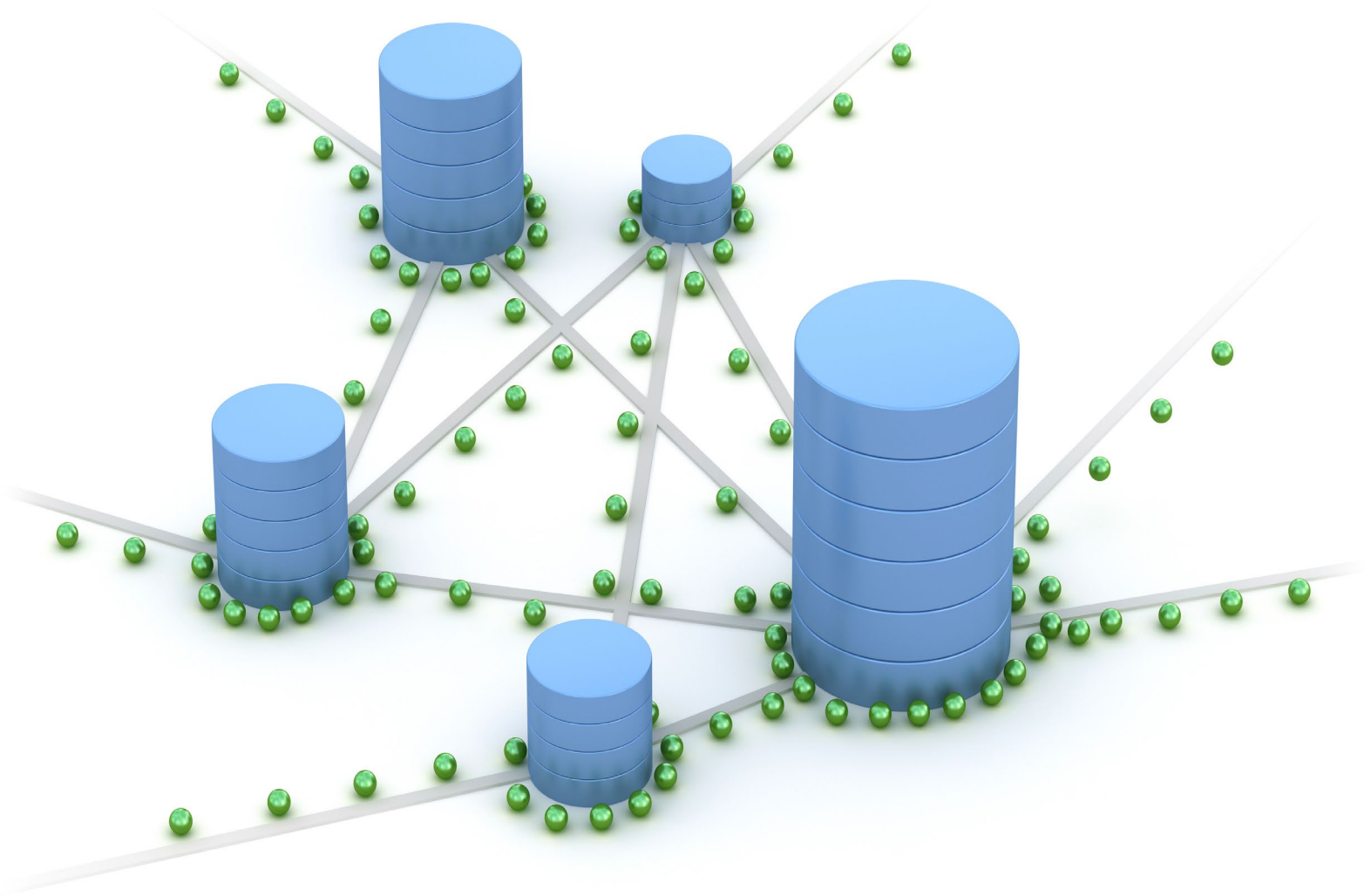


## Managing the Information Exchange

*An Executive Summary From the Privcap Series "Building a Better PE Firm"*



# Managing the Information Exchange

## Key Findings

1. LPs want to see a strong back-office infrastructure
2. Inability to answer a question or provide reliable information can be costly
3. Increased due diligence is putting a greater strain on private equity firms
4. Checks and balances can make a world of difference
5. Private equity firms need to strengthen their protection of investor data

## The Panelists



*Cameron Hillyer*  
Chief Financial Officer  
MatlinPatterson Global Advisers



*Steven Millner*  
Managing Principal  
Gen II Fund Services



*Howard Weiss*  
Chief Financial Officer,  
Castle Harlan

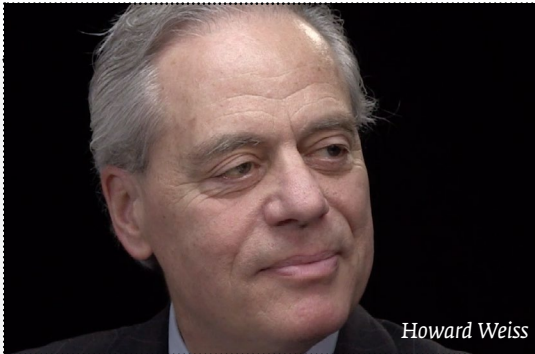
**T**he current fund raising cycle combined with enhanced regulation is uncovering some important new LP trends. In addition to expected questions about returns, investment focus, unique access to deal flow and the team at the GP, there are new questions cropping up – those focused on the GP’s operational infrastructure.

During and beyond the fundraise LPs want to understand the people, processes and technology that will deliver the key financial information on their investment in the fund after they have made their commitment – and want to ensure that not only does a GP have these items in place, that they are institutional grade and provide a level of independence when it

comes to the fund’s economic calculations and individual investor allocations.

Gone are the days when GPs could focus solely on investment performance, industry specialization and unique deal flow access. Now, an important part of the investor presentation is how a GP will manage key operational tasks, the quality and timeliness of investor reporting, and how the firm will stay compliant with required industry regulations.

Add to that a heightened expectation of consistency of information flow and it’s no surprise that GPs are looking more intently on how to strengthen their firm’s operations - or seeking to partner with a fund administrator to help them meet these requirements.



Howard Weiss

## Truth in Information

Supersize helpings of information. That's what LPs want these days. And private equity firms must be prepared to provide it. "LPs ask us for information and more information and every kind of information you could possibly want," Weiss said. "And very often they'll challenge us on what we've issued."

They mount these challenges by taking the information the firm hands over and comparing it to the information they have to see if it matches. When this happens, Weiss said, his firm tries to anticipate and ameliorate possible issues by asking to see the LP's information in return, so his firm can run a parallel review and explain any conflicts.

Another reason to be meticulous with data furnished to LPs is that the information offers LPs a window into the firm's back-office practices. "I can't say they're going to call us up and ask what software program we're using," Weiss said. "But they want to know what their capital accounts look like, they want to know their waterfalls, they want to know their IRRs. And that's how they learn what goes on in our back office."

## Key Findings

### 1. LPs want to see a strong back-office infrastructure.

LPs previously invested in private equity funds based almost entirely on expected performance. That's no longer the case. Today GPs are getting peppered with questions about the back office and LPs won't move forward unless key questions are answered.

Why the change? Increased regulation and scrutiny in a post-Madoff world. "Returns are still the top consideration for LPs but other factors, including infrastructure, the culture, governance, transparency, they're no longer just purely secondary considerations," said Cameron Hillyer, CFO of MatlinPatterson Global Advisers.

Steven Millner, Managing Principal of Gen II Fund Services, agrees that LPs are shining spotlights on internal operations like never before. His firm provides outsourced back office services to private equity firms.

"We've been doing this for more than 20 years. For the first 15 years, LPs never visited our offices," he said. "In the last five years we've had a steady stream of LPs coming to our offices. They want to take a look around, understand our processes, get to know our people, ensure we have disaster-recovery and business-continuity plans. We've established complete due diligence binders where they look at our processes, our controls and our team."

### 2. Inability to answer a question or provide reliable information can be costly.

LPs are asking increasingly sophisticated questions about the back office. That's not surprising given the rise of professionals at the LP who are purely dedicated to conducting operational due diligence.

"There used to be just one team that would cover everything," Hillyer said. "They would do the investment returns and then they'd ask the back office a couple of questions. Well, now you've got dedicated people who are very experienced in that regard. They understand best practices and what's appropriate for a firm of a particular size."

A big part of their job is sniffing out back office

concerns and identifying red flags. And alarm bells ring when GPs can't answer questions directly or can't provide sufficient data to support their answers.

"LPs are going to request certain information and your responsiveness, your accuracy, your understanding and your ability to communicate the answer is going to tell them a lot," noted Howard Weiss, CFO and CCO at Castle Harlan.

"Investors want to have confidence that the information they're getting is reliable, that it's accurate and timely, because they have their own constituency, their own stakeholders that demand this information," Millner added.

### 3. Increased due diligence is putting a greater strain on private equity firms.

LPs are placing greater demands on private equity firms, requesting more and more information and reports. At some firms the situation is near the breaking point.

"It's creating a strain," Hillyer said. "The volume of requests from all LPs is just exploding. It's not only on your quarterly valuations but also every underlying portfolio company metric."

Some firms are so overwhelmed they're in danger of making critical mistakes, passing along inaccurate data to LPs. One solution is to leverage technology. "I think we're starting to see a software-driven approach to this," Hillyer said.

Another solution is to outsource the back-office function to a third-party provider like Gen II, which firms are doing more often.

"Sometimes we get called in not by the CFO but by the CEO of a firm, because he wants that CFO thinking strategically and not chained to a desk," Millner said. "They're stuck behind mounds of paper in their office and they're really not able to provide the value to the organization that they otherwise need to be providing. That's another effect that increased demand for information is having on GPs."

### 4. Checks and balances can make a world of difference.

Warren Buffet famously said, "It takes 20 years to build a reputation and five minutes to ruin it." In private equity, where LPs have many choices, the smallest mistake can



Cameron Hillyer

## Culture Can Mitigate Risk

Mistakes are made. It happens in every industry. The harsh reality is that no company can ensure 100-percent accuracy in every process all the time. But private equity firms can minimize mistakes in the back office by cultivating a scrupulous culture.

"You can't monitor everything that happens in a firm," Hillyer said. "But you can control the culture of the team. We try to bring together people who are thoughtful, who have strong intellectual curiosity, who have all the personal characteristics, as well as the professional characteristics, to be part of the team."

Escalation policies are great. But back offices the world over have workers who deal with problems by sweeping them under the rug. PE firms should seek back-office people who are ready and willing to call out problems when they see them. "You need people who know when to elevate an issue and who ensure that it does get appropriately elevated," Hillyer said. "That mitigates risk for you as a firm."

have large ramifications for the firm's future. That's why it's critical for GPs to communicate accurately and honestly with LPs and make sure no errors are made when sharing data or answering questions.

"We're not a big office, we only have half a dozen people. But nothing goes out without someone else checking it first," Weiss said. "That person can even be



Steven Millner

## LPs Are Agents for Change

Don't blame LPs for being inquisitive. They need to have confidence that the information they're getting is reliable, accurate and timely because they have their own constituency to report to, whether it's an endowment, pension plan or other stakeholder. That's why they're so demanding.

"I'll give you an anecdotal example," Millner said. "I was invited on behalf of a client to sit in on a due diligence meeting at the client's office. The LP people went through their checklist and one of the questions they asked of the client's CFO was, 'Who can sign off on moving money?'"

The reply, in this case, was that the CFO could wire any amount of money without another signature. "Wrong answer" was the response from the LP.

"The LP said, 'We require two signatures for transactions over a certain amount of money in order for us to invest,'" Millner said. "So in that particular instance, the LP was actually mandating that the GP would have to modify their processes in order to accept the investment."

junior to the person who did the work."

You need another set of eyes—and nostrils—to ensure that what you're sharing with LPs passes the sniff test. "There are times when I am shown something and I know it can't be right," Weiss added. "If, for example,

the IRR was X three months ago and nothing changed, I know the IRR can't be Y now. It's essential to always check and double-check the numbers."

Millner said that before his firm sends financial statements to a client, at least three people read it. "You never want to hurt your reputation by disseminating incorrect information. People trust sponsors to manage their money and one way that trust is manifested is in the accuracy of information LPs receive. And if there's an inaccuracy, you can appreciate how someone could wonder, well, if that's not right, what else isn't right?"

LPs and their advisory boards view third party oversight as quite positive and comforting. "It's like having an extra set of eyes in the mix," noted a Gen II client in a recent study. "In today's regulatory world, having that independence changes the ballgame."

## 5. Private equity firms need to strengthen their protection of investor data.

So far, the PE industry has managed to avoid a high-profile data breach. But how long the industry can stay out of the headlines is anyone's guess.

"There aren't many things that keep me up at night but this is one of them," Millner said. "When you consider what the industry has in their files, Social Security and Tax ID numbers, bank information, names, addresses—we all control lots of information. LPs and GPs are understandably concerned about cybersecurity."

"I can assure you that if someone at a GP took investor information and accidentally sent it out to the wrong recipient, that would be a calamitous event," Millner said. "So we have made a very significant technology investment to protect our clients and their LPs. We've established procedures to safeguard client data and have enacted clean-desk policies so we can't leave confidential information on desktops at night."

Weiss is determined that Castle Harlan will never fall victim to a data breach. That's why the firm has invested in state-of-the-art technology and made security the primary mandate for its IT director.

"There are attempted breaches on a regular basis and we're all over it," he said. "The right systems can protect you. But there are very large companies out there that have been breached and you've got to be on top of it all the time." ♦

## ABOUT GEN II

with **Steven Millner**,  
Managing Principal,  
Gen II Fund Services



Gen II offers private equity firms the best-in-class combination of people, process and technology, enabling GPs to most effectively manage their operational infrastructure, financial reporting and investor communications.

Gen II administers more than \$75B of private capital covering more than 600 fund entities and reports to more than 6000 LPs on behalf of our clients. The Gen II team is the most experienced and longest tenured team in the private equity fund administration industry, and has received the highest levels of customer satisfaction of any fund administrator.



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