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Who You Do—And Don't—Need in Your Back Office

An excerpt of the Privcap webinar
"Human Capital in the Private Equity Back Office"

Joe Healey
Korn Ferry

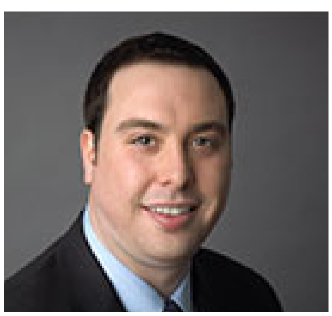
Matthew Herzog
Hamilton Lane

Who You Do—And Don't—Need in Your Back Office

Experts from Korn Ferry and Hamilton Lane talk about which positions should be in-house and which should be outsourced

The Panelists

Joe Healey
Senior Client Partner,
Private Equity Practice Leader,
Korn Ferry



Matthew Herzog
Principal, Client Services,
Hamilton Lane

David Snow, Privcap: The back office is transforming rapidly as private equity institutionalizes and investors become much more sophisticated. Joe, what's driving those changes?

Joe Healey, Korn Ferry: If you look back maybe 15 or 20 years, this was a much simpler business than it is today. A private equity firm does three things: it invests money, it raises money, and it administers an asset management firm. And those [functions] are the same as they've always been. However, the level of complexity on the part of firm administration has gone through the roof.

Any managing partner or leadership team of a private equity firm you talk to will quickly tell you that this business is a whole lot more complicated business to run today for any number of reasons—regulatory complexity from a finance perspective, and from a talent perspective. And as soon as you turn a single-strategy firm [into] a multi-strategy firm, you've increased the nature of administration pretty dramatically.

Today we'll see a fund with a chief operating officer, and a general counsel, certainly a CFO—in years past, the CFO might have been a glorified controller; increasingly today they are very senior, oftentimes general partners of the firm.

Matt, what have been the most important catalysts in causing firms to add people to the back office and elsewhere in the firm?

Matthew Herzog, Hamilton Lane: In the last 10 years [there's been] growth in the need of people, and also the need for technology, and the need for more information transparency. What flipped the

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switch was market-to-market valuations about 10 years ago. That made everyone spend a little bit more time on the private equity portfolio.

Then, as we got more and more regulatory insight and auditor insight into what was expected from us, that led to more work for back office and middle office in communicating to LPs and in making sure that you have the right regulatory processes so that your data is accurate and transparent.

What are some of the roles that are now within the private equity firm?

Healey: [The roles] are getting more senior and more experienced as time goes on. There was a time when a single-strategy midmarket buyout fund didn't even have a proper CFO, in part because it wasn't really required. Now, it's a CFO, [who is] probably someone who's been around for 25 years and is quite sophisticated.

Same in investor relations. There was a time when that was more of an administrative role and much less client facing. Today, the head of investor relations is as likely to be a partner. And marketing and communications we often see dovetailed with investor relations. Branding and packaging the [firm's] message is now critically important, and maybe not surprising given the level of competition in the market.

Many firms have a head of talent management—almost an operating partner with a talent orientation—for their portfolio company leadership issues. And we often see marketing and communications dovetailed with investor relations.

Let's say you're a medium-sized firm. Which of these roles would you typically not have?

Herzog: When you're looking at the smaller firms, from an LP perspective the concern that you want answered is [whether] that the separation of duties is still there. Even at the small end. No longer is it acceptable for the CEO and partner to also be running deals and wiring capital out to the individual investments. You're not going to get institutional dollars if you continue to have a four-partner shop.

Healey: There's actually a bigger issue—when you have the pricing pressure on the industry that you have, where carry is now much more back-ended, [and a] 1.5 percent management fee is probably more likely than 2 percent [carry] in many markets.

It speaks to a question about scale—what does the critical mass of a firm need to be in order to properly run an administration with all of these capabilities? The complexity, even at a modest-sized firm, has gone up at the same time that you have this pricing pressure on the top-line revenue of these firms. It's a big risk factor in analyzing firms as to whether they can do all of this, particularly the smaller firms.

Matt, I don't know if you have any insights off the top of your head, but how important is this issue of how good or bad their administration is when Hamilton Lane is doing due diligence on a fund? Does it really have weight in the decision?

Herzog: At one time we were very focused on "Are these the best investors?" As more and more time has gone by, there has been much more focus on the administrative aspect of running a fund. And now, our focus is: Are they good investors? Are they really good fund managers as well? That means, do they understand the timing of capital calls, and do they have the staff to be able to enact strategies to have an LP experience that is expected by the market as well as that is good for their returns?

Joe, how are you seeing private equity firms outsource certain functions in a way that helps them to scale?

Healey: The roles I have the most experience with at a high level are really hard to outsource. If anything, you could argue that there's a trend for in-sourcing some of these critical roles. I'd point at capital raising as one. There was a time when it was routine every four years to hire a placement agent to raise your fund. And today, your first thought is: I need a direct relationship with my LPs. I need the person who is the proxy to the leadership team in the office, and a member of the firm. If you need to augment that with a placement agent, that's a different question. And investor relations actually have been more in-sourced, as opposed to outsourced.

Herzog: There are some functions that are simply not expected or not allowed to be outsourced. And IR is one of them. You need in-house resources that can manage the outsourced relationship, and

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–Joe Healey, Korn Ferry

then can also speak to investors and internal stakeholders on that function.

We see outsourcing in three different areas, the first of which is the fund admin component. That allows you to spend carry and other compensation on resources that are purely bottom line, creation-level resources.

The next place that we see [outsourcing], for regulatory reasons, is valuation. Outsourced valuation firms [are] more and more prevalent within the industry. That allows you to provide comfort to your LP base.

The last place we see outsourcing is in technology. When you're a firm of 30 to 500, spending the dollars on managing your own technology platform is a very difficult and expensive proposition. We have some shops at the larger end that actually do run their own technology group, and have their own software, but for the vast majority of the industry, the size of our firm doesn't allow for in-house development with top execution.

Joe, you mentioned a head of talent management, or some permutation of that role, being a new trend in private equity firm. Can you talk a bit more about that?

Healey: Like most things in the private equity industry, every firm has its own idiosyncratic view as to how this role would be defined. I'll give you a couple of examples. We finished a search recently for a person who is the head of talent management, and the objective of that person—hired by the general partnership, not outsourced to portfolio companies—was to simply engage with executives who might enhance the origination process.

By the time [a firm gets] to 30, 40 people, most find themselves with the need, and the leadership of the firm has a need, to find a CHRO [chief human resources officer] to manage the activities of the firm, [and] the recruitment of people on the investment team.

Matt, can you talk a bit more about how private equity firms are starting to hire heads of IT?

Herzog: Heads of IT, or technology specialists, are a big investment to outsource. You're talking six-figure, sometimes seven-figure price tags. And with that comes big responsibility to make sure you're getting the most out of that investment. That's when I've seen firms really decide that they need somebody who's a technology specialist, whether that be at the level of a CTO, or as somebody with project manager skills who knows technology well.

They want somebody to be able to run an initiative from start to finish–firms don't want to spend a lot on an internal technology person, as well as outsourcing their technology systems to somebody else. ■

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