, a lot (maybe all) back-end activities, particularly on the operations side, will be outsourced. Outsourcing as an industry has great potential, and the most successful outsourcing firms will be those that invest into getting to know their clients better. ■



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## SEC actions

### A year in compliance sanctions

**T**he Securities and Exchange Commission's Enforcement Division has had a very busy year, **writes Graham Bippart**. In total, the agency levied \$4.3 billion in monetary penalties in fiscal year 2019, with 191 cases brought against investment advisors and investment companies – 36 percent of the total and a nearly 77 percent increase on FY 2018.

"The SEC basically is the Enforcement Division at this point," says Todd Cipperman, a compliance consultant. On the other hand, says Alma Angotti, a former senior SEC enforcement official: "They are focusing on the basics... It's a direct shift from the 'broken windows' approach they had taken for a while that had gotten so much criticism."

Actions against private funds, and individuals associated with them, appear to support that theory – most were for fundamental compliance failures, along with one for a major alleged fraud.

#### 2020 looks complicated

Here, we give a timeline of major enforcement actions against private funds in FY 2019, and summarize some key takeaways, but it's going to get more complex in 2020.

Industry players also noted actions against firms and individuals for improper valuations, as well as a high-level instance of a former SEC enforcement agent getting caught in the revolving door. He was federally indicted for allegedly leaking details of an ongoing SEC investigation into an alternative asset manager, in order to obtain a job at that manager as... CCO.

With the increase in SEC actions, proposals to loosen restrictions on retail access to private investments and to change marketing rules in the Investment Advisers Act, private fund managers would do well to get their compliance houses in order.

## Expensive fee fines

**Topping the list by volume of private fund enforcement actions (especially as regards private equity) were those taken against firms for misallocation of fees and expenses**

#### NB Alternatives Advisers

December 17, 2018

**Disgorgement and prejudgment interest:**

\$2.36 million

**Civil penalty:**

\$375,000

**Total:**

\$2.74 million

#### ECP Manager LP

September 27

**Disgorgement and prejudgment interest:**

\$122,304

**Civil penalty:**

\$75,000

**Total:**

\$197,656

#### Lightyear Capital

January 3

**Civil penalty:**

\$400,000

**Total:**

\$400,000

#### Yucaipa Master Manager

December 13

**Disgorgement and prejudgment interest:**

\$1.93 million

**Civil penalty:**

\$1 million

**Total:**

\$2.93 million

The SEC made claims against four PE firms for alleged misconduct regarding fees and expenses in FY 2019. It isn't a new phenomenon. Some of the most notable settlements with PE firms in recent years have been in this area. In 2017, TPG partners was fined \$13 million for taking accelerated monitoring fees coming from the sale, IPO and exit of portfolio companies. In 2016, it was Apollo stumping up \$53 million and KKR paid out \$30 million to the regulator for an alleged \$17 million in misallocated fees in 2015.

Lightyear became the most recent private equity firm to fall foul of rules protecting investors from unfair fees and expenses in December 2018, settling with the SEC in January over charges it misallocated expenses to its flagship funds. The firm settled without admitting wrongdoing and voluntarily agreed to reimburse investors after a 2016 SEC exam found misconduct. Lightyear paid \$400,000 to the SEC, which accused the firm of allocating expenses associated with broken deals, legal, insurance, consulting and other fees to its flagship funds between 2000 and 2016. These should have been proportionally charged to co-investors and funds that Lightyear's employees invested in. All in, the SEC said the flagship funds lost out on \$1 million in management fee offsets as a result.

Cipperman Compliance Services suggested that, with a reasonable compliance program, the firm could have avoided overcharging altogether – or discovered the problem and reimbursed investors before the SEC examination. "C-suite executives should re-think the cowboy mentality that ignores compliance until the SEC or a client makes them change," wrote the firm's founder, Todd Cipperman.

A month before Lightyear's settlement, a unit of Neuberger Berman settled for \$2.74 million for allegedly misallocating compensation-related expenses to three private equity funds it advised. The same month, Yucaipa settled for just under \$3 million over claims it failed to disclose financial conflicts of fees to funds it advised, as well as misallocation of fees and expenses.

## Dubious claims

### As far as compliance imperatives go, “don’t commit fraud” is the most straightforward

The SEC charged Dubai-based Abraaj Growth Markets Health Fund and its founder Arif Naqvi with misappropriating \$230 million of money raised for investment in healthcare-related businesses in emerging markets. The SEC claimed the money was used to cover cash shortfalls at Abraaj IM and its holding company parent. Abraaj Group folded in 2018, before any charges were levied, after investors complained about misuse of their funds, according to reports.

Naqvi was arrested in London in April. In June, a judge unsealed an updated indictment that included several other executives, laying out details of alleged deceit, bribery and personal enrichment. That indictment claimed the group manipulated the valuation of another fund, prompting speculation that LPs may renew calls for LPAs to mandate external valuations and valuation reviews. And in July, Dubai’s financial regulator fined Abraaj IM and Abraaj Capital Limited a combined \$315 million.

Abraaj wasn’t alone in being charged with fraud. Bluepoint Investment Council, its co-owner Michael Hull, his Greenpoint Asset Management, as well as Christopher J Nohl and his firm Chrysalis Financial were all charged with fraud in September for their operation of Wisconsin-based Greenpoint Tactical Income Fund. The SEC claims the men and their entities were paid \$6 million in fees even as they told investors that the fund was illiquid and couldn’t meet redemption requests.

#### Abraaj Investment Management

April 11;  
Amended August 16

Ongoing. SEC asking federal court for disgorgement, interest and civil monetary penalties. Abraaj Group collapsed in 2018; biggest private equity insolvency in history

#### Bluepoint Investment Council, et al.

September 30

Ongoing. SEC asking federal court asking for disgorgement of any ill-gotten gains, civil penalties and other appropriate relief.

## Too many hats

### Two cases illustrate that the SEC harbors a special distaste for failures in compliance at firms where the CCO also plays another executive role

#### Corinthian Capital Group

May 6

Censured

Civil penalty:  
\$100,000

Civil penalty (CEO):  
\$25,000

Civil penalty (former CFO-CCO):  
\$15,000

Total:  
\$140,000

“The SEC hates the dual-hat compliance officer model, where an executive assumes the CCO role but doesn’t really know what he or she is doing,” says Cipperrman. It is also the kind of thing the SEC likes to fine both firms and individual executives for.

Corinthian settled with the SEC for \$100,000 and chief executive officer Peter Van Raalte was ordered to pay \$25,000 for not properly overseeing its former CFO-CCO David Tahan, who agreed to pay \$15,000. All settled without admitting guilt.

The case grew out of a 2014 exam by the Office of Compliance Inspections and Examinations. In 2017, Corinthian’s auditor withdrew its unqualified opinion because the advisor had misclassified expenses (though “most of these expenses were misclassified before Tahan joined the firm,” the SEC said). That resulted in overcharging one of its funds. For three years, the firm also missed its 120-day deadline to issue audited financials to investors, violating the custody rule.

The list of alleged offenses went on: the SEC said Tahan arranged an improper loan between the fund and the firm to meet a clean-up provision on a bank credit line.

In September, Elliot Daniloff (aka Ilya Olegovich Danilov), the Brooklyn-based managing member, sole owner and CCO of ED Capital Manager, settled with the SEC for allegedly failing to provide audited financial statements for four years. The firm, a small investment advisor and manager of private funds, was also fined and censured. Neither the firm nor its many-hatted CCO admitted guilt.

#### ED Capital Management

September 13

Censured

Civil penalty:  
\$75,000

Civil penalty (managing member, sole owner and CCO):  
\$25,000

Total:  
\$100,000



## Ask the CFO 'Move from yes and no to see shades of gray'

# Q+A

With **Thomas Mayrhofer**  
EJF Capital



**T**homas Mayrhofer is CFO and deputy COO of EJF Capital, which manages hedge funds, private equity funds and structured products. He joined the firm in 2018 having previously been a partner and managing director at the Carlyle Group and CFO of Carlyle's corporate private equity segment.

### Q How has your day-to-day role changed in the last five years?

The role of the CFO has evolved along with the growth in the industry. There is an increased emphasis on the things needed to effectively manage larger pools of capital. Firms are integrating technology platforms, automating processes and enhancing data quality to build seamless operating environments across all functions within a company.

Last year, I moved from a large firm where I was principally focused on private equity to a mid-sized firm, EJF Capital, which manages hedge funds, private equity funds and structured finance products. My responsibilities are broader, but in many ways focused on the same things: how do we run our funds and our firm so that we can report reliable and timely information to the investors in our funds and the partners in the firm?

### Q How do you think the role of the CFO will change if we're faced with a recession in the coming years?

It shouldn't fundamentally change. CFOs have the opportunity to get involved in a variety of elements of the business, but at heart the role must ensure that the firm operates with integrity and produces high-quality financial information for internal and external consumption, while ensuring that the firm spends money prudently. That said, in a downturn, a

CFO should lead the way in evaluating where prudent belt-tightening is possible.

### Q As the CFO role becomes less focused on financials, how exactly do you think CFOs can excel at what they do?

First, I don't agree that the role is less and less focused on financial responsibilities. Managing the firm's financial operations and ensuring integrity in reporting is and always should be at the core of the job. As the industry has evolved and grown, the ability to put in place more robust and automated control and reporting infrastructures has required the CFO to develop a broader set of skills to oversee technology and data initiatives. Simply put, the modern CFO needs to be more involved in where the business is going as opposed to just tracking where it has been.

However, with a strong financial infrastructure in place, CFOs are often able to take a broader role within the executive leadership team managing the business. You see this as firms evolve through leadership succession and a generation of executives emerge who are more focused on using data and internal reporting to manage the business versus founders who tend to be more intuitive decision makers since they have grown the business from inception. The CFO also takes a leading role in managing

the firm's capital structure as it evolves – whether to raise debt or take in outsider investors.

### Q How much of your work do you feel could be automated?

You have to distinguish between the executive function, which is focused on culture, strategy and leadership structure, and the day-to-day financial operations that a CFO is responsible for. In a highly functioning organization, the CFO should spend as much of his or her time on the judgment and leadership elements that can't be replaced by a machine.

In the near to medium term, we will see the industry move further along the automation curve in terms of basic financial operations. Currently, only the largest managers have the size and volume to automate significant portions of their business processes the way a traditional operating company might. Over time, I expect the technology and data quality initiatives throughout the industry to drive the automation bar lower and lower.

### Q What skills would you like to develop to do your job better?

Most CFOs grow up in a binary world: yes and no, right and wrong. As CFOs progress in their careers, hopefully they learn that when someone else has a different opinion, it's not necessarily that one is right and one is wrong, but that each has a different point of view. This perspective helps when a situation requires consensus building or change management. Over the years, I have evolved along this path to see the shades of gray and other folks' points of view, but like most people I could always do a better job of walking a mile in someone else's shoes before I make a decision. ■



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## Ask the CFO It pays to get help upfront on tech implementation

### Q+A

With **Sandra Kim-Suk**,  
Norwest Equity Partners

**S**andra Kim-Suk is the new CFO of Norwest Equity Partners, a Minneapolis based mid-market investment firm. Prior to joining the firm in April, Kim-Suk was the CFO, Americas, for L Catterton, where she spent five years, *writes Connor Hussey*.

The firm has also hired two partners in the firm's Minneapolis office. NEP is currently investing NEP X, a \$1.6 billion fund which began fundraising in 2015. We spoke with Kim-Suk about her new mandate as CFO, as well as her experiences dealing with outsourcing teams, and some of the perils of technology implementation.

#### Q What has been at the top of your agenda since arriving at NEP?

Given the evolution and maturity of private equity firms as an industry, there has been an increased focus on how to manage data. We are no different – we have fund data, portfolio company data and deal pipeline data. In the past, everyone had stored that information in Excel. Now that there's an abundance of technology, it's trying to figure out how to harness that information in a way that's useful for the firm overall and consumable to our investors. There are a lot of great analyses that can be done, but trying to get to it is time-consuming and manual.

#### Q What do you have direct responsibility for?

Finance, accounting, technology. I also collaborate with our general counsel on compliance.

#### Q What parts of your firm do you outsource?

Currently, we do not outsource anything.



“Now that there's an abundance of technology, it's trying to figure out how to harness information in a way that's useful for the firm overall and consumable to our investors”

With NEP, it's important to understand what we have currently, before we go down the path of outsourcing. It may make sense in certain areas, but it's one of those things where you don't want to jump in too quickly until there is an understanding of what we have in place today.

#### Q What's one piece of technology you feel you couldn't do your job without?

Outlook, and my iPhone, are probably the most useful and both definitely something I can't do my job without. Now, that being said, we are looking at other technological solutions to move the firm overall, so perhaps in some time my answer may change.

#### Q Were you ever a party to a big tech project that turned into a nightmare?

At previous firms I have been involved in technology projects which were challenging.

One of the things I've learned after having experienced a few implementations is that it sometimes pays to get the help upfront and get help implementing. Your in-house teams may not have the skillset and/or the time to undertake an implementation.

#### Q What's the number one thing that outsourcers do that annoys you?

To really leverage the relationship with an outsource provider, you have to bring them into the fold of the team and have them understand and realize that their work is being checked and reviewed. Outsourcers who assume that they know everything and that you are there to rubber stamp things will ultimately lead to misses in controls and process. But back to something that annoys me about outsourcers: finding out that one of their team members who works on your account is leaving and then being surprised by an increase in time since they had to train a new person... that's on the outsourcer. ■



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# Private equity goes public

*Private funds have been in the political crosshairs in 2019. **Graham Bippart** reports*

It's been a very public year for private markets. As sectors like private equity have become mainstream in recent years, populist sentiment – with its suspicion of globalization and corporate greed – has spread its tentacles globally.

Rising inequality and the legacy of the Great Recession have generated debate on the impact of business and finance on voters' day-to-day lives – not just in the US, where anti-private equity political rhetoric has intensified ahead of the upcoming 2020 presidential election, but also abroad. As one COO at a private equity firm said: “Realistically, populist fervor is up around the world. That will impact private equity, whether in the US, Europe or anywhere else.”

The public finger-pointing began ramping up in 2017, when Toys ‘R’ Us filed for bankruptcy. Politicians cite the case as a manifestation of private equity avarice (despite conditions in traditional retail being infamously difficult). Then in 2018, *The Washington Post* alleged that the downfall of care provider HCR ManorCare was caused by the Carlyle Group saddling the company with debt, adding further fuel to the fires of public debate.

Since then, politicians – namely, Democrats in the US – have publicly taken the industry to task on other PE-backed failures. Shopko's bankruptcy filing in January led several party leaders to publicly denounce Sun Capital Partners. Senator Elizabeth Warren of Massachusetts and New York Representative Alexandria Ocasio-Cortez sent a joint letter to Sun's co-chief executive officers in July, demanding severance pay for Shopko employees.

Also in July, Senator Bernie Sanders of Vermont singled out Paladin Healthcare Capital head Joel Freedman over the firm's closing of Hahnemann University Hospital in Philadelphia. More recently, Sanders has attacked Great Hill Partners-owned G/O Media as an example of the supposed threat private capital represents to independent media. Warren, Ocasio-Cortez and Representative Mark Pocan of Wisconsin have also written to five private equity firms accusing them of profiteering off privatized services to prison inmates.

The scope of the attack ranges from mid-market firms to the biggest players. And not just in the US. In October, the new left-wing parliament of Denmark indicated it would tighten regulation on single-family rentals, citing Blackstone as a cause of concern in rising rental prices.

And, of course, there's the ‘Stop Wall Street Looting Act’, the legislative proposal from Warren, Pocan and three other Senators that aims to fundamentally alter the economics of private equity. The bill counts carried interest as regular income for tax purposes, and holds funds and their managers financially liable for failed investments, among other things.

Industry groups have been quick to re-



spond. The American Investment Council has been active in pointing out how private equity benefits the real economy, seeking to familiarize the public with the day-to-day ways in which the industry has impacted their lives for the better.

AIC president and chief executive Drew Maloney penned an op-ed in Iowa's *Des Moines Register*, highlighting the \$14 billion in private equity investments in the state in recent years. In a piece published by *Fox Business News*, he praised the comeback of Popeyes' spicy chicken sandwich, noting the food chain was owned by Freeman Spogli before being sold to 3G Capital in 2017.

AIC also released videos promoting private equity's impact on the economies of Texas, Michigan and Florida before the primary debates in each state. And it partnered with EY for a report which, among other things, points out that the industry paid \$174 billion in federal, state and local taxes last year.

## Unlimited liability

Warren's proposal represents the most concrete threat to private equity. “The Warren legislation would punish an industry that's an engine of growth,” the private equity firm

# \$174bn

**Federal, state and local taxes paid by the industry in 2018**





Political battle: Senator Elizabeth Warren's 'Stop Wall Street Looting Act' is increasing the scrutiny on the private equity industry



COO said. It adds that the proposal to hold funds and fund managers financially liable “would violate a 300-year-old convention that when you put money into something, you can’t lose more than what you put in.”

That part of the bill even includes LPs in its scope; a fact not gone unnoticed by the Institutional Limited Partners Association. The legislation would have holders of economic interest in a fund be held jointly and severally liable for all the liabilities of each portfolio company. “There doesn’t seem to be a carve-out for investors in the fund,” says Chris Hayes, senior policy counsel at ILPA. “But even if we were carved out it would be problematic. This runs against years of case law that establishes the principal of limited liability.”

A report published by the US Chamber of Commerce – the largest lobby group in the US – on November 13 echoed that concern. It noted the provision “is the equivalent of requiring PE funds and their principals to guarantee the performance of their portfolio companies to all of their creditors, which would just end PE investing altogether and is contrary to the principle of American business, which is to respect the corporate form.”

The paper, written by USC Marshall professor Charles Swenson, claims that the bill could result in the loss of up to 26.3 million jobs, and as much as \$475 billion in local, state and federal tax revenue, annually. In a modest-case scenario, Swenson wrote, the proposed expansion of liability would result in a 19 percent reduction of the PE industry. There would be up to a 19 percent failure rate for PE-backed companies and up to a 19 percent reduction in returns to investors in PE.

Hayes suggests there is nothing stopping GPs, if the legislation were passed as written, from taking out large insurance policies to protect themselves and charging them back to LPs as an expense – and by extension, their end investors. But perhaps even more fundamentally, it poses a risk to

the very companies the industry often tries to turn around. “Companies who need capital the most, and therefore are already at a higher risk of failing, would not be able to access capital from private equity funds,” Hayes says, since they would present a higher personal risk for fund operators.

### More scrutiny on the way

As we went to press, the House Financial Services Committee was holding a hearing entitled “America for Sale: An Examination of the Practices of Private Funds” – perhaps the first Congressional hearing on private funds since the Dodd-Frank Act, Hayes speculates.

While the hearing portends some of the inevitable political grandstanding private equity firms are wary of, Hayes welcomes the growing investor concerns in private equity. ILPA members are pushing for greater market transparency and raising their eyebrows at what they see as an ongoing erosion of fiduciary duties to LPs. “Given that some of these investor related issues are highlighted in the [Warren bill], we do expect that some of those issues will be raised and discussed at the hearing,” he says.

“Transparency and sunlight are generally bipartisan ideals that can be achieved.”

Those are issues that will need addressing if the Securities and Exchange Commission broadens access to private funds to retail investors – something the SEC has been officially considering since June. This could both produce another surge in private fund investment, as well as even more intense political scrutiny.

For the sponsors, the hearing underlines the unnerving potency of the Democratic party’s recent campaign against private equity: even if the bill is unlikely to pass, it has already impacted the broader political debate, and parts of it could find their ways into future legislation. But while the industry takes the threat seriously, few firms are ready to panic.

“People have their concerns with Warren’s rhetoric, but it’s relatively early,” says a CFO at a mid-market firm. “Around here, it’s a wait-and-see approach,” the executive adds, noting that, even with a Democrat in the White House, Republicans have a good chance of retaining a majority in the Senate. Such a result would significantly hamper a Democratic president’s ability to pass legislation hostile to private equity. ■

## KEYNOTE INTERVIEW

# Passive competition puts pressure on private equity



*Hands-off investment offerings wouldn't seem to be competing with the private equity funds, but RSM's **Anthony DeCandido** suggests they pose a real challenge for the industry*

No buyout firm touts their 'hands-off' approach to investing. On the contrary, 'hands-on value creation' has become an industry cliché that appears in virtually every private placement memorandum on an LP's desk. And GPs do plenty to substantiate their claims that they pay attention to every line in every balance sheet of a given portfolio company – and do something about them. After all, what are all those generous management fees paying for?

Given the record fundraising tallies of late, the pitch is still resonating. But elsewhere, passive investment strategies have been enjoying an even more dramatic boom. According to Bloomberg, passive overtook active investors in AUM last year, with actively managed assets at \$4.7 trillion

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and passive AUM at \$4.8 trillion. As recently as 2004, passive investing represented only \$725 billion of AUM, while active investing AUM was \$3.2 trillion.

RSM partner and financial services senior analyst Anthony DeCandido suggests that private equity firms shouldn't ignore the surging popularity of these passive offerings.

On the contrary, they might put pressure on management fees and force GPs to further substantiate the value they bring to their portfolios, especially as politicians and journalists become more vocal about the industry's size and influence.

### **Q** Why should GPs pay attention to trends in passive investing vehicles?

For investors of all types, whether they're on Main Street investor or Wall Street, there are various options, and the cost point for passive investing has the attention of many within the marketplace. As retail investors and institutions get greater access to all kinds of strategies, this will inevitably be another source of competition for private equity as an asset class.

For now, private equity's popularity is high, mainly because the return profiles have been so rich. Furthermore, when we look at the period from 2000 until today, the asset class has outperformed the S&P index by a compound annual rate of around five percent. So for sophisticated investors, I

think it's crystal clear that private equity is a preferred asset class.

But it'll be fascinating to watch as we near the end of this business cycle, what happens when those return profiles aren't achievable anymore. Because, as we all know, any organization, regardless of industry, will become much more cost conscious. And then there are broader societal trends.

**Q Are we talking about the criticism of private equity in the press and on the campaign trail?**

We are in the midst of a US presidential election season and there's still this stigma around private equity managers. Elizabeth Warren has put forth the Wall Street Looting Act that puts private equity groups in the regulatory spotlight when a portfolio company goes through bankruptcy. Democrats are hoping to achieve better protections for some of the stakeholders, whether it's health benefits, or reducing major windfalls to management and investors at the expense of employees, or communities.

But the conversation around this can easily unnerve the public and lead to criticism that causes large public pension plans like CalPERS to review their allocations. That might further accelerate the commitment to passive strategies. However, this isn't just about politics. People expect new levels of transparency today regardless of who they elect. Look back to 2012, and the conversation around the Dodd-Frank legislation, where there was a real desire for investors and all stakeholders to understand the mechanics of what these managers do.

This led to a focus on managers adequately reporting their investment thesis, their strategies and their tactics. And people have only grown more interested in these kinds of details as they learn more about how managers work. They want to understand the mission and values of their managers and ensure they align with their own, especially in terms of social responsibility and ESG.

The Vanguard ESG ETF has proven quite popular with Main Street investors, as a passive strategy that delivers returns that investors can feel comfortable earning. However, such vehicles really need to stay true to these higher standards. One Vanguard ESG offering mistakenly included the gun manufacturer Ruger this past June, and under investor pressure, had to sell the shares in August and promise to put great-

*"For sophisticated investors, I think it's crystal clear that private equity is a preferred asset class"*

er controls in place. And I think this growing trend of individuals wanting to allocate their money to places that they believe are aligned to their mission and values is only going to continue. This might benefit these kinds of passive strategies at the expense of private equity.

Some GPs might argue that they work with sophisticated investors who may have their own ESG concerns, but these LPs will find the right solution within the asset class, and not venture into some passive strategy instead.

It's not merely public criticism. This is about the business cycle, coupled with those transparency issues. We're monitoring the middle market, which is the DNA of the client base we serve. And while we've enjoyed a robust M&A and private equity climate of late, there's some telling signs that the business cycle is coming to an end, with some kind of slowdown on the way.

And then what? We're all guilty of being

a bit more cost conscious when the market retreats, particularly when there's not enough delta between the private equity and passive strategies. That preference for the cheaper option is just human nature.

**Q So if a GP were take these passive strategies as a factor, how should they respond? How do they argue that they're still worth those fees?**

Their value proposition will always include some element of helping to drive a company's operating agenda. When that GP shows up to invest in that industrial business in Iowa, there are relationship synergies that are going to improve that enterprise and make it more valuable during that three- to seven-year period of ownership, a period that can allow them to weather a tough economic climate.

And GPs are already willing to reduce fees, though this is clearly isn't ideal. The traditional 2 and 20 percent model has now become something closer to 1.6 and 16 percent. Though it should be noted that it's debut funds where firms are looking to offer more favorable terms. I don't think top quartile firms are looking to compete on fees anytime soon.

But I do think private equity groups will need to up their game on technology. Let's face it, passive management strategies have benefited namely because of the technologies they've implemented that deliver value creation with near zero marginal fees.

So private equity groups are also going to have to look for ways that they can continue to drive their return profiles by leveraging technology. So we see it in ways they're using satellite imagery or geolocation, or other mechanisms to get an edge in evaluating the markets that they operate in.

A classic example would be if a GP were investing in a financial institution or a credit union, and they pull the data on credit card usage for that institution. They could then scale that for thousands, even millions of people, and use that particular data point to improve the operating agenda for that credit union.

Today's sophisticated technologies may allow these passive strategies to thrive without that active manager. But they can also empower GPs to make even better decisions around value creation and maintain their status as an asset class worthy of those fees, and their investors' goodwill. ■



# How robots are changing private equity forever

*The revolution has begun. In June, we asked what the advent of robotic process automation and artificial intelligence means for your job*

In our inaugural issue, we delved into the world of AI and robotic process automation and shone a light on how these emerging technologies will transform private equity. For many, the mere mention of 'AI' sends a shiver down the spine, as they imagine clearing their desk to make way for a super-efficient robot that can work more efficiently at a fraction of the cost. But, as we found in this story, the reality of the AI rollout will be very different for the private funds in-

dustry – though it will certainly raise challenges. Automating routine (and often mind-numbing) processes should in fact free-up professionals to apply their human brainpower in more useful ways. Yet, for smaller firms in particular, it will not be straightforward to justify the costs of applying and scaling tech solutions.

We can be certain that this topic will remain at the top of the CFO's agenda, as firms find new ways to make use of AI.

Cloverlay is not your typical mid-market firm. It is young – founded in 2015 – and bills itself as an investor in “adjacent private markets” through co-invests, platforms, joint ventures, fund restructurings and secondaries. Like many private capital firms, however, Cloverlay is a “slim shop,” says principal and CFO Omar Hassan. The firm has 12 full-time staff managing approximately \$360 million. It will soon raise Fund II with a \$400 million cap, according to market sources.

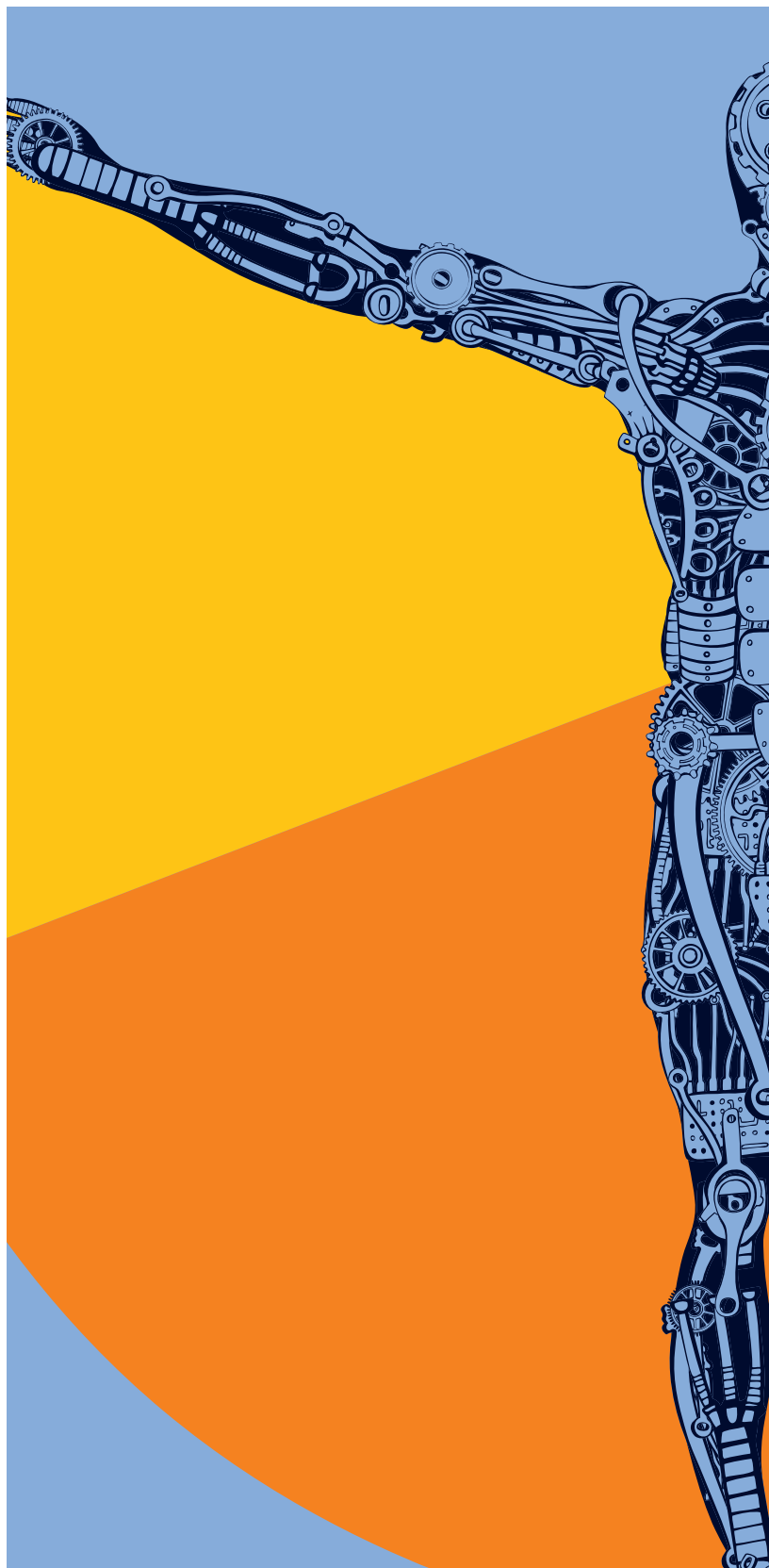
Processing invoices used to be a thankless job that required a lot of human hours and “you really needed to get it right,” says Hassan. Thanks to robotic process automation, for the last two years this has not been the case. Supplier invoices are now sent to an email inbox at Cloverlay; the invoices are scanned, information extracted, and costs allocated to the appropriate funds or cost centers for sign-off.

This was never a massive volume task for Cloverlay; the firm processes anywhere between five and 15 invoices per week. But the human intervention typically required to allocate the expenses with consistency meant headaches and human error. The robot, which has been taught how invoices from various suppliers should be coded, now takes the strain. Humans are not removed entirely from the process, but by the time a human is involved around 85 percent of the work is already done.

It took Cloverlay between four and six weeks to get it up and running and complete the necessary testing. The firm worked with a consultant; “in the grand scheme of things it was pretty painless,” says Hassan, who has discussed this with other CFOs at similarly sized firms, but has yet to come across a peer doing the same thing. A lack of volume is a commonly cited reason, he says.

If you’ve not come across RPA before, it is – put simply – a way of getting a piece of software to undertake simple rules-based routine activities. Think of a program that can open emails, access databases (it has its own log-in, like a human), gather data, fill out forms and perform calculations. It is best suited to repetitive, rules-based tasks that involve structured data. Among the leading providers of RPA software are Blue Prism, Ui Path and Automation Anywhere.

Giant financial services firms have





already caught on. In the space of 20 months, Royal Bank of Canada's wealth management division used Blue Prism software to save 153,000 hours of direct manual work, which in turn equated to circa 170,000 hours "given back" to the bank (the extra 18,000 hours comes from not having to correct errors). One process that formerly took a human around six hours is now completed in around 10 minutes by Blue Prism's bots.

Most private equity firms are not of the same scale of RBC. This should not preclude them employing RPA within their operations, as the Cloverlay example illustrates.

At the private equity coalface, however, "many smaller PE houses operate on spreadsheets rather than purpose built systems," says Ben Booth, chief information officer for fund administrator Ocorian.

We asked 15 CFOs of mid-market private equity firms how many used an automated waterfall calculation tool, and – in support of Booth's assessment of the situation – only three said they did, with respondents saying their waterfall was either too simple or too complicated to automate.

But the industry is changing. What could be called enterprise resource planning solutions for private equity – systems provided by the likes of eFront, iLevel and Investran among others – are starting to proliferate.

Automation will pay a huge part in the next generation of improvements. Eisner-Amper's Jay Weinstein, managing partner of markets and industries, explains how his firm is channelling resource into producing 'bots' that are capable of automating major processes within PE firm operations.

As an example, a fund may have month-end reporting for thousands of investors that they are currently recording on Excel spreadsheets. These spreadsheets include

numerous calculations, which they spend hours producing. A bot can automate the spreadsheet and eliminate the manual inputs and reconciliations to validate those investor calculations.

"Those tedious reconciliations can take two or three days to complete," says Weinstein. "And with the bot, the staff is freed up to handle more interesting and productive work, while also enhancing accuracy by limiting input errors."

These technologies allow firms to migrate to an exception-based review and reporting process, so that staff are not looking at every number or calculation, only those that represent aberrations, say when a data point communicates a loss, when the market for a particular portfolio company is booming.

### RP-nay

RPA may not be for every firm. Partners Group – a private markets firm with \$83 billion in assets under management across multiple asset classes – has a 90-strong technology team. The firm recently worked with a consultant to analyze the firm's operations to see where RPA could drive efficiency. The result came up negative. "Because we are quite tightly integrated from the front office to our database, we did not find a single place where we could get upside from RPA," Raymond Schnidrig, Partners Group's chief technology officer, tells Private Funds CFO.

"A typical application is when reconciliation is needed between two systems that are not talking to each other. We don't have much of that."

Partners Group does deploy software robots to conduct regression testing when implementing new software. "We have quite a big bank of internal developers either building or buying in software," says Schnidrig,

"We have to test this and use robots to do it, which is quite standard I believe."

What would it take to make RPA more relevant to Partners Group? "The heavily rules-based RPA methods would have to become more intelligent, with more variable input and output handling; this could result in coverage of more use cases," he says. "Then it might become more applicable to lower volume work."

Which leads us on to artificial intelligence. There is much excitement around how AI will change private equity firm operations. A survey conducted in late 2018 by fund administrator Intertrust found that 91 percent of private equity professionals believe AI will disrupt their sector within the next five years.

So how does artificial intelligence differ from RPA? Definitions of these types of tech can be slippery (and debated fiercely by technologists). Consulting firm CBF Bots puts it like this: "On the most fundamental level, RPA is associated with 'doing' whereas AI and ML is concerned with 'thinking' and 'learning' respectively. Or brawn versus brains, if you like."

Taking the invoice processing example: RPA knows what steps to take, because it has been told, but it may require AI to read the invoice and consider where to find each bit of the data it needs.

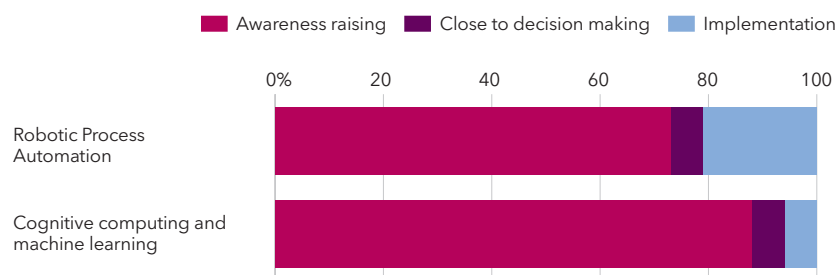
By this definition, AI is already hard at work in many private equity firms. Anyone using an expense system that scans pictures of receipts taken with your phone and transforms these into a claim – such as SAP Concur – is already working with it.

AI is also more often characterized by its ability to take oceans of data and discover patterns that humans cannot. And this is where private equity firms are starting to use their imagination.

Returning to Partners Group: the firm worked with a niche provider to develop an AI approach to identify negative news about its portfolio companies. This resulted in the creation of a bespoke tool used by its ESG team as part of its due diligence and portfolio monitoring activities. The firm has several thousand portfolio companies around the world, so to use conventional search engine notifications would have produced too much "noise" for humans to sift through. The AI program does the sifting.

Most private equity firms do not have many thousands of portfolio companies to monitor. Indeed, most do not even have

**A significant minority of private equity firms have begun implementing RPA; less so machine learning**



Source: KPMG

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ESG teams. What all private equity firms have, though, is a need to source deals.

A million analysts to look at a million companies? How about one investor to look at a million companies? This is the vision presented by Paris-based growth equity investor Jolt Capital.

Jolt is a relatively new firm, having been established in 2012 with backing from Temasek subsidiary Vertex Ventures among other investors. It has a team of 11 and right now it is raising its fourth fund for which it is seeking around €200 million, according to market sources. It is not a private equity giant, but the expectation of its partners is that one day it will be.

Jolt's ability to scale should be greatly enhanced by its investment in a proprietary AI-driven software platform, Jolt Ninja.

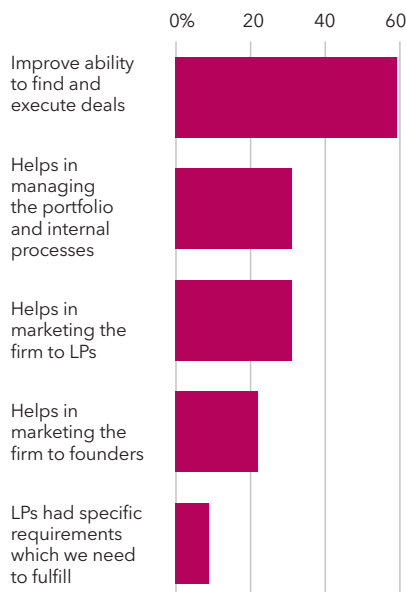
Ninja monitors a vast array of open source and third-party information services to find suitable investment targets. Since starting development in 2016 and going "live" in 2018 it has led to two bolt-on acquisitions for portfolio companies and one new investment for the firm. Another Ninja-sourced deal is due to be announced imminently, managing partner Schmitt tells *Private Funds CFO*. This is impressive for a firm that is not a volume player.

Jolt's target investment universe is opaque and not easy to map; at least not for the human brain. Ninja, however, ingests data from open web sources, like company websites, as well as closed ones like subscription databases. It takes in datapoints from LinkedIn, news sources, patent filings, events and other data sources numbering in the hundreds of thousands. It uses natural language processing software to extract relevant information and build graphs of people, companies, revenue numbers and distribution agreements with resellers.

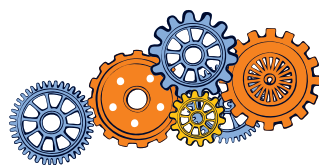
It has ingested and processed information on over 300,000 companies. Now half of all Jolt Capital's outbound deal sourcing is led by Ninja's recommendations.

Ninja even tailors its recommendation depending on the preferences shown by each member of the investment team. What's it like working with this type of robot? Much like working with a rookie human who responds well to training. "Every week I get an email saying that here are the companies that have been matched by Ninja," says Schmitt. "At the start, probably only one in 20 leads would be interesting, but the more I tell it what I like, the better it gets."

**Finding and executing deals was the most commonly cited motivation for VC firms to increase or improve their technology stack, according to a 2017 survey**



Source: Blue Future Partners' survey of 137 VC funds, 2017



*"To be effective, machine learning needs millions, if not billions, of data points. And many firms are still in the process of structuring all their data into a 'single source of truth'"*

**JASON BINGHAM**  
Sanne

Such a program is not cheap to build. Schmitt does not give a figure for the investment, but the project has been the work of three full time engineers reporting into chief technology officer Philippe Laval and four analysts since work began on it in 2016.

Exciting as it is, has it been worth it? If Jolt were to remain a small player – raising less than €100 million per fund – then the answer would be no, says Schmitt, but this is about scalability: "We formed Jolt in 2012 and are growing fast. We asked ourselves what firm we wanted to be when we reached €1 billion in AUM. We are now more scalable." Ten percent of Jolt's revenue will continually be invested in Ninja.

Side note: the existence of Ninja has, says Schmitt, had a deep impact on the partners investing behavior; they feel they can negotiate on a different footing. "Most people are worried about losing an opportunity. We are less worried about losing a deal because our dealflow is so robust."

### Robots finding deals

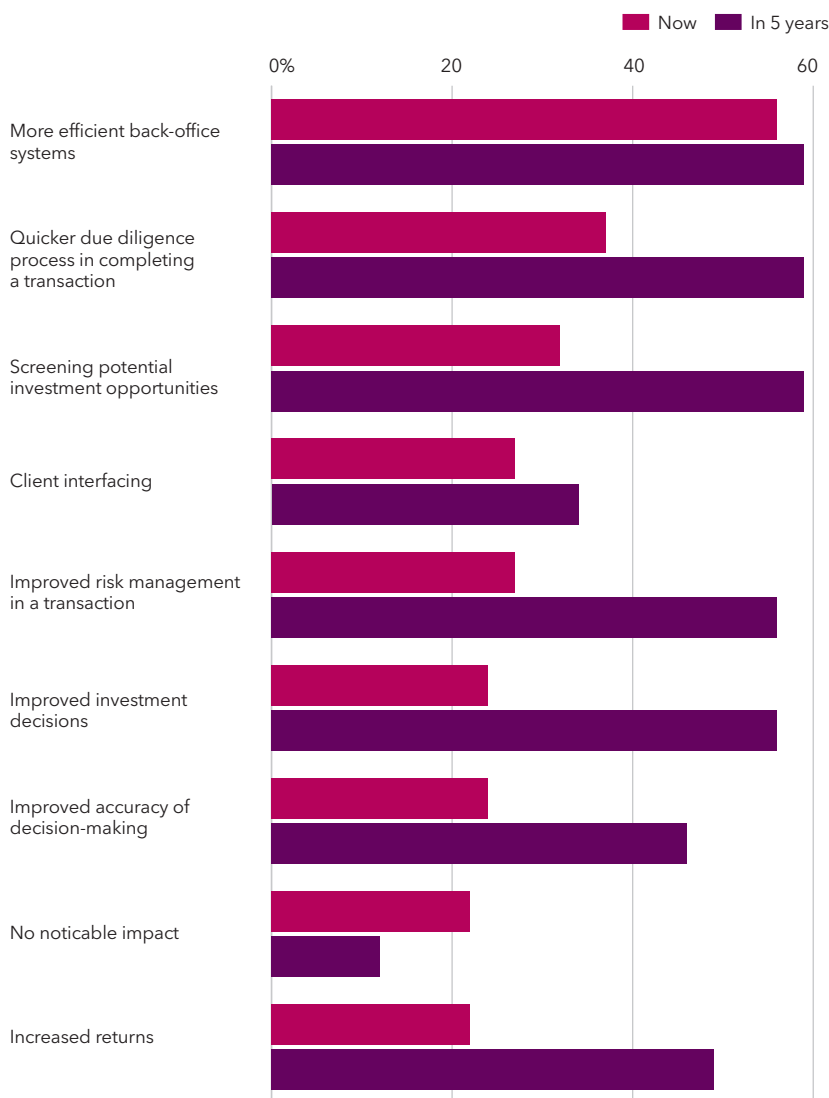
The ability to find and assess investment targets is clearly where many firms see the future. While a young firm like Jolt Capital is looking outward at what data it can absorb, firms with decades of their own data are looking inward. One is Riverside, a global firm focusing on businesses with enterprise values of less than \$400 million. In private equity terms – certainly in the lower mid-market – Riverside is a volume player, with more than 90 companies in its portfolio. The firm has made more than 600 investments since it was founded in 1988, so within its vaults is an ocean of data to analyse.

Before this dream becomes a reality, Riverside must overcome an obstacle that will be familiar to many of its peers: organizing and structuring data that is currently "scattered around a dozen or so" different internal systems.

Chief information officer Eric Feldman tells *Private Funds CFO* that the firm's leadership dreams of being able to look at a small manufacturing company in Omaha and immediately analyze hundreds of thousands of comparable businesses around the world in a way that none of the humans around the table could.

Implementing the AI technology is the easy part, experts say. What's difficult and can turn firms off the whole idea is the creation of one data source. Before firms can

A survey by a fund administrator in 2018 asked where private equity firms believe digital innovation was having the greatest impact currently, and five years from now



Source: Intertrust

take advantage of AI technology, automation processing and robotics, they have to go back into their data and create a data warehouse.

“Surprisingly, the single ‘source of truth’ approach to deal-management enabled by effective data warehousing was not adopted by a large margin of funds until very recently,” says Michael Asher, chief information officer of RFA, a service provider with a focus on technology.

“By doing so, GPs can build algorithms that look at portfolio data from all phases of the cycle holistically and say, ‘Well, this is a great deal’ or ‘Our research indicates this is

something that we should be looking at.’”

In other words, AI requires an enormous amount of data to learn from, says Jason Bingham, managing director of product development for the fund administrator Sanne. “To be effective, machine learning needs millions, if not billions, of data points,” says Bingham. “And many firms are still in the process of structuring all their data into a ‘single source of truth.’ Much of the ‘big data’ captured in the past five years does not as yet have a long enough time series to be properly validated and may be more commonly used by firms five years from now.”

## Luddites will be proved wrong

So we are all agreed: robots are great. But how afraid should members of the knowledge workforce be as automation eats into their workload? A recurring theme among CFOs and service providers is that this next wave of technology is about maximizing what current staff can do. The asset class tends to staff leanly as a rule and every firm aims to do more with less.

“We are looking for how many hours automation can save, not just now, but during future growth as well,” says HarbourVest’s CFO Karin Lagerlund.

“So, we fully expect to be able to increase efficiency, without necessarily increasing our accounting staff.”

Cloverlay provides a case in point. Processing invoices was never a full-time job – two or three hours a week typically. Instead, the hours “given back” allow operations professionals room for creativity.

“It allows us to step back and say, ‘What do we want to spend our time on?’” says Hassan.

For many it is difficult to imagine a world in which robots take on human tasks and the result is not human job losses. But as ever, the picture is more complicated than that.

For small, young, lean firms with ambition, automation provides tools to scale quickly. In the case of giant firms with legacy systems, we are more likely to see repetitive finance jobs replaced with technology positions.

We have grown used to the idea that the role of the private fund CFO transcends finance to encompass wider operations and projects. In the automated world this will be more so than ever. The future-proof CFO will be adept at managing IT projects... or hire someone else who is. ■



This is an edited version of the cover story from the June issue of Private Funds CFO. For the full article, go to [privatefundscfo.com](http://privatefundscfo.com)

# KEYNOTE INTERVIEW

## London calling for US managers



*More and more US investment managers are listing funds on the London Stock Exchange. JTC's Wouter Plantenga and Simon Gordon discuss why it makes sense*

### **Q What attracts US managers towards a UK listing?**

**Wouter Plantenga:** Currently there is a lot of competition for capital in their home market, which gives US managers an incentive to try to find a new pool of capital. That's a driver towards the UK, where they can get access to a relatively sophisticated institutional investor base and a financial system and equity capital market that offers the level of infrastructure that US managers are comfortable with.

British investors are also often looking to diversify portfolios away from Europe, and so there is an appetite there for US investment funds. Since 2017, over \$5 billion has been listed by US-based managers on London investment fund markets.

The other element is the fact that the UK is a less regulated environment, which

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**JTC**

offers more flexibility in terms of fund structures than the US.

**Simon Gordon:** Often investment trusts that are listed on US exchanges go to IPO and end up trading at a discount, which is not good news for the US manager. In the UK, by contrast, closed ended investment trusts have this ability to grow from a relatively low IPO size through just issuing shares in secondary issues. In the UK, a manager can do an IPO at £150 million and grow that. Over five years it is not uncommon to grow to £1 billion-plus through more and more secondary raises and issuing more shares.

There are also tax laws in the US that force listed managers to distribute a certain amount each year, resulting in less flexibility around the ability to roll up capital for reinvestment.

### **Q What type of US manager is most likely to be interested in a UK listing? Does it appeal to some asset classes or types of funds more than others?**

**WP:** If you look at the US funds that have listed vehicles over the past few years, there have been various asset classes, including energy, renewables, private equity and hedge, so it's hard to pinpoint a trend. There is certainly an argument that more energy and renewables managers are going in that direction, in part because the London Stock Exchange offers a more stable



financing proposition and the investor base is more interested in sustainable finance and ESG-type investments.

**SG:** The underlying theme over the last few years has been yield cos, so anything that can generate income is attractive to the institutional investor market via the LSE. The LSE is open to alternatives beyond equities and bonds, and the type of manager looking at the UK is a manager who either is already investing in an asset class that generates a reasonable level of yield, or one who wants to open up a new sub-investment strategy that they have not done before.

For example, maybe they have been doing straightforward private equity investing in the energy sector and they want to start investing in renewable energy infrastructure projects. They can diversify that strategy and it is popular with investors as long as there is that underlying theme of yield.

Whether there is going to be a clamour for a greater element of growth in those funds remains to be seen – at the moment, yield and income are the attractions.

**Q** From your experience, are there any top tips or common pitfalls that US managers considering a listing in London should know about?

**SG:** The number one rule for US managers coming into this market for the first time is to speak to a London advisor as early as

possible. There are lots of great brokers and legal advisors in London, and my advice would be to speak to two or three brokers early on in the process. They will be able to offer first-class advice on how attractive the proposed strategy is going to be for London's institutional investors.

It is quite a small community of people, so the brokers will know who they are going to market the opportunity to. They will also be able to work with a manager to tweak the proposition and make it as attractive as possible to those investors. The pre-marketing is very important to make sure that managers meet the numbers they are looking to achieve in an IPO.

There is also a cultural difference between the US and the UK when it comes to lawyers and other service providers. They will all bill on an hourly rate basis in the US, whereas in the UK a manager will be given a fixed fee quote. Often, US managers will come here with a fear of running up bills very quickly, but that is not how advisors operate in the London market.

**WP:** For US managers going abroad, there is often a fear of the unknown. London offers an Anglo-Saxon framework, which is helpful, but it is also critical to connect with the right providers from a professional standpoint.

**SG:** In the UK, it can take months to IPO and you need to deal with regulations like AIFMD, which US managers are not familiar with. There is a danger that US managers over-egg the AIFMD pudding by thinking that they need to go for full AIFMD passporting, when actually that is rarely the case.

There is a lot of flexibility in the process and the team at the LSE is really helpful, so advisors can run a prospectus past the listing authorities and there is quite a collaborative process that goes on.

**Q** How do you expect the attractions of the London market to develop? What are your predictions for activity in 2020?

**WP:** It is obviously difficult to make predictions at the moment, but the Brexit uncertainty will eventually pass and I think we will see a very attractive environment, potentially supported by the government as it seeks to attract capital into the market again.

**SG:** In 2018, there was quite a lot of inter-

*“There is a danger that US managers over-egg the AIFMD pudding by thinking that they need to go for full AIFMD passporting”*

**SIMON GORDON**

est from US managers looking to list on the London exchanges. This year, there has probably been a bit less activity, and there have not been many IPOs of funds generally. The two that we have dealt with for US managers this year have both been in the renewable energy space, but it has been slower for new listings.

The income-generating funds that are already in the market, whether they are RE-ITs or renewables, have done extremely well on the secondary raising market and have been oversubscribed a lot of the time. So that is a clear sign that there is a lot of cash out there looking for the right products.

At the moment, due to Brexit and political uncertainty, the exchange rate for the pound against the dollar has been extremely volatile and investors are a little nervous about investing into new products. Once we have got this out of the way, hopefully early next year, then sterling should be a little less volatile and I think by the second quarter of next year we will see an uptick in the number of IPOs coming to market.

I believe we will continue to see a lot of activity around renewables, but we will also see more innovative products come through, like the music royalties fund that listed earlier this year and was very successful. ■

Wouter Plantenga is the US-based head of group client services at JTC.

Simon Gordon is the London-based director for fund and corporate services.

*“The LSE offers a more stable financing proposition and the investor base is more interested in sustainable finance and ESG-type investments”*

**WOUTER PLANTENGA**

DATA PROTE



PROTECTION

# Prepare to do battle with data privacy

*In our July/August edition, we looked at how new regulations around data governance are coming to a state near you*

So far, the GDPR's bark has been worse than its bite. European regulators have tended to hand out only minor fines for breaching the data privacy directive. But multiple experts told us that enforcement is about to get harsher – and we found widespread confusion among private equity firms on what they need to do to stay compliant. We are now just weeks away from the rollout of the California Consumer Privacy Act (although last-minute amendments have now pushed back some aspects of the law). Much like with the GDPR,

it is unclear how widely the CCPA will be enforced. Could any firm with investors in the Golden State be exposed to fines for data privacy breaches? Our prediction that many firms will opt to play it safe and comply with the strictest privacy standards looks like it is being borne out. Microsoft, for example, has promised to conform with the CCPA across all its US operations. Even if private funds tend not to harvest customer data on a vast scale, compliance teams certainly have plenty to do as we brace for more onerous data regulations.

€ 56 million: that's how much European authorities had imposed in fines on companies that breached the EU General Data Protection Regulation by February this year, nine months after the law's introduction. Admittedly, that amount has been spread across more than 200,000 cases – equating to an average penalty of €280 – but experts predict regulators are just getting started.

Alex Scheinman, a director at ACA Compliance, warns that since GDPR has been around for a year, regulators will be handing out more fines.

“The supervisory authorities in the EU are indicating that we should see a significant increase of firms that are subject to monetary penalties,” he tells *Private Funds CFO*.

“We should expect to see more and more of these fines beginning sometime later this summer and this should serve as a wake-up call for many private equity firms that have not been paying attention or have taken a wait-and-see approach with respect to GDPR enforcement.”

If you are having doubts over whether your firm is compliant – or even needs to be – you are not alone. “I don't think anybody is compliant,” says one Europe-based chief compliance officer of a US private equity firm. “I regularly meet with other compliance officers and have observed a wide range of GDPR implementations. It's difficult to know how to comply without unnecessarily going too far.”

Even after putting in place what they consider to be a best practice program, it's

still difficult to know if they are fully compliant, the CCO says, stating that GDPR as a whole is “overly complicated” and based on an “ambiguous set of rules.”

### Complying in the US

Chances are that you have already considered the implications of GDPR and either enacted a compliance program or decided it does not apply. It is a European law but applies to those outside of the EU, Dan Silver, a partner at law firm Clifford Chance tells *Private Funds CFO*.

A US-based fund manager must comply with GDPR if it has a physical establishment or operations in the EU and processes data in connection with that physical location or if it offers goods or services into the EU.

“It's not crystal clear what the latter means in the fund context, but we usually interpret that as actively marketing a fund to EU investors and, in particular, to individual investors,” says Silver.

If you are in the decided-it-did-not-apply camp, it may be time to think again.

The California Consumer Privacy Act comes into force on January 1, 2020 with a one-year lookback provision, so it is essential private fund managers understand how it affects their data operations now.

The law requires companies to inform California residents: which of their personal data the company collects or holds; the purpose for which it was collected; where the company got that information; how the information is being used; whether the information is being disclosed or sold; and to whom the information is being disclosed or sold. Under the law consumers have the



DATA PROTECTION DATA PROTECTION DATA PROTECTION



right to request to opt out of a business selling their information, to access any personal information the business has stored and to the deletion of any personal information the business has stored. Businesses will also be obligated to provide an opt-out page or link on their websites' homepage that notifies consumers of their right to not have their personal data sold.

The CCPA was inspired by the GDPR, but while they share some similarities there are key differences to keep in mind with geographic scope being the most obvious. That said, for the CCPA, it is less than clear what "doing business in California" means, says Silver. "It will likely apply if you have a physical presence in California or have California-domiciled investors."

Those businesses complying with that hazy definition are required to comply with CCPA if they have revenues over \$25 million or data on 50,000 or more residents, households or devices, or if 50 percent of the business's revenues are coming from selling personal information.

The two regimes are also subtly different in how they define personal data. In broad terms, both include any information that could identify a person, including name, email address, date of birth and phone number. The CCPA goes a little further in terms of including data that identifies either person or household, says Silver.

Penalties for transgressions differ. A breach of GDPR could be as much as 4 percent of global revenues or €20 million, whichever is greater. For the CCPA it's \$7,500 per violation, and the violating company will be subject to an injunction. The CCPA also allows fines for statutory damages of between \$100 and \$750 per person.

"If you have a database with covered per-

sonal data – for example the bank account numbers of a million Californians – and a hacker got in and stole that database, there would be potentially a class action filed against you for \$750 million, even if the hackers didn't do anything with that database," says Ed McNicholas, a partner at law firm Ropes & Gray.

Both data privacy laws allow individuals or customers to request access to any personal information that a business may have collected about them. GDPR requests must be complied within 30 days (with a possible 60-day extension), while CCPA requests must be dealt with in 45 days.

### Personal data: what counts

Private equity firms are not – for the most part – in the business of vacuuming up oceans of personal data and monetizing it. For some, particularly those with only institutional investors, this is enough to feel compliant with either GDPR or CCPA. "In my view, the only way a private equity firm would be directly responsible for that data is if you have multiple portfolio companies that are consumer facing," says Sanjay Sanghoo, CFO and COO of Delos Capital, a lower mid-market private equity firm based in New York.

For Sanghoo, the robustness of the firm's cybersecurity is the most relevant part of data governance. Delos has a compliance consultant that comes in quarterly to review the results from its IT consultants and security tests. They also express opinion about best practices seen at firms that can be implemented. "From the perspective of HR or protecting the information of our investors, which is obviously a huge focus for us, our cybersecurity set-up is very robust," Sanghoo adds. "Our default position is that we





*“The SEC is putting some teeth behind that rule and the industry needs to pay attention”*

**GUY TALARICO**  
CEO of Alaric Compliance  
Services, on Regulation S-P

do not share data with anyone, unless either legally required to do so, with explicit permission to do so from an employee or investor, or with a prior understanding of what information we need to share in the ordinary course of business.”

So exactly what personal data does a typical firm gather? “We have mainly three kinds of personal data that we process,” says the Europe-based compliance officer. “First is investor data. All our investors are required under local KYC and anti-money-laundering regulations to provide certain information to us. Second is the information of our employees. We also handle third-party personal data, which can be related to service providers, portfolio companies and current employees.”

The same CCO also mentions having to keep track of data regarding individuals interested in working for the firm.

Job applicants’ résumés are also noted by Fredrick Shaw, chief compliance officer of NASDAQ-listed private equity investor and advisor Hamilton Lane, as data that needs to be considered PII (personal identity information). “It was apparent to us that we have obligations to these people now, even if we never speak to them, even if their résumé is completely off-base.” As

a side note, job applicant data will likely be taken out of the CCPA definition; an amendment approved by the California Assembly on May 29 saw collection of personal information from job applicants, employees, contractors or agents removed from the legislation.

### The SEC’s warning shot

So if you haven’t been caught by GDPR, you may have to comply with CCPA... and then there is good old Regulation S-P.

The Securities and Exchange Commission’s rules on safeguarding customer and client data have been around for nearly two decades, but a risk alert released by the commission in April is a signal that examiners are going to be paying closer attention to this. “It’s an old rule being looked at in a new cyber world. The SEC is putting some teeth behind that rule and the industry needs to pay attention,” says Guy Talarico, CEO and founder of consulting firm Alaric Compliance Services.

Greg MacCordy, a former SEC industry expert who now works alongside Talarico, rams the point home: “Every Office of Compliance Inspections and Examinations team that is going out, even if they didn’t participate in this set of risk exams, will be looking for this in a firm’s policies and procedures.”

Regulation S-P “requires a registrant to provide a clear and conspicuous” privacy notice to customers or clients when the initial customer relationship is established, annually and opt-out privacy notices if a customer or client doesn’t want personal information shared with third parties. Registrants must also have adequate written policies and procedures that address “administrative, technical, and physical safeguards for the protection of customer records and information,” according to the April risk alert. This regulation only concerns private equity firms with individual investors.

SEC-registered firms will certainly have considered and made some effort to comply with S-P (although the aforementioned risk alert highlights some common compliance shortcomings).

In general, federal privacy regulation will have a complicated relationship with the state privacy laws, says Ropes & Gray’s McNicholas. “Right now, anything processed pursuant to GLBA (Gramm-Leach-Bliley Act), which was the source of Reg S-P, is exempt from the CCPA. If

other states don’t allow for that exemption you could have a fight over pre-emption,” he says.

Pre-emption is when a state and federal law contradict, and the federal law supersedes the state law because it is ranked higher under the Supremacy Clause in the constitution. Reg S-P and CCPA overlap because they both enforce the idea of keeping data safe by having proper policies and procedures in place to ensure security.

“The CCPA goes beyond that by imposing additional restrictions on what you can do with personal data,” Silver says. “For example, it requires that you give consumers the right to opt out of the sale of their data and also provide a detailed disclosure as to how you plan to use that data. This is far more aligned with the GDPR approach.” “We could easily see litigation over pre-emption or litigation over the constitutionality of the CCPA,” McNicholas adds. “For instance, when California put out a financial privacy law years ago there was a long-running battle about whether or not it was pre-empted by the Fair Credit Reporting Act. After many court battles it was decided that it was partially pre-empted.”

After the CCPA was passed, a number of US states started to push for their own privacy laws similar to California’s. If the US adopts a state-by-state model, then private equity firms have to start coming up with a plan now to get ahead of the wave.

“We’re providing guidance to our private equity clients. The first thing they need to do is to really figure out if the law applies to them, and if it does, what kind of data are they collecting that they would have to worry about,” Bonnie Yeomans, special privacy counsel at Proskauer, says. ■



This is an edited version of the cover story from the July/August issue of Private Funds CFO. For the full article, go to [privatefundscfo.com](http://privatefundscfo.com)



## EXPERT COMMENTARY

*The use of more sophisticated, integrated technology by GPs is gaining steam.  
Rey Acosta, CEO of Allvue Systems, looks at four factors motivating  
fund managers to move away from Excel*



# Tech shapes the future for private funds

Over the past 20-plus years, I have seen private equity evolve from what was once a small cottage industry to become an important component in capital markets and the economy.

As we enter a new decade and with private equity assets under management at an all-time high, it's worth looking at how fund managers' own technology, operations and infrastructure are evolving as well.

Once the domain of spreadsheets, advances in technology, particularly around cloud computing and system integration, have provided GPs with the tools they need to efficiently scale their operations. The use of spreadsheets to run fund and management company accounting, not to mention keeping track of investors and deal flow, is finally becoming a distant memory. The drivers governing these transitions are both market-orientated and idiosyncratic.

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### **1 LPs are driving GPs to adopt new technology**

In Allvue's 2019 Private Capital CFO Survey, portfolio monitoring was the number one functional process that GPs were looking to improve over the next year (75 percent of respondents). This is not surprising given the manual and tedious work involved in using spreadsheets to collect and analyze portfolio company metrics and KPIs.

As LPs want more insight into their fund manager's investments, both the back office and IR teams are actively seeking solutions to bring better and quicker information about their portfolio holdings to their investors. If we see a turn in the cycle, and with the amount of dry powder still looking to

be deployed, you can bet investors will be doing deeper dives into portfolios. Insights into ESG management practices and adoption only complicates reporting needs.

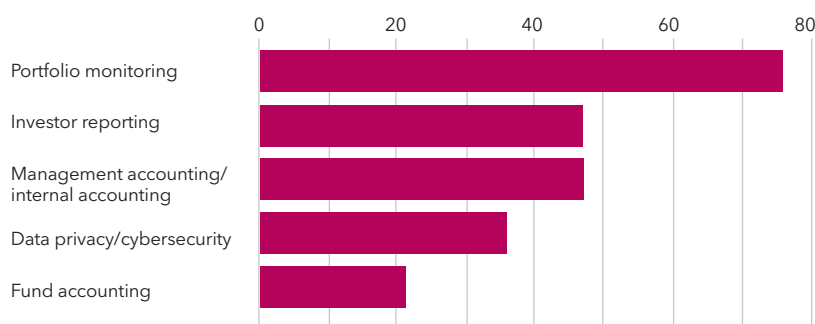
Technology – particularly systems where portfolio monitoring, fund accounting and front office technologies such as the CRM and investor portals are integrated – will play a pivotal role in getting LPs what they need on a timely basis.

### **2 The era of Excel running the back office is over**

Everyone loves Excel. And why not? It's easy to use, most people are familiar with it and it's fairly cost efficient. That is, until mistakes begin to happen, employees get frustrated and, in the worst case, LPs either get incorrect information or capital account statements and notices start to get delayed.

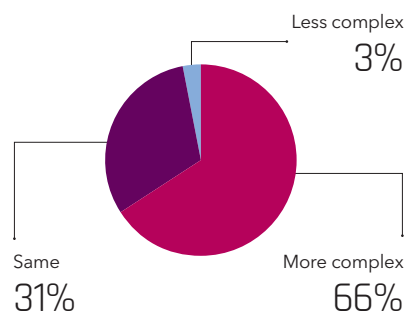
Private equity and venture capital strat-

What operational areas are you looking to improve over the next 12-18 months? (%)



Source: 2019 Private Capital CFO Survey

Are your fund structures becoming more/same/less complex?



Source: 2019 Private Capital CFO Survey

egies have seen a remarkable increase in assets under management in the last five years. GPs are growing, not only in assets, but in personnel and the number and types of investors as well (think co-investing as well as bringing on new investors from various domiciles). This ultimately results in a substantial increase in the number of entities that need to be created, managed, allocated to and reported on. Again, referencing our 2019 CFO survey, 66 percent of respondents stated their fund structures are becoming more complex.

We have seen many GPs come to us saying, “We’re growing, and Excel is just not a viable option for us anymore.” These managers ultimately hit a breaking point where the familiarity of Excel as a fund accounting and reporting system is not enough keep up with the complex entity relationships and LP reporting communication requirements they are facing.

Another trend we have seen is that GPs that have moved away from an Excel-based ‘platform’ have installed various pieces of disparate technologies to run different parts of their operations and processes. They might have installed some type of generic accounting software, like QuickBooks, or a standalone VDR to function as their investor portal. A non-PE specific CRM like Salesforce might also be used.

While an improvement over Excel-based processes, these systems lack the true integration capabilities that GPs will need to scale their firms successfully in the future, particularly as they grow in assets and investors. To address what will ultimately entail more complex processes and workflows, GPs will look to a more unified platform where the various pieces of software are truly integrated, allowing information to flow

freely, and accurately, from the back office to the front office, and ultimately out to stakeholders such as investors, operating partners and regulators.

### 3 Credit strategies create new operational challenges

The private debt market is growing – and fast. Current assets are approximately \$650 billion but are expected to grow to \$1 trillion by the end of 2020, according to the Alternative Credit Council. What’s driving this growth? On the fundraising side, institutional investors continue to be challenged by low interest rates in the traditional fixed income markets, driving allocations to private credit managers. Healthy returns, low correlations to other strategies and further diversification in their portfolios are driving the attractiveness of private debt.

On the GP side, the retrenchment of traditional lenders after the financial crisis (due to asset/liability management and Basel III requirements in Europe) has created a sizable opportunity set for credit managers to provide needed financing. Distressed fund managers, who have long waited for default rates to start ticking up, may finally be seeing the light of day as the global economy slows down. Private equity managers, for their part, have become acutely aware of these dynamics and are ramping up their private debt capabilities.

However, a private equity manager looking to step into the private debt market or even one that already has lending capabilities and is looking to expand its assets must face an inevitable challenge. From an operational perspective, managing a portfolio of credits is very different from a portfolio of equity investments. Significantly different data points and metrics between the equity and fixed in-

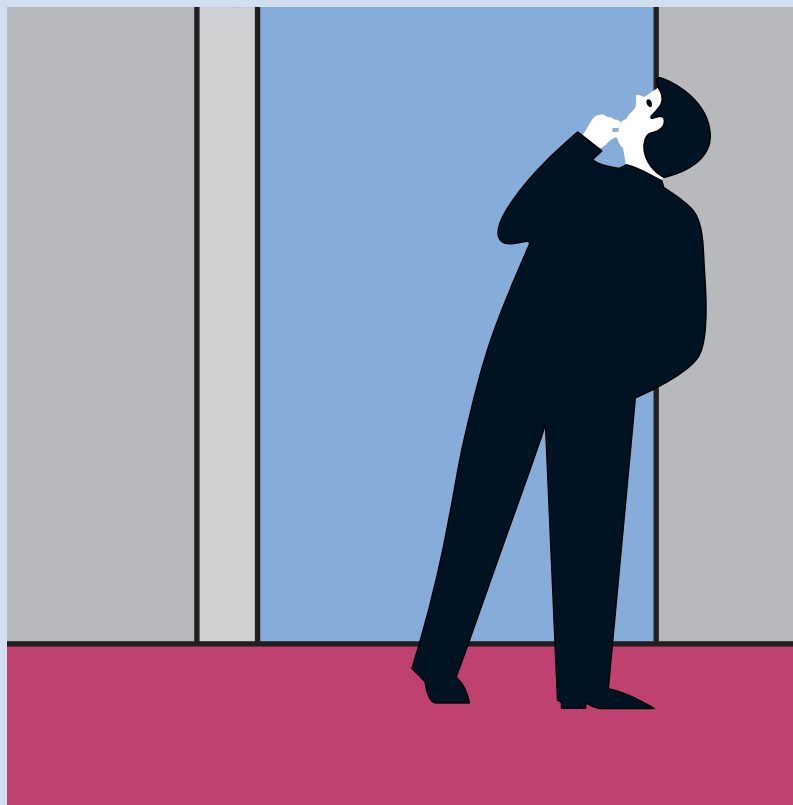
come portfolios must be taken into account, as any multi-asset class CFO can attest to.

When private equity and private debt come under the same roof, the technology to support both types of strategies changes the required infrastructure of the GP. This is one of the reasons why AltaReturn and Black Mountain, private equity and private debt technology specialists respectively, have joined forces to address the continued evolution of the capital markets and the operational challenges that will have to be addressed.

### 4 Data ownership and reverse outsourcing

As GPs grow and look to scale their businesses, they will inevitably face the decision as to what functions to keep in-house and what to outsource. Both have their advantages and disadvantages, particularly when it comes to working with a third-party administrator. While many managers understand the benefits a TPA can bring in helping to scale their businesses, many don’t want to give up ownership of their data or processes to an outside vendor.

A new model we have seen gaining traction with fund managers – and we believe will continue to grow in popularity – is ‘reverse-outsourcing.’ In this GP-administrator working arrangement, the GP ‘hosts’ or owns the accounting and external reporting data and technology. The administrator utilizes, not their own software, but the GP’s in-house system to assist in the fund accounting and investor reporting function. For GPs looking to capture the efficiencies of the outsourced model while maintaining control over their underlying information, reverse outsourcing can provide an optimal balance between the insourced and outsourced models. ■



# Everything you wanted to know about GP-led secondaries

*Once associated with problem funds, we found in September that GP-led processes are now part of the smart manager's tool kit. Should you be doing one?*

Not so long ago, we would only have written about GP-led secondaries if we were covering a fund that was lurching into crisis and desperately trying to keep its investments on life support. But, as we found in September, such stigma is misplaced and outdated. The market for GP-led secondaries is thriving. And such deals can make perfect sense. When the lifecycle of an investment doesn't fit neatly into private equity's 10-plus-two-years model, then a GP-led buyout can be the most rational option for delivering value creation over the

long-term. Not that secondaries deals are without complications and controversy. For fund managers not wishing to receive a knock on the door from the SEC, transparency throughout every stage of the process is crucial. Indeed, it is not easy for GPs to avoid a conflict of interest, when it has a fiduciary duty to get the best price for existing LPs at the same time that it is designing the transaction and might even be a buyer of the assets. As the market continues to grow, we hope that this article proves instructive.

CrownRock Minerals came into being in February 2007 when private equity firm Lime Rock Partners struck a deal to provide up to \$100 million in growth capital to a joint venture with oil and gas business CrownQuest Operating. The investment came from Lime Rock's fourth fund, which closed on \$750 million in September 2006.

Fast forward to 2018 and Lime Rock Partners IV was all but liquidated, save one asset and a few residual holdings. However, that one asset – CrownRock – had a net asset value of close to \$1.9 billion and still had room to grow in value, in Lime Rock's estimate, by a significant amount. The situation, an end of life fund and a remaining asset with a future of continued growth, was ripe for a GP-led secondaries process. "We had been talking about the potential for a longer holding vehicle with investors in the course of our regular site visits for several years before launching a process," Gary Sernovitz, a Lime Rock managing director, tells Private Funds CFO.

In pursuing a GP-led secondaries process, Lime Rock was to join a wave of private fund managers doing similar deals. These

processes have emerged to solve one of the major structural shortcomings of the private equity model: that a 10-plus-two-years fund life does not always fit with the trajectory of the underlying portfolio companies.

Such deals were once considered a fix for a broken fund, in which GPs and LPs had become misaligned and something drastic was required to reset the economics. This stigma has now been consigned to history and GPs have grown to see the secondaries market as a tool for efficient fund management. In-demand managers such as Warburg Pincus, TPG, Blackstone and the owner of PEI Media Bridgepoint have undertaken processes.

With investors consulted on an informal basis, Lime Rock selected an advisory team. "We spoke to our existing LPs who have secondaries programs and asked them which intermediaries they work with who bring them the best product," says Sernovitz. Evercore's private funds group was selected.

### Good advice

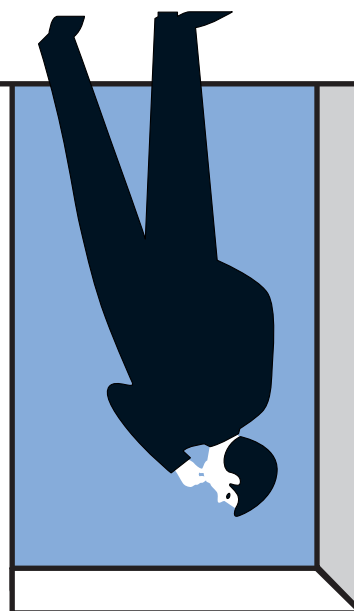
It is technically possible to run a process without an advisor – EQT ran a stapled tender offer in 2017 without one – but normal procedure is to hire one. "These are time-intensive processes and there is an art

to running an auction," says lawyer Andrew Ahern of Debevoise, who has worked on GP-led deals for a number of general partners and advised HarbourVest on its investment in Lime Rock's restructuring. "A good quality advisor can lend a credentialization to the process that it will happen and be done well."

The process from the GP's perspective broke down into three strands, Sernovitz adds: finding the right secondaries buyer; working through the legal documentation and structuring; and the process around the limited partners.

The first of these – finding the right secondaries buyer – involved pitching the opportunity to a roster of established secondaries investors. "We basically spent three days in Evercore's New York conference room giving the same presentation 12 times," says Sernovitz. After a competitive process, the firm lined up HarbourVest Partners, a private markets investor whose secondaries program ranks in the top 10 in the world, according to our sister publication *Secondaries Investor*.

While prices are presented as a discount or premium to net asset value, sophisticated secondaries investors will reach their own conclusions as to the value of the assets, par-





ticularly because reference dates for pricing tend to lag the deal by months. In the first half of the year, the average high bid across all secondaries deals for buyout funds was 95 percent of NAV, according to advisory firm Greenhill, but “certain high-quality GPs or funds continue to price at significant premiums (eg, 120 percent of NAV).”

For the second strand – the structuring – Lime Rock opted to create an acquisition fund that would buy the assets from the old fund. Those investors who wanted to roll into the new fund, rather than cash out, would receive a distribution in kind of an interest in the newly minted Lime Rock Partners IV AF, so that no tax liability was incurred. The original Fund IV would be marked as fully realized.

Fund terms are not standardized across continuation vehicles, says Debevoise’s

## The VSS case and the path toward best practice

### **When the SEC released details of its settlement with Veronis Suhler Stevenson, the secondaries community took note**

Amid a fast-growing GP-led secondaries market, the SEC case that came out in September 2018 only confirmed that information asymmetry and potential conflicts of interest in GP-led deals need to be addressed promptly.

The sanction related to stakes in the New York firm’s Fund III, which was raised in 1999 and VSS was looking to dissolve in late 2014. The fund had two remaining portfolio companies at the time VSS offered a deal to LPs: a cash distribution-in-kind payout at a price based on 100 percent of the fund’s December 2014 net asset value. The SEC says the NAV of the fund at the time was \$33.9 million, and VSS used this as the basis for the offer to LPs.

However, at the beginning of May 2015, before the deal went through, VSS failed to inform limited partners that it had received information indicating the NAV of the fund had “increased significantly” on the amount previously stated, to the tune of approximately \$1.74 million, the SEC said.

The regulator said the “omission of this information regarding the potential increase in the value of Fund III’s portfolio companies resulted in certain statements in VSS’s May letter being misleading. In addition, after the offer was made, VSS did not provide the remaining Fund III limited partners with the first quarter 2015 financial information, which, according to VSS’s calculations, still showed an increase in Fund III’s NAV.”

The SEC said that the offer letter made it appear the limited partners would receive the full value for their interests.

VSS and one of its managing partners, Jeffrey Stevenson, settled for \$200,000 with the SEC.

The essence of the case wasn’t a complete surprise. The SEC has focused on potential conflicts of interest in the private fund management world for years and had already expressed concerns – coincidentally starting back in May 2015 – about those arising in fund restructurings.

Add to that the growth of the secondaries market and of GP-led secondaries in recent years, it didn’t come as a surprise that the SEC started paying closer attention.

“In certain of these transactions, the net benefit may be geared towards the GP rather than the LPs,” says Brian Mooney, a managing director at secondaries advisor Greenhill. “What the SEC is saying is that GPs need to be very clear and specific about how they are managing the inherent conflicts.”

In many GP-led secondaries transactions, the GP, which has a fiduciary duty to its funds’ LPs, finds itself on both sides of the table. It is representing the existing LPs, but also designing the transaction, running the process, picking the advisor and the buyer, negotiating the terms, and as in cases like VSS’s, it is also a buyer of the assets.

That position, combined with the fact it is the party that knows the most about the assets, puts it in a highly conflicted position.

Ahern. “I generally see pretty bespoke waterfalls with varying carry points and return points. Unlike commingled funds, where you have no idea what you are going to invest in and a lot of different investors, here we know exactly what the portfolio is going to be, you can better project what the returns are going to be and you are negotiating with one counterparty: it is a platform to design something bespoke.”

Returning to Lime Rock, the LP part of the process began with seeking the approval of the LPAC. There was no specific language in the limited partnership agreement that warranted this (there never is for a 2006 fund), but Lime Rock judged this to be a reasonable interpretation of the spirit of the agreement.

GP-led secondaries deals are rife with conflicts of interest. There are four stakeholder groups with different priorities: existing investors looking for an exit, existing investors looking to roll, new investors backing the deal and the financial sponsor.

“It’s always good to go to the advisory board first, explain why you’re doing a transaction, what you’re doing, provide maximum transparency, listen to your LPs and ask them for their opinion,” says a managing partner at a secondaries firm active in GP-led deals.

“Every LP has an opinion and a preferred outcome, so you need to figure out what makes sense, and then create a level playing field.”

*“A good quality advisor can lend a credentialization to the process that it will happen and be done well”*

**ANDREW AHERN**  
Debevoise

The important thing for Lime Rock was to be open about the fact this is a process that can pose potential conflicts, Sernovitz says. Each of the variables needs to be addressed, including the price being offered as a percentage of NAV, the terms of the new capital and whether there is a stapled component to the deal (which in this case there was not).

When the data room was opened to all the existing investors, it contained the same information that had been made available to prospective new investors.

In the end around 40 percent of Fund IV investors either held or upped their stake, 30 percent chose to partially liquidate and another 30 percent sold out entirely. As lead buyers, HarbourVest accounted for around half of the \$741 million in new capital and a book was built around that cornerstone that including familiar names from the investor community.

According to news reports at the time, CrownRock ended up making 24x invested capital for investors in Lime Rock’s 2006 Fund IV, and the whole fund ended up at 2.9x.

## Skin in the game

One of the keys in terms of getting existing investors comfortable with the deal was being clear about how the GP would benefit from the deal; the GPs’ carry from the original fund became an LP interest in the new fund and the GP became the largest investor in the new vehicle.

“When you sit across from investors saying that management, the senior management of Lime Rock and others on the team are rolling their entire stake over, given their conviction in the opportunity, they appreciate it and understand it,” says Sernovitz.

A fund restructuring is not the always the answer and should not be undertaken lightly.

“We have talked clients out of doing these,” says Ahern. “You could do a term extension if it is just about time. Need more capital? Raising a side car is probably easier. Some investors want out but there’s nothing else that needs to be changed? A tender offer can solve that.”

This market is booming. Advisory firms predict that secondaries deal volume will once again break records this year after a busy first half. Greenhill found that \$42 billion in secondaries transactions closed in H1 2019, of which GP-led transactions – as opposed to LP-initiated stake sales – accounted for a \$14 billion. If anything is to slow this trend down, it will not be a lack of available capital to back the deals. Secondaries Investor research suggests that five of the largest managers of secondaries capital will hold final closes in the second half of the year raising nearly \$50 billion between them. ■



This is an edited version of the cover story from the September issue of Private Funds CFO. For the full article, go to [privatefundscfo.com](http://privatefundscfo.com)

## EXPERT COMMENTARY

*qashqade's Oliver Freigang and Gregor Kreuzer  
explore different options for firms seeking to modernize  
their approach to calculating waterfalls*



# Waterfalls: should you buy a car or a driver?

Building a waterfall model in today's most used application – Excel – is a bit like building your own car. When you imagine your car as a chair with four wheels and a steering wheel, building it yourself might seem doable. But then, would you risk driving it on a highway? Not to mention that you forgot the engine...

Comparing a waterfall model to building a car is not that far-fetched. Like a car, the waterfall model tends to have more moving parts than meets the eye. When you set up a waterfall calculation in Excel, you might not think about all the cases the calculation needs to cover, what sort of transactions may come along, the side letters that add further complexity or the requests for transparency

that come from LPs. With all these balls to juggle, it would be a minor miracle if you didn't make some mistakes along the way.

And did you think about the possibility that maybe over the life cycle of the fund, somebody else might be responsible for using your waterfall model in Excel? This inevitably leads to (overly-)complex workbooks, workarounds like creating a file per version, hand-over issues with multiple layers of logic within the same file, undetected errors, delays in response and the looming possibility of reputational damage and loss

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of custom in the highly competitive funds market.

But then, there is no need to build a car by yourself. There are experts out there, who do that every day. They learn from the past and make the car better every time.

They ensure that every new model has features that improve the driving experience. And you feel rather safer driving the car on a highway.

The same is true for waterfall calculations. There is no need any more to create them in a tool not built for the purpose. There are services out there which allow you to buy the solution, instead of trying to find it yourself.

Essentially there are two different types

of offerings available in the market: a car with a driver, or a car you drive yourself.

### The 'full service' model

Outsourcing the waterfall calculation to experts who possess specialized tools (but often use Excel as well) is not a new idea. Plenty of fund administrators or technology companies have been established to provide services with and around carry calculations. This 'full service' model allows firms to profit from service providers' experience in setting up waterfall models. It has the additional advantage that the fund manager can insist the service provider works according to their requirements, in order to avoid obstacles and to understand and solve issues.

But if the car is just a chair with four wheels, then the driver can only do so much. In addition, it requires significant experience and expertise to correctly calculate very complex waterfalls.

This skill set is not readily available and can usually be found only at a high price. Fund managers therefore often end up calculating the waterfall again using their internal models, just to ensure that the service provider's calculations are correct (which often they are not).

An additional disadvantage of the 'full service' model for calculating waterfalls is the need for regular communication. A fund manager has no direct access to the wheel and must communicate anything it wants changed to the outsourcing partner. But there is always the risk that information gets lost in translation and the fund manager might have to endure frustrating delays as they wait for the service provider to respond.

### The 'self-service' model

Using new technology to calculate the waterfall is a rather new trend. Often it is labeled as self-service. Here, the product carries all the experience and knowhow. And therefore, the product needs to be able to handle all the complexities currently found in the alternatives industry. There is no driver to cover up for weaknesses in the product. The fund manager is in the driver's seat and decides what to do. Any data entry, modeling or calculation that the fund manager needs can be done immediately.

Using self-service software has many advantages, including:

- Increased flexibility: when utilized properly, with new or existing data, de-

*“The skill set to correctly calculate very complex waterfalls is not readily available and can usually be found only at a high price”*

*“The self-service tool should provide you with easy-to-use software that can be used without any major training”*

cision-makers can easily create specific scenarios for their waterfall calculations and can therefore address key business challenges quickly and effectively;

- Speed of decision-making should improve, since you can model and simulate with the right software in real-time and do not need to rely on someone else first having to make those calculations or perform the analysis;
- Costs: in general, a self-service model should be more cost effective than a full-service model since you do not have to pay for the 'driver'.

The disadvantage is that whoever uses the self-service tool must be open to new technology and digitization. The fund manager then needs to trust the software and the outcome. While this is easier said than done, the fund manager also needs that trust if they outsource to an external provider.

### Verdict

Whatever model you might choose, be it the full-service model or the self-service model, you should decide beforehand what you would like to get out of it.

If you are looking to outsource everything, and are willing to trust the output from a service provider that comes with a high price tag, then the full-service model might work best for you. Just consider as well what your investors might say if the calculations are erroneous and how you might handle complaints if you have outsourced everything but are ultimately still held responsible.

If you are looking to keep full control and are interested in maintaining the highest flexibility for your calculations, then a self-service tool might work better. The self-service tool should provide you with easy-to-use software that can be used without any major training. It should be able to reduce the time you spend on these waterfall calculations significantly, while increasing the transparency of your calculations.

As you move away from Excel and all its weaknesses to explore new technology, ultimately it is up to you to choose the right model for yourself and your firm.

Some changes need courage, time, money and effort, but it will be worth it all! ■

Oliver Freigang is the chief executive and co-founder of qashqade. Gregor Kreuzer is chief product officer and co-founder.



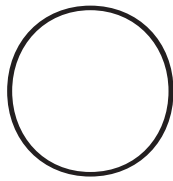
# sale

## Why you should be selling a piece of your firm

*There has never been a better time to raise capital by selling a stake in your firm.  
In our October edition, we told you what you need to know*

Do you want to turbocharge the growth of your firm, resolve succession and develop new strategies? If so, selling equity might be an exciting option. In October, we explored the growing trend for private equity firms to look to outsiders for a capital injection. Most firms sell a relatively small stake (usually no more than 20 percent); in some cases, the founding partners are bought out, allowing leadership to pass to the next generation. But the majority of transactions

are driven by the need for an infusion of primary capital, allowing firms to grow in size and expand into new areas. Of course, selling a stake in a private equity firm is not simple or straightforward. There is no clearly accepted formula for valuing a firm and transactions typically involve an army of lawyers and advisors. But, much like any other industry, selling an equity stake is becoming common practice for GPs. It's an issue we're sure to return to in future editions.



ver the summer, two storied European private equity houses were putting the finishing touches on milestone deals. Partners at EQT

in Stockholm and BC Partners in London were both lining up an infusion of capital aimed at supercharging growth in their already sizeable private equity franchises.

While the two deals were set to raise similar amounts – both around the €500 million mark – the two firms were pursuing different paths. In what has become an increasingly rare move in modern private equity, EQT confirmed plans to list on the public markets, joining its long-time shareholder Investor AB on NASDAQ Stockholm.

BC Partners, on the other hand, was busy inking a private transaction to sell a minority interest to Blackstone's Strategic Capital Group. In doing so, BC joined a fast-growing list of firms to have raised permanent capital from specialist investors. The three largest buyers – Dyal Capital Partners, Blackstone and Goldman Sachs' Petershill Funds – have been linked to at least 32 deals with private capital firms, most of which have happened in the last 18 months, according to research by our sister publication *Private Equity International*. Advisors in this area say the number of such deals is closer to 40 in the last two years.

While these three investors account for a large share of the market, other investors are also active. Wafra, which is backed by the Public Institution for Social Security of Kuwait and partners with other global asset owners, has invested in 16 GPs, according to senior managing director Daniel Adamson, with most of these deals coming in the last three years. Advisors also point to RDV Corporation, the DeVos family office, as being an active participant in this market.

New entrants are currently raising capital to invest in this market: Aberdeen Standard Investments is raising \$1 billion for its GP interests program, Bonaccord Capital Partners, while StonyRock – launched by former Blackstone and Carlyle AlpInvest execs – is partnering with Jeffries Financial Group also seeking \$1 billion.

### What's the money for?

Typically, these deals involve combinations of both primary capital going back into the business and secondary capital going into

the pockets of the selling shareholders. “Most of the time the majority of capital being raised is primary capital to grow the firm, not secondary capital,” says Herald Ritch, the founder of DC Advisory US, who advised lower mid-market firm MSouth on a minority stake sale to Aberdeen’s Bonaccord in June this year.

There are plenty of uses for the primary capital. As fund sizes grow, for example, the need to commit more to one’s own funds – both in relative and absolute terms – becomes more pressing. Research from law firm MJ Hudson this year found that 35 percent of all funds had a GP commitment of 3 percent or more, which is an increase on each of the prior three years.

Then there is the question of transitioning ownership of the firm’s economics to the next generation. As a GP stake sale allows senior partners to monetize a portion of their equity, it allows the next generation of leadership to participate in the transaction – either in the form of loans from the balance or a simple allocation of capital – to buy out the senior partners or increase their participation in subsequent GP commitments.

The other reasons for raising external capital are all about growth, like funding expansion into new locations and hiring talent. “It brings an extraordinary ability to grow the business,” says Daniel Lavon-Krein, a senior partner in law firm Kirkland & Ellis’ investment funds group.

“If you look at the deals that have been done, after every deal the sponsor pours money into new strategies, new offices, new products and they bring in extra operational resource to, for example, raise capital in a new market.”

Lavon-Krein’s team advised on Blackstone’s investment in BC Partners and is understood to have worked on most major GP interest transactions this year.

According to sources, Kirkland is one of a handful of law firms to have developed a deep track record in this type of transaction. Other firms cited by market sources include Fried Frank, Simpson Thacher, Wilkie Farr & Gallagher, Debevoise and Holland & Knight.

In terms of what gets sold, “the vast majority of these deals have been 20 percent or less at the outset,” says Saul Goodman, head of the alternative asset management practice at investment bank Evercore.

### Better call Saul

Few people are better qualified than Goodman to opine on the shape of these deals. He has advised on transactions involving New Mountain Capital, Lexington Partners, Providence Equity Partners, Vista Equity Partners, Silver Lake Partners, Platinum Equity, Leonard Green Partners, Starwood Capital and Bridgepoint, the owner of PEI Media, as well as many others. The firm has been part of 35 minority interest deals in recent years. This summer he added BC’s investment from Blackstone to his credentials. Evercore is the 800-pound gorilla in this space.

The headline percentage of the stake sold in these deals is often less than 20 percent, because it might comprise a 20 percent stake in the management company, “but half of these deals are done with a non-congruent stake of the performance fees,” says Goodman. “When you blend it all together, it might only be 12-13 percent of the overall economics, with many even lower.”

The percentage stake is not really of paramount importance to either the investor or the seller, Goodman adds. “The investors aren’t solving for a minimum percentage ownership, because they are getting the same limited governance protections anyway; they are focused on the strip of economics they are purchasing. The sellers aren’t solving for a percentage either; they are looking at their business plan needs and any secondary proceeds, if desired.”

Advisory sources differ as to how templated these deals have become, but a “typical” deal, if such a thing exists, will involve the acquisition of a percentage of the management company – and the management fee income that comes with it – plus immediate participation in the carry vehicles, as if they had been an investor on day one. These are permanent capital deals, so investors are buying into these income streams in perpetuity. Existing GP commitments can also be thrown into the deal. In some instances, the incoming investor can also pledge to cornerstone future funds as a limited partner.

### How much is my firm worth?

“If you are only selling 10-15 percent of the economics and some of that might be going back into the firm, then valuation is not the most important piece of the puzzle,” says Goodman. “This market focuses on long-term cashflow and franchise value; not just

putting a multiple on current earnings,” he notes, adding that the management company and carry vehicles are valued differently.

Goodman stresses that these private markets investors do not look to the publicly listed firms for comparables. “The private market is separate and people are looking at a much longer time horizon – not just the next year or two.”

Most advisors are, understandably, reluctant to outline any sort of “back-of-the-napkin” approach to valuing a PE firm. For one thing, they don’t want to publicize commercially sensitive information. “No, no, no,” chides one banker when asked if there is a ready way a CFO can put a valuation on their own firm. “They are valued on a DCF basis – very complicated models – but I don’t want to get into it for competitive reasons. Given the long-life nature of these investments – not just one fund, but multiple fund cycles – these tend to be long-dated models.”

Another advisory source breaks it down more willingly: “Assuming a typical 2-and-20 structure, we would advise that the firm is worth around 10 percent of its AUM, and maybe you would look to sell 5 to 10 percent of the firm.”

“It is a small set of financial and legal advisors who know the deal pricing, deal structures, terms, fit and preferences of the buyers,” says Ted Gooden, head of private markets advisory practice at Berkshire Global Advisers, “so you need to go to someone with multiple reference points of completed deals.” Gooden has advised on a number of GP interest transactions, including Clearlake Capital and Siris Capital.

### Am I big enough?

There is no litmus test in terms of AUM or maturity to tell whether a transaction like this will work for you, says Goodman. “Obviously it works better the bigger you are, the longer you have been in business and the more profitable, but it’s not like there is a checklist covering certain metrics which have to cross a certain threshold.”

One restriction on whether your firm will be a suitable target is the size of check that investors are looking to cut. Advisors say that the largest investors in the market will want to deploy circa \$150 million to \$200 million at a minimum.

Wafra, however, invests across the entire GP lifecycle: “We’ll be the first dollar in, catalyze growth or partner with mature

managers,” says Adamson. The majority of its GP investments have been in younger firms. What Wafra is looking for is “defensible franchises in asset classes and strategies that have enduring value for asset owners around the world,” adds Adamson. In other words, if you have proven your ability to invest well in a segment that is in favor with global investors (with which Wafra boasts intimate knowledge), you may be of interest regardless of size. There needs to be a clear rationale for the transaction in terms of what the GP will be doing with the proceeds and what they are looking for from a partner. Wafra, for example, will avoid GPs who are “purely looking for a financial transaction,” says Adamson.

These deals are, ironically, about more than just capital. When BC Partners announced its transaction with Blackstone this summer, partner and chairman Raymond Svider said, “We look forward to leveraging Blackstone’s best-in-class resources and exceptional talent.” Those resources were not specifically identified, but likely refer to portfolio company cost savings, back office perks, new platform advice and introductions. GPs considering a deal should know what they want to achieve and what capital and resources they need to do it.

These deals are sensitive subjects. None of the GPs contacted for this article were willing to discuss their own transactions. Speculating on why, most contacts attribute it to the optics of what their LPs might be thinking. “It is not as commonly accepted as it should be,” says one banker.

Looking at the names that have undertaken these transactions – and their subsequent fundraising success – there is certainly no evidence to suggest investors are being put off. ■

*“Most of the time  
the majority of  
capital being raised  
is primary capital to  
grow the firm, not  
secondary capital”*

**HERALD RITCH**  
DC Advisory US



This is an edited version of the cover story from the October issue of Private Funds CFO. For the full article, go to [privatefundscfo.com](http://privatefundscfo.com)



# KEYNOTE INTERVIEW

## Translating the TCJA



*As the 2017 tax reforms take effect, there are still questions over how private equity interprets the landmark changes, according to*  
**Simcha David** of EisnerAmper

The Tax Cuts and Job Act of 2017 was one of the most significant pieces of tax legislation in decades. Headline reforms like the drop in the corporate tax rate from 35 percent to 21 percent earned cheers from Wall Street, despite many deductions and credits vanishing.

Even the densest passages of legislative language still leave room for interpretation, much to the delight of tax attorneys everywhere. The inherent complexity of how private equity funds are structured and how firms invest means that the industry is bound to discover unintended consequences within the TCJA. So we spoke with Simcha David, a tax partner with EisnerAmper, about some of the thornier questions the law raises for GPs.

**Q There is plenty of tax relief contained in the TCJA, but not all of it applies to the private equity industry. In fact, doesn't it tighten**

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### **standards in the case of carried interest?**

The TCJA states that if someone holds an applicable partnership interest, they need to hold that asset for greater than three years before selling it in order to qualify for the long-term capital gains rate. Previously, the minimum holding period was greater than one year. Private equity frequently holds assets for longer than three years, so there shouldn't be too much of an issue, although this new standard may cause a wrinkle for some funds.

However, this rule is not entirely clear in certain respects. Suppose a new fund of funds invests in an underlying fund. A year later, the underlying fund sells a portfolio company that it has held for more than three years. This sale generated enough income

for the fund of funds so that the GP of the fund of funds is entitled to carry. The long-term capital gains rate clearly applies to the limited partners of the fund of funds. But does it apply to that GP of the fund of funds, whose fund of funds has only been around for a year? Practitioners currently assume the three-year holding period pertains to the underlying assets, but there hasn't been guidance that fully resolves that question. And for funds of funds which may face this situation quite frequently, some clarity would be welcome.

**Q GPs don't time an exit solely by tax considerations, so what are firms doing when they're fortunate enough to sell that portfolio company after only two years?**

What does not work is utilizing the general GP waiver provision that is currently in many fund operating agreements. That was put into operating agreements for situations

where the GP will waive the carry because the GP believes that it will eventually be subject to clawback. That is a real waiver. Simply waiving the carry on the early deal just to take it on the next deal is not a waiver, especially if the value is already inherent in the subsequent deals.

Instead some attorneys are drafting waiver provisions that mimic a management fee waiver for carry. Historically, some funds had a management fee waiver in place. Practically this means that the management company has the right to waive a portion of its management fee in exchange for the GP entity receiving a deemed capital contribution into the fund. The GP will have priority in the cash waterfall for this amount for a future realization event. As long as the deemed capital is subject to the entrepreneurial risk of the fund, this arrangement should be respected.

Under the current law, should the fund sell an asset in the first two years of ownership, the GP can't simply waive that carry and say they'll take that amount on the next deal. In that case, the GP hasn't really waived the carry income and the IRS would not respect such a waiver. Instead, the GP needs to waive the carry on the current deal, and only take the waived amount from the profits or increased value in the future, precisely because that value doesn't exist yet. There is no guarantee of getting that waived carry in the future. It would require that investments increase in value enough to trigger the payment of traditional carry, and the waived carry as well.

### **Q What has been the effect on the private equity industry?**

The new tax law ended a lot of deductions, including the one for investment expenses. LPs would use this deduction for management fees. Private equity firms will often take a management fee based on the committed capital. This could be a rather large amount of income in the early years of the management company. So, as mentioned above, the management company will retain the right to waive a portion of their management fee. Without waiver the investor ends up with an expense they can't deduct and the manager has ordinary income.

Under a fee waiver arrangement, the management company has less current ordinary income, the limited partners have less of a non-deductible expense and ultimately the GP (same ownership as the management

*“The new tax law ended a lot of deductions, including the one for investment expenses”*

company) could end up with long-term capital gain.

So the fees are waived, and in lieu of that, the GP gets a phantom stake in the partnership equivalent to the fee they waived. The interest from the future appreciation of the fund will arrive sooner in a standard waterfall calculation than the GP's usual carry, and those monies may arrive at the lower tax rate of long term capital gains. Such waivers are a win-win proposition, but the IRS is sensitive to a GP's abuse of it. They need to see the GP face real 'entrepreneurial risk' that the fees they've waived might not arrive.

And that's the thinking behind the carry waiver being rooted in the increased value of assets in the future. However, while they're using the management fee waiver as a model, there is no guidance that the IRS approves of the practice.

### **Q What other deductions have been eliminated that might adversely impact the private equity industry?**

One worth discussing is Internal Revenue Code Section 461(l). This is part of the new law that limits the use of trade or business losses to offset investment income. Section 461(l) states that losses from a trade or business can only offset investment income up to \$500,000 (married filing joint). For example, if the general partner of a private equity firm gets \$1 million in investment income from the fund, but operates the management company at a loss of \$1 million, the liability is not zero, as it would be before the TCJA. Instead, now they can only use up to \$500,000 (married filing joint) of those losses to offset the investment income.

But questions remain around the definition of trade or business. Does the sale of an operating partnership, which is common in private equity, give rise to trade or business income or investment income? There's no guidance on that.

### **Q Are there any other uncertainties?**

We also don't know what to do with the losses that exceed the \$500,000 limit. Say a private equity partner has earned \$5 million in capital gains income and suffers \$10 million loss at the management company. Since that \$10 million loss is considered from a trade or business, the partner can only offset \$500,000 of that loss against the \$5 million of income, and that leaves \$9,500,000 of losses that were not utilized in the current year. Which means on the partner's personal tax return, they have \$9,500,000 losses they couldn't use.

Practitioners have been assuming that the \$9,500,000 rolls over to next year, and is no longer subject to the limitation, as it would be treated as a normal net operating loss deduction, and offset up to 80 percent of the subsequent year's income with it. So the partner could use 80 percent of the \$9,500,000 in a subsequent year to offset investment income and not be subject anymore to the \$500,000 limitation.

Most practitioners are interpreting Section 461(l) as a one-year deal, and next year it's a normal NOL. But we don't have guidance on that either. That doesn't mean guidance won't be forthcoming on any of these issues, but the industry should tread carefully as there aren't definitive answers just yet. ■



# Lessons from the front line of tech implementation

*In November, we asked how you can stop a technology project  
chewing you up and spitting you out*

We all know that a tech project, which promises to streamline our processes and eliminate inefficiencies, can soon leave us tearing our hair out and screaming in frustration as budgets spiral, delays mount and design flaws become apparent. So how do we avoid the common pitfalls of tech implementation – and make sure that our colleagues actually use the gleaming new systems that we invest so much time and effort developing? That was the question we asked in our No-

vember issue. For answers, we turned to three firms – Insight Partners, Adams Street and Riverside – that have recently carried out major projects. As a starting point, the case studies showed us the crucial importance of stepping back and deciding what we want to achieve with tech improvements before we turn to service providers. And we learned how getting buy-in throughout the firm is a vital to a project's success.

# <h1>Tech tales</h1>

## <h2>Lessons from the front line of tech implementation</h2>

</h2>

<ul>

<li>Insight Partners</li>

<li>Riverside</li>

<li>Adams Street Partners</li></ul>

What is the secret to a successful technology implementation? “First and foremost, we want to be clear on the problem we are solving,” says James Fung, chief technology officer at global private markets firm Northleaf Capital. “If we decide to explore a technology solution, we want to be laser-focused on the primary objective for the solution, so we are not distracted by the ‘bells and whistles’ of the solutions of the day.”

That sentiment – that you need to know your goal before you go out and buy some shiny tech – is echoed by every technologist

we ask about successful projects. “Sometimes it is easy to get caught up in the excitement around a given type of technology, such as artificial intelligence,” says Ned Gannon, president of eBrevia an artificial intelligence software business. “In our experience, the most successful implementations of a given technology start with the user’s pain points.”

Clearly defined goals are common to the three case studies we look at in this issue. Insight Partners required a better way of gathering, analyzing and disseminating data from a growing stable of portfolio companies. Riverside needed a neater and safer way to sign off wire transfers. Adams Street Partners needed to centralize 40 years of fund data.

There are many other ingredients that go into a successful implementation. “Whoever is using the software needs to be properly trained, and that training needs to be ongoing,” says Oliver Freigang, chief executive of waterfall software business qashqade.

“The business” needs to be onside from the get-go, meaning both the senior management and end users.

“The business users are critical in providing details regarding the business need and feedback during the design and implementation phase,” says John Manganiello, head of business development at asset management-focused tech firm RFA. These themes and others emerge from our three case studies. We hope they are instructive.





### Insight Partners' 10-year quest for portfolio management software

#### *Insight Partners' CFO Mark Lessing discusses his firm's move away from Excel*

When Mark Lessing joined Insight Partners in 2000, the iPhone had yet to be invented. Facebook and Twitter did not exist. And Lessing found himself gathering financial data from roughly 40 portfolio companies and inputting it into a monolithic spreadsheet nicknamed 'the Bible.' Nearly two decades later and things look very different in Insight's finance function, but the road to operational efficiency has been far from simple.

He knew what was needed: a platform to gather and collate portfolio company data efficiently and consistently, that could be interrogated in real-time by the investment team. At that time – in the early 2000s – such a platform did not exist. Lessing, a technologically-minded CFO, set about building

the system himself with some tech support from India. It took him about two years to finesse the platform, which allowed portfolio company CFOs to log-in and input their financial data directly. "The system was really good," says Lessing. But regardless of how well a system functions, if it doesn't get used, it isn't much use. Lessing had an issue with buy-in: portfolio company CFOs were not logging in to upload and, crucially, Insight's senior deal team was not pushing them to do so since there were other priorities at portfolio companies. Lessing found himself pretty much back at square one. "I was the only one using it," he says.

Having got the self-built platform up and running, after about two years Lessing decided to shelve it. He was still deter-

mined, however, to move away from the biblically-proportioned Excel spreadsheet.

He kept his eyes open for an outsourced provider and accepted every meeting invitation from developers that came his way. In late 2008, he met with a firm spinning out of Blackstone, ultimately called iLevel Solutions. He was struck: "This is what I had built," he remembers thinking to himself. But it was too expensive and not much of an improvement, he decided at the time.

But as Insight grew, the need for a sophisticated portfolio management team grew with it. "Within a few years, we were projecting to have well over 100 active portfolio companies and in over 350 businesses since our inception. So we had an immense amount of data on private software companies – a unique data set – and wanted to ensure we could effectively mine and utilize it," says Lessing.

Throughout that process of searching for a portfolio management platform Lessing said he met with any service provider he could and recommends the same approach for any company looking to invest in software. It was iLevel that Lessing eventually returned to. At the time Lessing's team was considering a cheaper software option, but the final decision came down to a conversation between Lessing and his VP of finance about cost. "I said, 'We don't want to be cheap on this. Spending a few thousand dollars more a year is well worth it because if we use it the way I expect we'll use it, it will pay off in a big way.'"

Lessing estimated it would take a year to properly implement the new platform, but in the end, it took only three months.

Insight Partners now has nearly 200 investments to track. Switching to a third-party software has allowed the firm to disseminate information to all employees within the firm. Roughly two-thirds of those employees log in to the portfolio tracking software weekly, at minimum, to look up information on a portfolio company.

There is benefit, he notes, from using third-party rather than self-built software. The vendor's access to other clients, for example, gives them a wider perspective on potential upgrades and technology features available to private equity firms.

Return on investment from a technology upgrade is hard to measure. Lessing knows CFOs are cost-minded, but says eventually they have to take risk that fits their firm's situation and size.



A close-up, high-contrast image of a robotic hand holding a precision ball bearing. The hand is metallic and has a matte finish. The ball bearing is highly detailed, showing its internal structure with several red-colored balls visible within the outer ring. The background is blurred, showing the face of a person in a white lab coat, suggesting a scientific or industrial setting.

# SIEZE OPPORTUNITIES AS THEY ARISE

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## Adams Street on centralizing 40 years of data

### *Alicia Pando, CTO at Adams Street Partners, discusses normalizing and centralizing its data*

When Alicia Pando joined Adams Street Partners as its first chief technology officer in 2017, she was tasked with modernizing the venerable firm's systems: no mean feat for an organization that has been collecting fund and portfolio company data from GPs since the 1970s.

"We believe our portfolio company data is among the largest in the private market space. We collect data for hundreds of active GP funds on a quarterly basis," Pando tells Private Funds CFO.

In a scenario that may be familiar to many PE executives, Adams Street had acquired various third-party tools and built proprietary systems over the years to tackle changing business needs and growing complexity. "Each system hosted its own set of

master data but also needed to be synchronized with data hosted in other systems," says Pando.

"The architecture presented a number of problems. Firstly, the number of synchronization points grew rapidly with each additional system. Secondly, implementing applications or reports that required data from multiple systems was challenging as developers had to mine data in multiple databases. This severely hampered the delivery time of applications and reports."

In other words, if Adams Street wanted to keep making full use of new and exciting third-party products as they became available – as well as develop its own applications – its data needed to be "normalized and centralized" into one hub: "a layer that

*"We believe our portfolio company data is among the largest in the private market space"*

**ALICIA PANDO**  
Adams Street Partners

sits above all these systems" known as a data mart. The creation of this hub was therefore to become Pando's first priority, as it would then pave the way for the introduction of new applications, such as a new client portal.

Pando's strategic technology plan – of which the hub was the starting point – was signed off by the Adams Street leadership by the end of 2017 and after scoping the project and hiring the team, implementation could begin from Q2 2018. It would take four full-time developers around a year to have the hub – built on Microsoft SQL Server – operational.

Pando also built a data management team – something new to Adams Street. "We have established a team that is fully responsible for the quality and timeliness of the firm's operational data," says Pando. "In addition, our data management team oversees a large offshore group that is responsible for the ongoing digitization of our portfolio company data."

Overall the firm has just over 30 in the technology team, broken up into the infrastructure team, which consists of help desk and engineering and the largest group – developers – of which there are around 15.

The benefits of the hub are now being reaped by Pando's developers in the speed with which they can create new applications on top of it.

"We are in the process of replacing our data mining and reporting modules and our client portal with more powerful applications that source their data from the hub," says Pando.

"The time to delivery for these user-facing tools is significantly faster than without the hub."

Moving large sums of money around: it is part and parcel of a private equity firm's operations. It is also a process that can be vulnerable to error and fraud.

Riverside, a firm whose international private equity and structured capital portfolios include more than 100 companies, and which operates from 16 offices, knows this as well as anyone. The company is averaging nearly four new transactions a month in 2019. With investment professionals spread across most time zones, there came a point last year when it deemed it was no longer appropriate to handle the request for, and sign-off, for wiring funds by email.

"We were concerned about not having easily identifiable and documented records of appropriate approvals for investing in portfolio companies," chief financial officer Béla Schwartz tells Private Funds CFO.

The old transfer protocol involved an email chain requesting sign off from relevant parties, and the information included in each email would often differ, Schwartz says. "Each fund family sent an email their own way with their own comments."



## Riverside on building a wire service fit for purpose

### *Riverside's Béla Schwartz and Russell Leupold talk about creating a safer way to send money*

The system left Schwartz and others unsure as to who had been involved in the approval process. "It was not necessarily clear who began the wire process," Schwartz says. "It could have been a very junior person. It wasn't clear whether the fund manager had signed off on it, or whether it was just the senior folks. Sometimes the fund admin team would get involved. It was hazardous."

The system's shortcomings led to a lot of time expended on verification, and while there were no known instances where Riverside made an errant transfer, one of the firm's CEOs saw the need to improve the system to avoid a potential mistake being made. "There was a request made by one of our CEOs saying, 'This email thing is

a little shoddy; we really don't know if the money being asked for has been approved.'"

Riverside's director of project management, Russell Leupold, explains how the new sign-off works: "Each time we need to kick off a new workflow, a member of the deal team goes into the platform to fill out a simple form. They enter a description of the transaction, the amount to be approved at this funding, along with other supporting details.

"When they then click save, a number of notifications are sent. Initial alerts go out to the fund administration team, to the CFO, to the deal team and to the partner on the deal related to the approval request. The partner will then log in, click 'yes' to confirm. That then routes another notification to our fund manager. When that is confirmed, another notification is sent to the co-CEOs, who then give the final approval. At that point, a 'funds approval is completed' notification is sent to the entire audience."

As is ever the case, buy-in from the top was paramount. "After we went live anyone who tried to sidestep the process would be identified and forced to go through the proper channels," Leupold says. ■



This is an edited version of the cover story from the November issue of Private Funds CFO. For the full article, go to [privatefundscfo.com](http://privatefundscfo.com)

## EXPERT COMMENTARY

*Landmark reforms have added further twists to the tax labyrinth for private funds, writes Withum's Michael Oates*



# Can funds duck the TCJA's punches?

The 2016 campaign trail introduced the nation to then-candidate Donald Trump's promised tax cuts, which gave way in 2017 to sweeping reality in the form of the Tax Cuts and Jobs Act.

In the almost two years since, the extensive repercussions of the TCJA have become increasingly apparent within the private equity, hedge fund and venture capital space. While IRS clarifications are typically intended to clear up ambiguity, on the TCJA front they also have created muddled waters for individual, fiduciary and business taxation.

Across industries and fund types, the TCJA has created a wave of uncertainties and challenges as finance departments attempt to understand the new provisions.

Expansions of certain deductions,

as well as new limitations of others and changes in various tax rates have significantly altered the taxation landscape in the immediate future – and will do until at least 2025.

Most prominently, the TCJA has raised the limits of standard deductions to nearly twice their previous amount while severely curbing itemized deductions. According to the Tax Foundation, the aim was to simplify tax returns by discouraging the headache-inducing technicalities of itemized calculations.

So, how has the TCJA altered the alternative investment fund landscape?

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### Trader fund versus investor fund

It is absolutely crucial to understand and differentiate between these two types of funds. Quite simply, the distinction significantly influences the tax treatment of the partnership and its investors. As a result, it is essential to determine the fund's classification each year.

On one side of the ring is the trader fund – typically high-risk, high-reward endeavors designed to capitalize on micro-market trends and short-term swings with a high level of portfolio turnover. And in the other corner is the investor fund: notable for buying and holding assets over the long term to generate income from interest, dividends and capital appreciation.

Despite the differences, the proverbial fence between the status of trader and



investor funds is not as rigid as one might imagine. In fact, the area between the two is quite grey and has been developed by case law over the years. Hence the TCJA presents deep nuances and occasional loopholes.

Since the impact of the trader versus investor debate has longevity on its side, funds need to carefully evaluate their investment strategies in order to achieve intended returns. This is due to the TCJA's shift of the trader/investor fund landscape with profound effects on both investors and managers. Some important highlights include:

- (1) Suspension of itemized deductions for miscellaneous expenses (including management fees and other investment expenses)
- (2) A new limit on business interest deductions
- (3) Limits on excess business loss from a partnership

### **Non-deductible Section 212 expenses**

The trend from itemized to standardized deductions favors trader funds – primarily because funds with the ‘trader’ designation are categorized under the umbrella of business expenses, according to IRC Section 162. Thus, business expenses can be deducted as standard expenses.

The same, however, cannot be said for investor funds. Under the TCJA, itemized expenses under Section 212 are no longer deductible by investors (apart from C-corps,

*“The TCJA presents deep nuances and occasional loopholes”*

which we will address later). This greatly reduces the extent to which investor fund expenses can benefit taxpayers. In fact, the new Section 11045 stipulates that tax-related expenses – such as investment advisory fees – are no longer deductible.

But (there's always a but) if these fees are tagged as business expenses and fall into the same category as trader funds, there is a possibility they can be deducted. This minor wrinkle in the system is a perfect representation of the complex and often-convoluted implications of applying the TCJA's provisions on funds' above-the-line/below-the-line expenses.

### **Business interest expense limitations**

But when are they limited? It should be noted that new Article 163(j) has introduced a limit on deductions to business interest expenses. According to the IRS, relevant taxpayers must ensure the total of such deductions comes in lower than three different criteria – business interest income for that year; 30 percent of adjusted taxable income; and floorplan financing interest expense. Any excess is carried over to future tax years.

Article 163(j) does not apply to investor funds, since they do not qualify as business expenses. But both investor funds and trader funds are restricted by other limits tied to annual investment income.

### **Excess business losses in trader funds**

Perhaps one of the most puzzling components of TCJA is Section 461, the excess business losses provision. Under the guidelines, there is a cap of \$250,000 on non-corporate business losses. Any amount beyond this limit is subject to a net operating loss that passes over to the next tax year.

What makes this a head scratcher is its

undermining potential with taxation at a higher rate. However, regardless of fairness or utility, trader funds could benefit from calculating business losses under the \$250,000 ceiling (which is raised to \$500,000 for married couples filing jointly).

### **QBI's minimal impact on funds**

The qualified business income deduction was heralded as providing substantial tax savings for eligible pass-through entities. But these benefits have not yet materialized on the trading fund front. Under Section 199(a), a deduction claim can be made if there is income from a trade or business operated as a pass-through other than a specified service trade or business. This includes the activity of trading securities in a partnership. There are limited benefits for the deduction for fund investors for the following types of income:

- (1) 20 percent of ordinary dividends from a real estate investment trust
- (2) 20 percent of ordinary income from a master limited partnership with QBI.

### **The pass-through to C-corp reality**

The expectation that a tidal wave of pass-through entities would soon be converting their status to C-corps has proven to be misplaced. In reality, few have made the jump, despite the new corporate income tax rate of 21 percent.

C-corps still retain the double layer of taxation – the first associated with the corporate tax rate on profits and the second at the shareholder level on dividends. Rather than being an incentive, this has been a deterrent as pass-throughs have taken a ‘wait and see’ approach that appears to be working in their favor. And why not? Pass-throughs are taxed on the individual rate, not the corporate rate.

The TCJA – at its initial roll out – was comprised of 400+ pages of twisting tax reform, and its volume has since expanded with the ensuing clarifications, regulations and final rules. While the TCJA is neither heads nor tails, black nor white, one thing is certain: it is a complex, turbulent ocean best navigated with experienced financial services industry tax advisors at the helm. ■

*“Across industries and fund types, the TCJA has created a wave of uncertainties and challenges”*

Michael Oates is a CPA with Withum's Financial and Investment Services Group and the practice leader for the firm's financial service tax practice.



# The search for stability in a shifting environment

*In an increasingly complex investment market, managers are sticking with traditional fund domiciles and outsourcing more of their operational functions, survey findings reveal. By Vicky Meek*

Private fund managers are increasingly opting to domicile funds in Luxembourg, our exclusive survey carried out in conjunction with RBC Investor & Treasury Services revealed in June. While the top three jurisdictions remain consistent with a similar survey we conducted last year – in which we polled only private equity real estate fund managers – with Delaware, Luxembourg and the Cayman Islands well ahead of rivals elsewhere, this year's survey, which includes the views of private equity real estate, private equity and private debt funds managers, suggests the popularity of Luxembourg has risen over the past year to match Cayman.

## Delaware retains top domicile status

When asked which domicile private fund managers would choose for their next private fund launch, Delaware emerges as a clear leader, with 45 percent of respondents choosing this as a jurisdiction, 36 percent opting for Luxembourg, and the same proportion selecting Cayman. All three are highly rated for their optimal conditions for doing business and for their regulatory and tax framework.

This is quite a turnaround in a relatively short space of time. "If you rolled back a few years, the UK and Channel Islands would have appeared among the top jurisdictions for private funds," says Leith Moghli, partner at Reed Smith. "While they are still relevant, Luxembourg's development as a fund

center has largely been to their detriment. It has been a key beneficiary of substance requirements under BEPS, the Paradise Papers and Brexit, while also introducing the SCSp, which has made structuring much more straightforward."

Luxembourg has increasingly become a hub for AIFMD compliance among those seeking capital from European investors. The launch of the SCSp, or special limited partnership, in 2013 – a limited partnership agreement that is effectively a copy and paste of Delaware and UK limited partnership documents – was the start of Luxembourg's rise.

But developments since have boosted its popularity, including the UK's vote to leave the European Union, the implementation of BEPS and increasing LP concerns about using offshore structures following the Panama Papers and Paradise Papers leaks, and the marketing passport available for AIFMD-compliant private funds.

A large part of Luxembourg's growing allure is down to the parallel structures being established by US managers. Proskauer partner Edward Lee points out: "In our own analysis of European funds, we've seen a big shift in Luxembourg's favor over the past 12 months, in particular among UK funds, a move that is clearly Brexit-related. However, we are also seeing a number of US managers establish parallel structures in Luxembourg, where they either establish their own AIFM or use third-party AIFM service providers and delegate back to the US."

"Luxembourg is a relatively easy place

*"If you rolled back a few years, the UK and Channel Islands would have appeared among the top jurisdictions for private funds"*

LEITH MOGHLI  
Reed Smith

for US fund managers to do business,” adds Stephen Meli, partner at Proskauer. “In key ways it’s becoming the Delaware of Europe for US managers. The entities Luxembourg offers are similar to those available in Delaware and the Cayman Islands for fund structures and the documentation is similar, even down to the way the documents read. There’s also a network effect, where every additional US manager that establishes a parallel vehicle there helps attract others.”

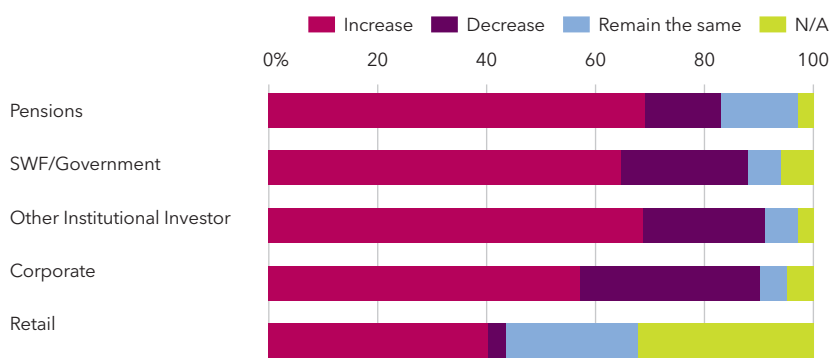
Investors are also gaining comfort that Luxembourg’s regulatory regime and requirement for depositary services under AIFMD offer added protection, a trend noted by Nicolas Fermaud, head of the New York office at Elvinger Hoss. “Where firms have had parallel structures for two to three years, we have noticed a disproportionate increase of the commitments collected through the Luxembourg structure,” he says. “In part, managers are raising more capital from European investors, but it’s also because investors globally are becoming increasingly comfortable with Luxembourg as a jurisdiction. For firms that equalize costs across their platforms, the Luxembourg set-up with its depositary and regulatory regime is clearly more attractive for many investors.”

Private fund managers are also eyeing fairly significant growth in assets under management. Over a quarter see an increase of 10-20 percent growth in the next year and over half expect over 20 percent in the coming decade.

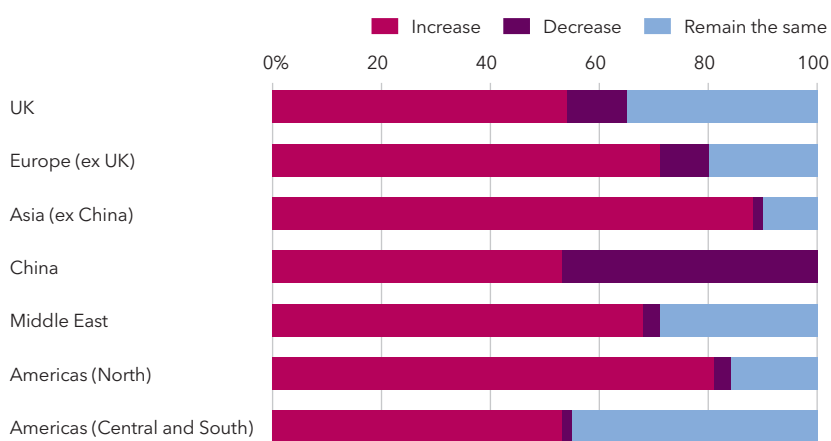
This increase will come from a wider variety of investors from a broader range of geographies. The majority of respondents (88 percent) expect to increase the proportion of investors from Asia (excluding China), 81 percent anticipate a rise in North American investors and 53 percent predict that capital from Central and South American investors will make up a higher proportion of their AUM.

All this adds up to increased complexity when it comes to managing private fund businesses. Many respondents are looking to outsource parts of their operations: 51 percent of respondents are seeking to outsource at least half of the fund administration part of their business and one-third of respondents want to outsource at least 50 percent of their technology function, with 28 percent and 20 percent saying the same about legal and regulatory services, respectively. “Outsourcing among fund managers is

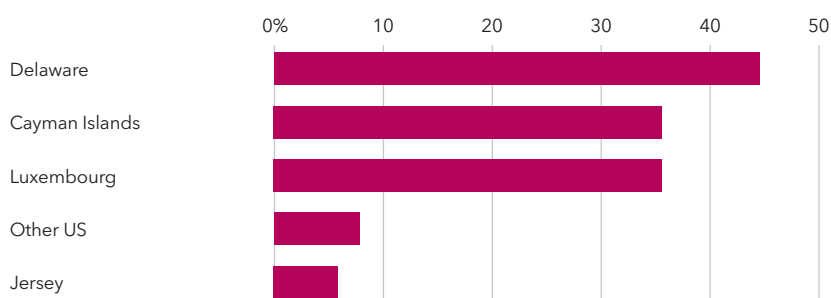
#### How do you expect your investor base to change in the next five years, by type of investor?



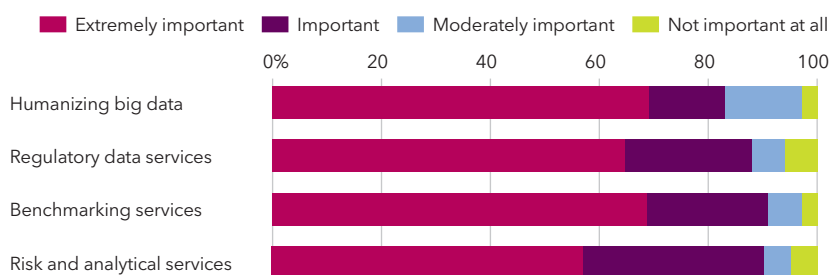
#### How do you expect your investor base to change, in the next five years, by location of investor?



#### Which domicile will you choose for your next private fund launch/reallocation?



#### How important are the following data management strategies to your firm?



## Analysis

clearly being driven by a desire to optimize their operations and focus on what they do best,” says Holz. “It’s also a way for them to manage certain risks, such as regulatory risk, given that it’s challenging to keep up with regulations across the different markets they are operating in.”

### Disruptive concerns

Big data, automation and artificial intelligence rank top among respondents for their potential to disrupt private capital investment in the next three years, yet over a quarter are not planning on implementing these technologies, and many report having little expertise in this area.

Less disruptive technologies could, however, help private funds streamline their processes without the need for high levels of investment. Priya Nair, managing director and global head of product management for private capital services at RBC, says: “Smart contracts, for example, can help create base templates where there are a lot of similarities, such as liability frameworks, without the need to have a large element of involvement from lawyers. Regtech has a lot of potential for helping firms monitor regulatory developments globally and ensuring firms can stay ahead of the game – it could streamline passporting, for example, and be applied to AML and KYC compliance.”

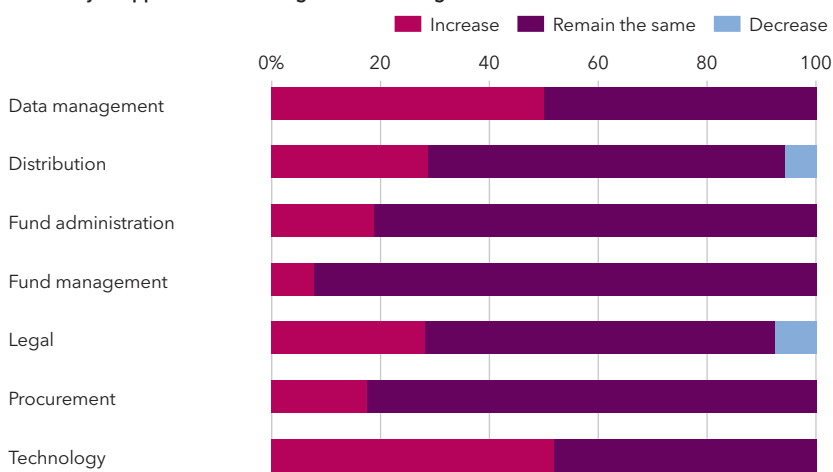
For those that invest in deploying technologies like big data, the prize could be better dealflow. “Firms are looking at how they digitize their internal processes at a time when there is a lot of dry powder in the private markets space,” says Nair. “They need to differentiate themselves around how they originate and how they create value in their portfolio.”

And being able to differentiate from the competition is uppermost in respondents’ minds. While the biggest barrier to achieving their objectives in 2019 is the economic environment (mentioned by 72 percent), competition is second for 42 percent. ■

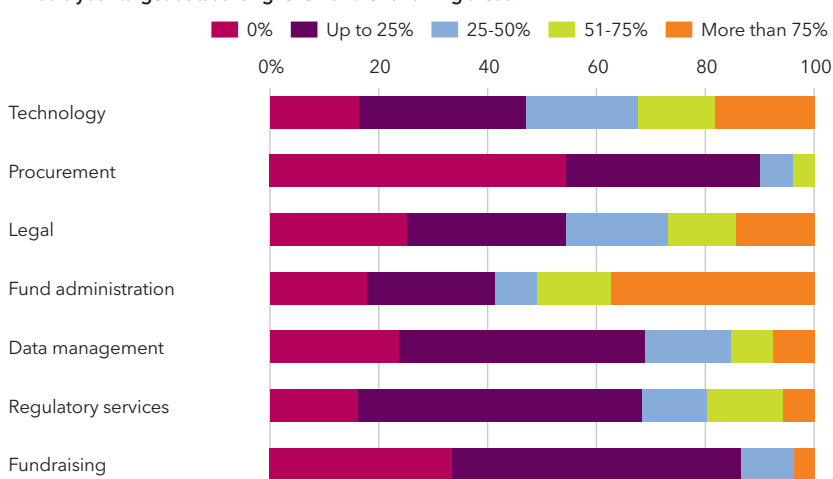
### Methodology

PEI Media surveyed 82 private fund managers about a range of fund domicile and regulatory issues. Answers were given on a strictly anonymous basis and the results aggregated.

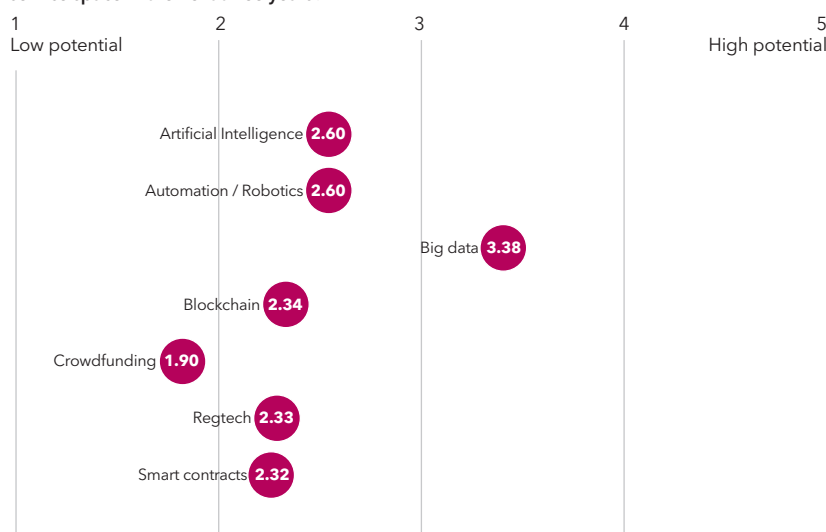
### How will you approach outsourcing of the following areas over the next 12 months?



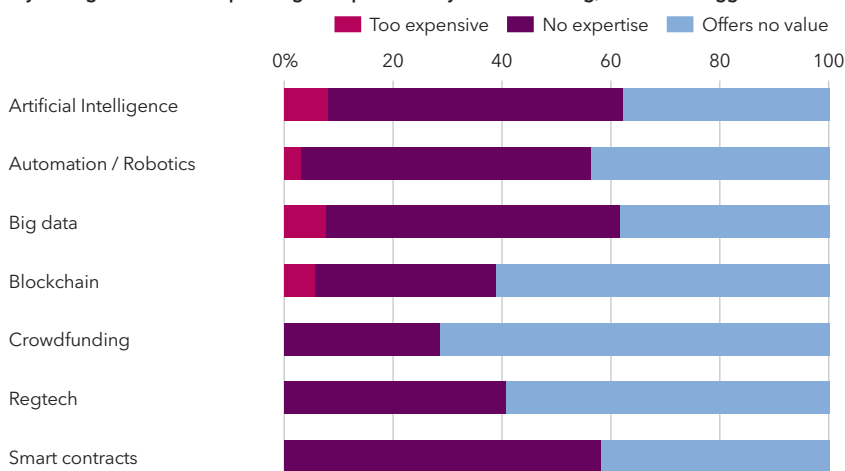
### What is your target outsourcing level for the following areas?



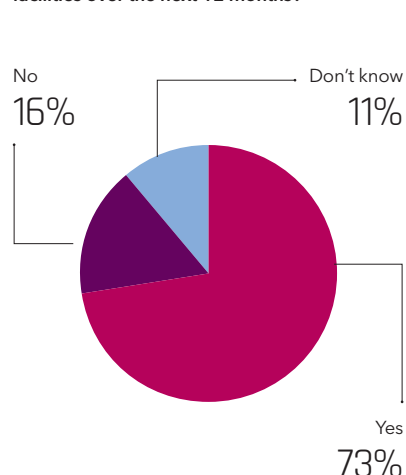
### What is the potential for the following to disrupt the private capital investment and service space in the next three years?



If your organization is not planning to implement any of the following, what is the biggest reason?



Do you intend to make use of any capital call facilities over the next 12 months?



## Tapping new demand for private equity

With 74 percent of private equity funds in our survey expecting an increase in AUM of at least 20 percent over the next decade, including more than two-thirds expecting to achieve this within half that time, investor relations and fundraising teams in this part of the alternative assets space are set for a busy time.

There is clearly demand from institutional investors as fund sizes have increasingly crept up over the years since the 2007-08 global financial crisis.

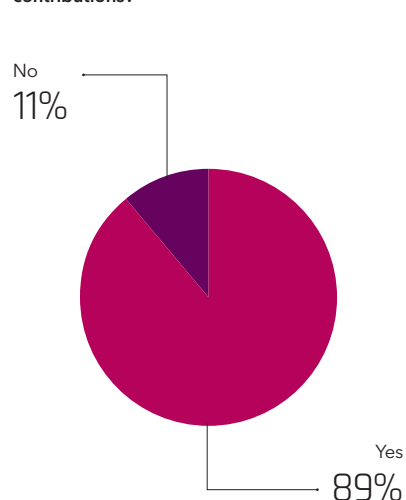
Yet private equity funds also have their eye on the retail market, our survey shows. Nearly half of respondents expect to increase retail investors in their investor base mix, including 19 percent predicting a large increase.

There has been some movement in this space, according to Reed Smith's Moghli. "Over the past 12 months, I've seen the launch of a handful of fully fledged private equity operating platforms aimed at retail investors that provide fully automated administration processes," he says.

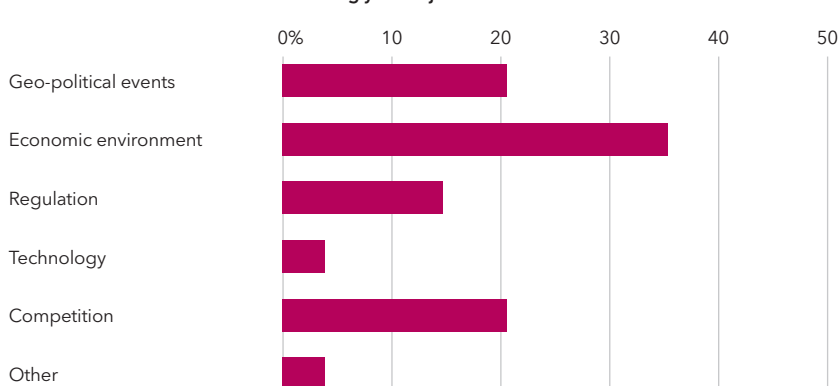
"However, they aren't targeting the average person on the street – they generally require minimum income levels of around £100,000 and assume a certain amount of investment sophistication."

Yet major developments look some way off, especially in Europe where regulations are currently not well tailored to the needs of private equity.

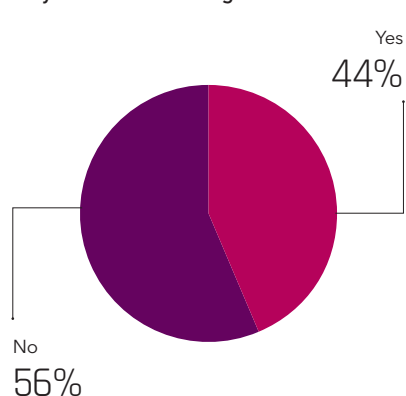
Do you use a capital call facility to bridge between an investment and the capital contributions?



What will be the main barriers to meeting your objectives in 2019?



Do you use fund financing loans?



# Regime ratings

*Delaware, the Cayman Islands and Luxembourg are the top jurisdictions, according to our survey of 82 private funds managers. All three domiciles rank highly in terms of regulatory framework, tax framework and business conditions*

The jurisdictions were rated based on the following questions. Where respondents were asked to give three answers, the first answer was given three points, the second two points and the third one point.

**Regulatory framework**

Which of the following domiciles offers the optimal regulatory framework in 2019?

**Tax framework**

Which of the following domiciles offers the optimal tax framework in 2019?

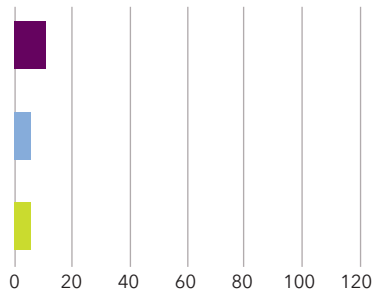
**Business conditions**

Which of the following domiciles offers the optimal conditions for doing business in 2019, such as expertise?

## Canada

Will you choose for next fund?

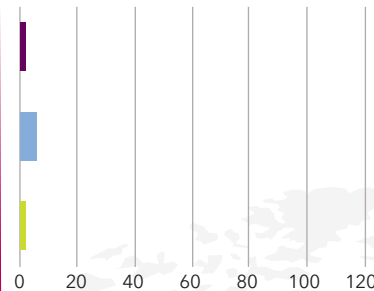
**4%**



## Bermuda

Will you choose for next fund?

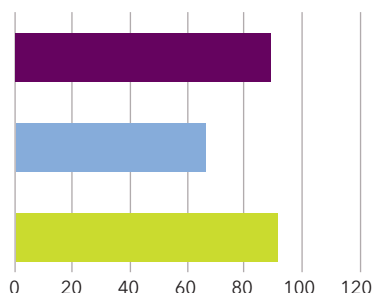
**3%**



## Delaware

Will you choose for next fund?

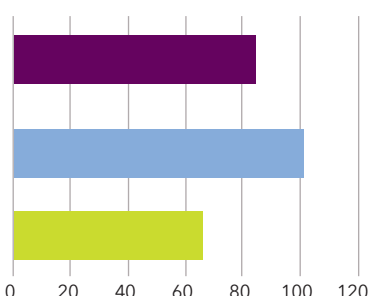
**45%**



## Cayman Islands

Will you choose for next fund?

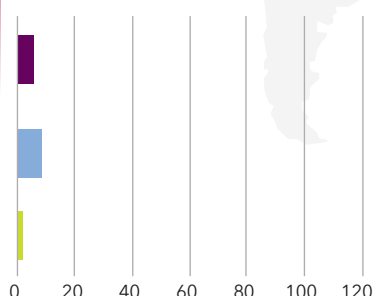
**45%**



## British Virgin Islands

Will you choose for next fund?

**3%**

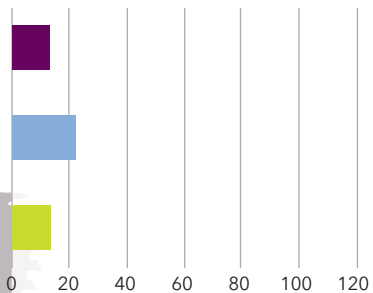




### Ireland

Will you choose for next fund?

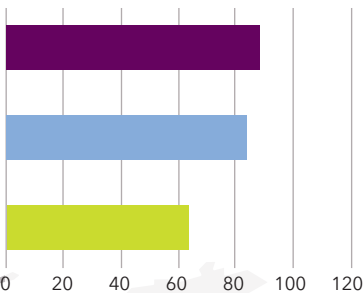
5%



### Luxembourg

Will you choose for next fund?

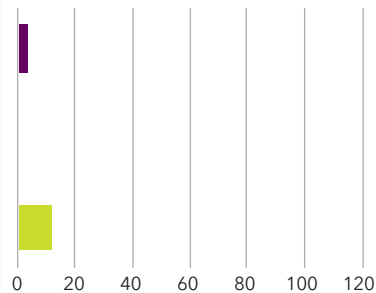
36%



### Hong Kong

Will you choose for next fund?

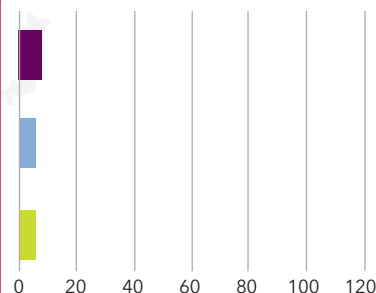
2%



### Singapore

Will you choose for next fund?

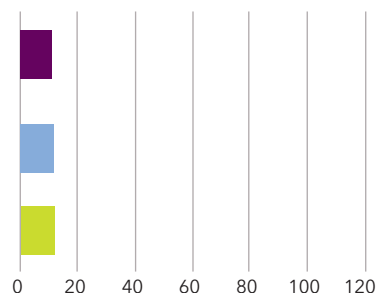
3%



### Jersey

Will you choose for next fund?

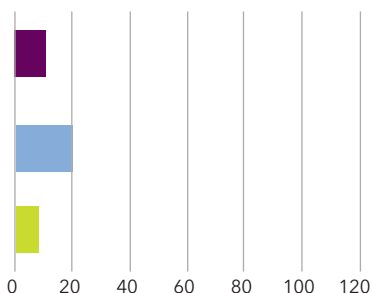
6%



### Guernsey

Will you choose for next fund?

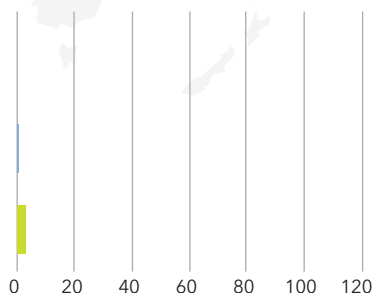
3%



### Australia

Will you choose for next fund?

1%



# Points of view on 2019

*“One thing remains certain: the demand for transparency and consistency is here to stay”*

**TOM ANGELL** of Withum on investor and regulatory scrutiny

*“Far too often, the private equity firms are like vampires”*

**US Senator ELIZABETH WARREN** is not a fan of private equity

*“What has been traditionally called the ‘back office’ is the heartbeat of the business”*

**Executive search expert EMILY BOHILL** on the indispensable role of the finance team

*“The finance team will be incredibly small”*

**TIM JANKE**, CFO of Xen, argues technology will streamline the finance function

*“The gap between politics and business has gotten wider. Our job is to seek to address that as well as we can”*

**MICHAEL MOORE** of the British Private Equity and Venture Capital Association warns of political turbulence

*“The technology seems to be moving faster than the regulators”*

**JAMES FERGUSON** of Intertrust Group on blockchain and data privacy

*“There’s a sense on both sides that the idea is to improve how we do business”*

**SANJAY SANGHOEE** of Delos Capital on co-operation between the SEC and fund managers

*“The biggest risks to deals and portfolio companies right now are geopolitical”*

**BRIAN RAMSEY** of Littlejohn & Co on the dangers of a widening political divide in the US

*“These benefits come at what we expect to be a modest cost”*

**Blackstone CEO STEPHEN SCHWARZMAN** on his firm becoming a corporation



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