



Fund Administration Outsourcing

**A GUIDE TO EVALUATING
THE OPTIONS AND MAKING THE
RIGHT DECISION**



The Outsourcing Revolution

Of all the duties the back office must perform, fund administration has changed the most over the past 10 or 15 years.

As the alternatives industry has matured, expectations among investors and regulators have grown, requiring General Partners to develop new capabilities and efficiencies in order to collect, manage, and report on a greater range of fund data than ever before. Once a relatively simple task, fund administration has become a resource-intensive and complex activity requiring a higher headcount, greater expertise, and more sophisticated technologies than ever before.

As recently as two decades ago, few firms outside of the hedge fund market would have considered outsourcing fund administration. But as industry pressures have transformed this back-office function, outsourced fund administration has become a viable option for funds of every size and type, including venture, buyout, debt, real estate, SPVs, fund of funds, and more. As a result, and within a remarkably short time frame, outsourced fund

administration has evolved from a small, niche industry to a business with \$8.4 trillion in assets under administration (AUA).¹

A few years ago, Preqin estimated that 30 percent of all assets under management (AUM) were administered by a third party, and predicted that by 2018, it would rise to 45 percent.² The latest numbers from Ernst & Young (EY) show that Preqin's ambitious prediction still fell short of the reality: in 2018, 55% of private equity managers outsourced the fund-accounting function and 71% outsourced compliance and regulatory reporting.³

This white paper examines some of the top considerations informing the decision to outsource fund administration, provides key criteria to apply to the task of selecting a fund administrator, and provides a useful checklist for evaluating the capabilities and cultural fit of short-listed fund administration partners.

A FAST-RISING TREND

According to eVestment research, the size of alternative assets under the administration of a third party grew by \$2.5B in five years.

2013 - \$5.90T
(↑20.2% YOY)

2014 - \$6.90T
(↑16.8% YOY)

2015 - \$6.66T
(↓2.92% YOY)

2016 - \$7.64T
(↑14.2% YOY)

2017 - \$8.42T
(↑10.2% YOY)

¹ eVestment, *Alternative Fund Administrator Survey*, 2018.

² Preqin, *2016 Preqin Global Private Equity & Venture Capital Report*, 2016

³ EY, *At the Tipping Point: Disruption and the Pace of Change in the Alternative Asset Management Industry*, 2018.

In House? Or Outsource?

To attract new investments, today's investment firms must not only deliver strong returns but also demonstrate an ability to navigate fast-changing regulatory requirements and deliver exceptional levels of service and transparency to their investors.

For CFOs who need to keep pace with the demands of regulators and investors, manage administrative costs, and carve out time for more strategic activities, outsourcing fund administration is an option worth exploring.

Many firms begin to consider outsourced solutions only when performance or resourcing issues begin to impact the firm negatively—an approach that can result in a decision made under pressure. Taking a proactive approach and recognizing emerging issues before they become critical gives General Partners time to evaluate their

options thoroughly and make a more informed decision.

The decision to outsource fund administration is usually motivated by one of five key issues, each of which will be explored on the following pages.

Growth. Alternative investment firms see bigger opportunities on the horizon and are preparing to meet them.

Investors. Reporting capabilities have become the most important selection criterion for a growing number of investors.

Talent. Turnover can be high in the back office, and firms are seeking ways to mitigate the impact.

Competition. Fierce competition for investors has led firms to explore new ways to attract capital.

Complexity. As the demand for specialty investments grows, so does regulatory and reporting complexity.



GROWTH

Growth is perhaps the single biggest factor in the decision to outsource, yet many firms fail to recognize the point at which their growth trajectory exceeds the ability of their back office to keep pace.

The issue is all the more crucial today because opportunities for growth have never been so plentiful as alternative investing attracts a wider range of investors than ever before.

Virtually every firm will experience a pivotal point beyond which the firm's existing staff can no longer stretch to accommodate growth. An in-house team that has successfully supported Funds I and II may suddenly find themselves struggling to prepare for subsequent fund launches and support the ongoing administration and reporting requirements. Increasing the headcount can ease the pressure

during the early years of a firm's growth, but as the firm continues to add to its portfolio, this option may no longer be financially viable.

There is a break-even point beyond which the cost of adding staff will exceed the cost of a third-party solution, especially when the expense of a private capital accounting platform (including staff training, IT support, infrastructure and integration) is factored into the equation. As the portfolio broadens, the in-house back-office team may also find themselves challenged to deliver specialized fund expertise across the full range of strategies, which is another area where a fund administrator can provide support.

Beyond alleviating back-office pressure, outsourcing fund administration enables the firm to

put its in-house talents to more effective and profitable use. When the CFO and their team can leave the day-to-day details in the hands of an administration partner, they can focus on supporting key growth levers, including sourcing deals, fundraising, and building strong client relationships.

Outsourcing can also fuel growth by saving costs and freeing up resources, especially for firms in major metropolitan areas where business costs—including office space and staffing—are particularly high.

GROWTH PREDICTIONS

GP perspective: 55% of PE firms said they expect to raise a new fund this year, and most say it will be larger than the last fund raised.⁴

LP perspective: 39% of institutional investors expect their private equity allocations to increase.⁵

⁴ EY, *Operational Excellence: One Path or Many? Key Findings from the 2018 Global Private Equity Survey*.

⁵ EY, *2019 Global Private Equity Survey*.

INVESTORS

For mid-tier and large investment firms alike, investor expectations around the flexibility, transparency, accuracy, and speed of reporting is placing a growing strain on back-office resources.

Firms of all sizes are struggling to keep pace as investors demand greater access to investment data than ever before. ILPA raised the bar considerably when it comes to the levels of communication and transparency required, the array of financial data expected, and the frequency with which it is expected, and those standards have transformed investor expectations and back-office workloads. The allocation and reporting of fees and expenses alone has become a complex and stressful exercise for many investment firms, even those with well-resourced back offices.

At the same time, the firm's ability to meet complex investor reporting

requirements has become integral to the firm's ability to attract future investment. According to EY, between 2014 and 2015, there was a 400% increase in investors that rank a firm's ability to handle reporting requirements as the most important selection criteria.⁶ While these requirements are top-of-mind for firms of every size, the issue is compounded for mid-tier, middle-market investment firms that move upmarket and need to appeal to bigger, more sophisticated LPs. Upper-market investors have very different service and reporting expectations, which can place unexpected strain on the internal team—not just from the perspective of an increased workload, but in terms of the level of expertise required. In fact, for many large investors, third-party fund administration is now a non-negotiable requirement.

A 2018 survey of institutional investors revealed that nearly two-thirds of investors (63%) consider operational improvements to be among the three most impactful things GPs can do to optimize returns.⁸

⁶ EY and Private Equity International, 2016 Global Private Equity Fund and Investor Survey.

⁷ EY and Private Equity International, 2016 Global Private Equity Fund and Investor Survey.

⁸ EMPEA, Global Limited Partners Survey: Investors' Views of Private Equity in Emerging Markets, 2018.

INVESTOR EXPECTATIONS ARE HIGHER THAN EVER

70%

of investors are not satisfied with any category of allocation or disclosure

29%

of investors make frequent requests for specialized annual or quarterly reports

27%

request customized templates

26%

expect timely delivery of reports

18%

expect a one- or two-day turnaround.

87%

of investors want to receive reports through digital portals⁷

TALENT

The attraction and retention of talent has emerged as a key concern for private equity firms. According to a recent EY report, 47% of CFOs rate talent management as a top strategic priority, making it an issue second only to asset growth, and more important than cost management or risk mitigation.⁹

As talent becomes an increasingly scarce commodity, back-office turnover can be one of the greatest threats to productivity and reputation and a significant point of vulnerability. Devastating at any time, the effects are heightened when a staff member leaves prior to a reporting period, resulting in not just a loss of capacity, but also of vital continuity. When a back-office employee walks out the door, irreplaceable institutional knowledge leaves with them, including a crucial understanding of the firm's history and processes, and an ability to locate key financial data. Backfilling and retraining is costly and disruptive, with institutional knowledge taking a long time—sometimes a year or more—to rebuild. And unfortunately, it is the most seasoned employees who are most likely to be lured away.

Outsourcing fund administration eliminates the cost and disruption

caused by internal turnover because fund administration firms have processes in place to protect service consistency and retain institutional knowledge. In addition to distributing critical back-office knowledge across an extended team, most fund administrators maintain documented processes and procedures that accelerate onboarding and facilitate knowledge sharing. The technology platforms used by many fund administrators also contribute to stability and enhance continuity by providing a central repository for current and historical fund administration data.

In addition to mitigating the impact of turnover, outsourcing fund administration ensures that in-house talent can stay focused on more strategic areas, which not only makes better use of their skills, but can enhance retention efforts. According to the latest EY data, CFOs at private equity firms want their teams to spend **the least amount of time on fund accounting** and the greatest amount of time on high-value activities such as portfolio analytics, technology, and investor relations.¹⁰



⁹ EY, *Operational Excellence: One Path or Many?* 2018 Global Private Equity Survey.

¹⁰ EY, *Operational Excellence: One Path or Many?* 2018 Global Private Equity Survey.

COMPETITION

Across the board, and especially in the bulging middle market, firms are looking for ways to stand out and attract the capital they need. The competition for investor dollars is intense, and General Partners must cover all bases to appeal to investors. In a climate where fiduciary activities and regulatory oversight are top of mind, firm performance is now being evaluated in terms of back-office operational excellence as well as proven returns, and the integrity of the back office has become as important to the investment decision as the manager's track record and investment philosophy.

A 2018 survey of institutional investors revealed that they believe fund performance is connected to operational performance: nearly two-thirds of investors (63%) consider operational improvements to be among the three most impactful things GPs can do to optimize returns.¹¹ Outsourcing fund administration sends a clear signal to investors that the GP is committed to operational excellence and supports the highest levels of transparency, diligence, accountability, and control.

FUND COMPLEXITY

When moving into a specialty fund area, even experienced firms can become overwhelmed by the added layer of regulatory and reporting complexity. While launching specialty funds such as debt funds, SBICs, or real estate funds can offer GPs an opportunity to attract investors with an advantageous and niche offering, these fund types often have complex structures or additional regulatory requirements.

That extra layer of complexity can significantly increase the amount of time and effort required to administer the fund, and it may also require specialized expertise that an in-house team doesn't possess. The right fund administrator can provide senior-level expertise for a specific fund strategy or situation, bringing years—or even decades—of experience to the table, and giving your firm access to guidance on demand.

SHRINKING MARGINS

Shrinking margins have become a reality for a growing number of firms. According to EY, margin erosion is affecting nearly 40% of private equity managers.¹²

Outsourcing has become part of the cost-management discussion for many private equity managers, with 37% reporting that they are increasing their reliance on outsourcing as a way to mitigate margin erosion of the management company.¹³ While not every back-office function lends itself to the outsourcing model, fund administration has emerged as one of the most valuable areas to outsource. In fact, more than two-thirds of CFOs (67%) consider fund accounting to be an area where outsourcing will add value.¹⁴



¹¹ EMPEA, *Global Limited Partners Survey: Investors' Views of Private Equity in Emerging Markets*, 2018.

¹² EY, *2019 Global Private Equity Survey*.

¹³ EY, *2019 Global Private Equity Survey*.

¹⁴ EY, *Operational Excellence: One Path or Many? 2018 Global Private Equity Survey*.

Choosing a Fund Administrator

If your firm has decided that outsourcing fund administration is the right choice, you'll want to carefully examine the options available to you.

Fund administrators range from small providers with a handful of staff to larger enterprises or custodial banks with upwards of several hundred employees. Aside from the differences in size, there are differences in the approach to services, the types of services offered, the underlying technologies, and the types and levels of expertise on staff. The breadth of offerings can make it challenging to compare options, but looking at these five key evaluation criteria will help you focus on the elements that are most important in finding the right fit.

1 CAPACITY

When selecting a fund administrator, bigger isn't always better. However, you do need to know that the partner you choose has the bandwidth to meet your needs—today and in the future. To gauge a fund administrator's capacity, many GPs focus on AUA, reasoning that the higher the dollar value, the more resources the firm has available to meet the GP's needs. But AUA fails to take into account the wide variety of service levels required by different fund types.

In fact, a firm that manages a significant multiple of AUA in high-value buyout funds may have fewer resources in place than a firm managing considerably fewer AUA if that lower figure includes mezzanine or debt funds, given the higher level of transaction activity in

such funds. If there are additional specialized reporting requirements and/or regulatory reporting elements for some of those funds, the administration process will involve an even greater commitment of technical and human resources, along with a higher level of expertise.

Instead of focusing on AUA alone, ask each fund administrator for a breakdown of the fund types they service, and look for firms with a substantial proportion of funds under administration that require more complex regulatory and compliance processes.



2 EXPERTISE

While bandwidth is a factor, you want to make sure that the fund administrator you choose has a strong and deep bench at the senior level: responsiveness is important, but so is the quality of the information and expertise provided.

A high level of expertise is especially important if your firm manages (or plans to launch) a complex or specialty fund, or has plans to scale significantly. When evaluating staff expertise, make sure that the accounting resources at the senior manager and staff level have direct experience managing private capital fund structures. General accounting experience isn't enough: the complexity of private capital funds requires specific expertise in this area.

In addition to a client services manager who acts as the main point of contact, your service team should include senior and staff accountants with specialized experience in a number of key areas, including fund accounting, financial reporting and compliance, and investor services.

3 CONTROL

If your firm currently administers funds in house, the idea of giving up control over the process can be nerve-wracking. However, a good fund administrator will provide tools and self-service options that enable you to track their progress, check their calculations, and access your fund data, enabling you to retain control and oversight at all times.

Reporting portals are a fairly standard offering, but some fund administrators offer a deeper level of oversight by providing financial statements and data that can be exported in a more granular format to your own environment where you can conduct further analytics. At a minimum, you should expect a fund administrator's system to give you direct access to current and past financial statements and underlying accounting details, including balance sheet, general ledger, trial balance, journals, and P&L statements. The data should be available through a secure online reporting portal in dashboard format and in a raw-data format that can be exported to a spreadsheet or other program that lets you conduct advanced analytics and use the calculations for additional internal reporting.

When evaluating fund administrators, have a checklist of your data requirements ready and always request a live demo of their technology platform so that you can confirm that their offering delivers the level of control, intuitiveness, and transparency you require. Ultimately, outsourcing fund administration should give you the best of both worlds, enabling you to offload the back-office burden to an expert without giving up control over your data.

At a minimum, you should expect direct access to current and past financial statements and underlying accounting details, including balance sheet, general ledger, trial balance, journals, and P&L statements.

4 SERVICE

Levels of service vary considerably among fund administrators, so it's important to clarify the exact nature of the relationship that each fund administrator promises. Terms such as "high-value," "high-touch," or "boutique" are frequently used but poorly defined. At a minimum, the fund administrator should be able to provide a standard service-level agreement (SLA) that defines the onboarding process, sets the ongoing communication cadence, and clarifies the roles and responsibilities for both the fund administration team and the General Partner's back office.

The agreement needs to specify turnaround times, communication frequency, deliverables, special reporting requirements, and any other key service elements. Ideally, it will also specify a standing weekly or bi-monthly call, which enables the fund administrator to stay tightly integrated with your team and prepare for upcoming activities.

Within large-scale fund administration firms, the ability to customize the SLA is usually fairly limited, with one level of service applied to every client account. Boutique fund administrators often take a more flexible approach and have the capacity to customize the SLA to align with the GP's specific requirements and preferences.

5 SECURITY

Financial data is at high risk of security breaches, and alternative asset managers are challenged to protect themselves and their investors. Nearly one-quarter of private equity firms (22%) have experienced a cybersecurity breach, and over half (58%) of those breaches were considered at least moderately serious.¹⁵

Data security should be top of mind for GPs as they evaluate fund administrators. Check to make sure that the company has SSAE 18 System and Organization Controls (SOC) 1 Type 2 audit standards in place, which means that an independent auditor has reviewed the company's procedures and controls over a period of six months or more. Without this standard in place, your firm can't be sure that the fund administrator is adhering to operational procedures, including multiple review touchpoints that protect the integrity of your data. Additionally, the SOC 1 Type 2 report should be for the entire scope of fund administration services, not just a single component of the service offering.

The fund administrator you choose should also have a documented disaster recovery and business continuity plan for their technology

stack. As the holder of your fund data and documentation, it's critical that your fund administrator have procedures in place that enable them to continue delivering service under any adverse circumstances. Their technology should be built on a platform that includes a production site, multiple redundant sites, and automatic daily backups.



¹⁵ EY, *Operational Excellence: One Path or Many? Key Findings from the 2018 Global Private Equity Survey*.

Technology in the Spotlight

When evaluating fund administrators, technology needs to be as much a part of the conversation as the expertise of the service provider's team or the integrity of its processes.

The technology that underpins a fund administrator's services impacts many factors, including turnaround times, the ease of data access, the quality and integrity of the data, the quality of the investor experience, and resilience to cyberthreats. Yet only 21% of fund administrators are fully confident that their technology is where it needs to be.¹⁶

Enhanced investor experience. Investors now expect a level of visibility and access to fund data that can't be delivered without state-of-the-art technology. A survey conducted in 2016 found that 87% wanted to receive reports through digital portals;¹⁷ today, that figure is likely to be even higher.

Look for a fund administrator that offers an investor portal capable of collecting key fund data and a range of performance metrics, including fund strategy, vintage year, unfunded commitment, total commitment, DPI, RVPI, TVPI, fund multiples, and IRR.

Streamlined reporting. Portal technologies can also support your back office by streamlining and organizing the information you need to produce quarterly and annual reports, conduct internal analysis, and prepare external reviews, reports, and audits for various management, tax, and regulatory purposes.

Look for a fund administrator that consolidates fund data on a centralized platform and offers customizable reporting dashboards and report templates.

Improved security. While SOC 1 Type 2 audit standards protect the integrity of your data and documentation, the right technology protects it against cyber threats by keeping sensitive information, including capital calls, distributions, financial statements, K-1s, and other fund-related documents, in a secured digital environment.

Look for a fund administrator whose platform technologies have advanced security features, including two-factor authentication and extended validation SSL certificates for all sensitive data.

Only 21% of fund administrators are fully confident that their technology is where it needs to be.

¹⁶ The FIS Readiness Report: The Hunt for Growth Across Fund Administration, 2017.

¹⁷ EY and Private Equity International, 2016 Global Private Equity Fund and Investor Survey.

Added Services

GPs often don't realize that outsourced fund administration services can extend beyond fund accounting, but many fund administrators now offer a wide range of back-office services.

Fund administrators may offer additional services such as investor services, investor vetting such as Anti-Money Laundering and Know Your Customer (AML/KYC), consulting, fund accounting for the management company, and more.

Finding a firm that offers both fund administration and specialized services can save your firm time and money and minimize the number of vendors you need to manage.

INVESTOR SERVICES

While a fund administrator's duties are primarily related to the back-office function, they can also take on key aspects of investor services, managing the issuance of quarterly and annual reports, capital calls, and distribution notices. Almost every fund administrator maintains an investor portal where reports and documentation can be securely accessed by investors and Limited Partners 24/7. The fund administrator is wholly responsible for managing the workflow, posting all required documents, and maintaining the underlying technology.

AML/KYC

Most GPs approach their attorneys for help with AML/KYC activities, but many fund administrators offer this service and provide it at a significantly lower cost. The process involves reviewing the subscription documents, running the investor or Limited

Partner pool or group through multiple databases to confirm their information and identify any prior legal issues, and collecting additional documentation to resolve or clarify outstanding issues.

STRATEGY AND CONSULTING

Many fund administrators provide targeted support for funds in wind-down mode or end of life. Services may include conducting regulatory compliance reviews and distribution analyses, providing secondary transaction due diligence support, reviewing the valuation methodology and calculations, assisting with tax planning, supporting litigation, and reviewing PPMs and LPAs.

MANAGEMENT COMPANY FUND ACCOUNTING

Many fund administrators also offer services for the management company, including expense reporting, bookkeeping, and record keeping.



FUND ADMINISTRATION

Evaluation Checklist

This list of questions can help your firm collect the information you need to ensure that your next fund administration partner is capable of meeting your needs and supporting the engagement with the right technology.

SERVICE

☐ Do you have a SOC 1 Type 2 exam performed on an annual basis?

☐ What is your Net Promoter Score (NPS) and/or customer satisfaction level?

Notes

☐ What's the average length of time that your clients stay with you?

Notes

☐ Which fund types do you support [debt/credit, SBIC, buyout, venture, real estate, fund of funds, etc.]? Please specify.

Notes

☐ Do you have clients in the same fund strategy as my firm?
Can I speak to them?

☐ Do you offer value-added services such as AML/KYC, management company bookkeeping, startup consulting, wind-down consulting, books and reports for GPs, and tax support?

☐ Do you attend annual meetings for clients?

☐ Do you respond to investor DDQs?

☐ What is the average turnover rate among client service personnel at your firm?

Notes

☐ How many people will be assigned to my account and what is their background/level of experience?

Notes

☐ How is coverage and service continuity addressed when team members take time off?

Notes

☐ Do you have a discovery process for determining the service levels required by the client?

☐ Do you have a documented onboarding process for new clients?

☐ Do you have a documented Service Level Agreement (SLA)?

☐ On average, how frequently do you communicate with your clients?

Notes

REPORTING

☐ Is the reporting you offer standard, or can it be customized?

Notes

☐ Do you support ILPA reporting?

☐ Do you provide a portal where investors can access reports and documentation 24/7? Is the reporting customizable?

Notes

COST

☐ Do you structure your fees based on assets under administration (AUA) or fund complexity and work required?

Notes

☐ Do you charge a fixed fee or variable fee, and are there any incremental or hidden costs associated with your services?

Notes

☐ What is the cost for onboarding and migrating our historical data?

Notes

TECHNOLOGY

- ☐ What accounting platform do you use?

Notes

- ☐ How would you migrate my historical data (including static and transactional data for investors, investments, and other accounting transactions) onto your systems?

Notes

- ☐ Is the accounting platform integrated with all processes and systems? If not, what processes are manual? What information is maintained outside of the core system in spreadsheets and other formats?

Notes

- ☐ How do you ensure data security?

Notes

- ☐ Do you maintain an online portal for Limited Partner reporting and communications?

Does your investor portal include these features?

- ☐ Searchable document repository
- ☐ Performance dashboards that capture DPI, RVPI, TVPI, fund multiples, and IRR
- ☐ Access to underlying, official, real-time fund data
- ☐ Individual investor commitments, contributions, distributions, and residuals
- ☐ Two-factor identification and extended SSL certification

- ☐ Do you provide a CFO portal that provides access to financial data at all times?

- ☐ Which technologies are your Limited Partner and CFO portals built on?

Notes

- ☐ How do you ensure platform performance?

Notes

- ☐ What type of technical support do you offer to support your technology platform?

Notes

- ☐ What types of business continuity precautions do you have in place?

Notes

- ☐ Do you have a documented disaster recovery process in place?

- ☐ Does your platform include a production site, multiple redundant sites, and automatic daily backups?

- ☐ Do you manage and maintain your technology with an in-house IT team?

Next Steps

As the private capital market matures and reporting and compliance becomes more rigorous, outsourced fund administration is an option that every General Partner should evaluate.

If your firm faces the challenge of accelerating growth and doesn't want to sacrifice service levels or widening margins, outsourced fund administration may offer a more cost-effective solution than continuing to add to the headcount while acquiring and maintaining increasingly complex technology.

Choosing a fund administration partner is a big decision, and one that requires a clear understanding of industry best practices as well as your firm's unique requirements. While there is no one-size-fits-all solution, this guide and the checklist on page 13 will help you consider your options, identify your priorities, and start a meaningful conversation with potential partners.



ABOUT PEF

Since 2002, PEF has helped some of the most complex fund types meet stringent regulatory and investor requirements. We are nationally recognized as one of the top boutique fund administrators and back-office specialists for General Partners, Limited Partners, and management companies in the alternative asset space.



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