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Managing the complexities of today's private equity firm

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FOREWORD

The Rising Value of the CFO

Colin Sanderson
Audit Partner,
Financial Services Practice,
RSM US LLP

The definition of "operational excellence" for a private equity firm has taken on a different meaning in recent years. And as that definition has shifted, so has the role of the chief financial officer.

A common theme is that the CFO is a much more valued person than they were perhaps a couple of years ago—the role has transitioned from a traditional finance function to one that optimizes performance through operational excellence.

For example, if an investor is deciding whether to invest with a private equity fund, in the past that has been all about performance. That definition has been expanding. Now investors want excellence, they want to know that the firm is managing operational and regulatory risk, that the operations are efficient, and that they are doing things in a way that's transparent for investors.

In essence, today's CFOs are being asked to do it all: mitigate operational risk by handling cybersecurity and protecting confidential information, manage regulatory risk, and develop an efficient back office to be able to handle heightened investor reporting demands.

The area of reporting is critical to address managing regulatory risk and increased investor demands. This is where a fund manager can truly create an advantage over its competitors. With increased SEC oversight and customized data requests from LPs, there is a need for faster, more transparent, and more granular reporting compared to even five years ago.

The GP-LP relationship has changed. Lack of transparency and restricted investor rights are no longer commonplace—now investors are asking for more and more data on investments and valuations. Investors are expecting more information from managers prior to and during investing, and it is imperative that managers can accommodate these requests to the quality and time standards set by investors to build relationships and attract capital.

Handling these volumes of data especially in a manual, non-integrated (spreadsheet) environment can be a huge burden on the CFO and operations staff.

CFOs are looking to technology solutions and outsourcing to address capacity challenges. Innovation and optimization will allow businesses to scale, minimize resource constraints, and enable CFOs to focus on strategic priorities.

In the end, private equity firms that report in a transparent, timely, and reliable fashion are the ones that demonstrate operational excellence.

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Privcap is a digital media company that produces events and thought-leadership content for the global private capital markets. Privcap offers communications services to market participants.

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David Snow
CEO & Co-founder, Privcap

The Back Office Is Top of Mind

If you're reading this publication, you care about improving the many functions that reside in what is often called the private equity "back office."

Given the centrality of compliance, valuation, reporting, budgeting, and human capital in today's private equity business, the term "back office" seems a bit of a pejorative. In reality, the integrity of the back office has moved near the top of a set of challenges that private equity firms will need to meet before they can claim to be first-rate institutional organizations.

While strong net returns remain the number one deliverable for private equity firms, returns minus evidence of sound firm infrastructure scares investors. What you'll find in the following pages is a series of articles, interviews, and panel discussions about how the industry is trying to up its game and the kinds of professionals needed to get there.

The common theme: It takes more money, man-hours, and attention to run a private equity firm than it did five to 10 years ago. PE firms have many decisions to make in terms of compliance programs, back-and middle-office personnel, IT systems, and even the economic terms within the general partnership. All this is taking place in an environment where generating returns is more challenging than ever.

It's tough work being a GP, but given the potential rewards, most are investing heavily in improved firm operations. It's no longer a choice but a necessity.

Enjoy the report,

David Snow
@SnowsNotes

4 Signs You Need a Chief Compliance Officer

Sometimes putting the CCO hat on the CFO isn't the best move

When the first wave of SEC registration requirements hit the private equity industry, many fund CFOs and COOs found themselves blessed with an additional title: chief compliance officer. But as regulatory pressures and alternative allocations continue to grow, the 'double-hatting'—or outsourcing—approach may create more headaches than it's worth. Privcap talked to a number of experts about when it might be time to add a full-time compliance officer to your back-office team.

When Entering New Markets or Raising Big Money

Pursuing an aggressive growth strategy requires greater compliance resources. That's generally true when a firm is adding significant capital for an existing strategy, and almost always true when it's going into a new asset class.

"If that traditional buyout firm decides to move into a more heavily traded strategy, like launching a hedge fund, that can require more compliance resources," says Luke Wilson of the ACA Compliance Group.

Likewise, Paul Gibson of the search firm Heidrick & Struggles explains, "If they expand into 40 Act lines of business, like a mutual fund, they'll need a specialist or might face consequences for going without someone who truly understands the risks unique to these businesses."

When Service Providers Aren't Up to Snuff

The challenge with outsourcing any core function is good communication and great attention to detail. And with something as mission-critical as compliance, having an in-house resource may be worth the cost.

Also, these "top cops" need to have more than regulatory expertise and industry experience—they need to be leaders in their own right. And it's tough to lead a team when you're not sitting with them every day and developing relationships.

"They have to be able to build consensus and communicate what is often very dry, very technical matters in such a way that partners understand the real risks," says Gibson. "Not just that 'we have to do this because the law requires it.'"

When Your LPs Demand It

Many investors have their own preferences of how compliance programs are run, and as they ramp up due diligence, compliance is on their radar. "There are institutional investors that prefer the independence of an outsourced compliance service, but some LPs decide a firm's large enough, complex enough that an internal CCO is required," says Guy Talarico of Alaric Compliance Services.

At the end of the day, if enough LPs demand a more robust compliance operation, you won't have a choice.

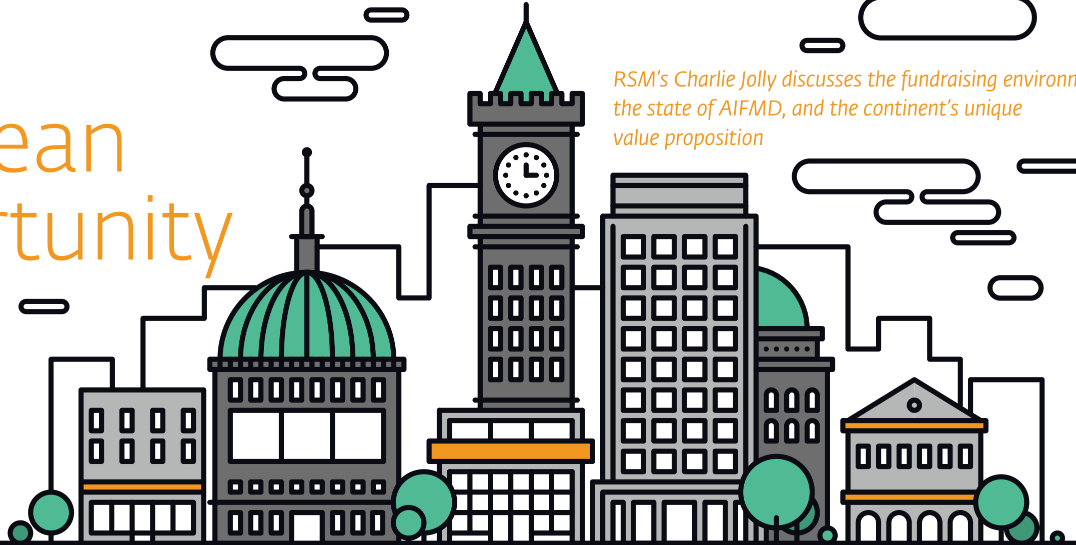
When Compliance Is Becoming an Afterthought

The biggest peril of simply adding compliance to an executive's task list is neglect.

"Sometimes people in double-hatting roles tend to favor their current responsibilities," says Wilson.

Things like audits have fixed deadlines, and needless to say, the IRS and SEC would prefer that you don't miss them. ■

The European Opportunity



RSM's Charlie Jolly discusses the fundraising environment, the state of AIFMD, and the continent's unique value proposition

Charlie Jolly
Partner,
RSM UK LLP

"A general partner that's able to acquire companies cross-border can grow a large business through acquisition quite effectively. And in certain sectors you have some tried and tested management teams in Europe that have proved they are able to execute that sort of roll-up strategy."

Privcap: What's the environment for fundraising in Europe today?

Charlie Jolly, RSM UK LLP: There's plenty of appetite from institutional investors at the moment for private equity exposure. That said, the fundraising environment is never that easy, because the supply always seems to meet demand. There's always plenty of competition to attract institutional capital.

Given that competition, which types of managers tend to be most successful?

Jolly: The most successful GPs are able to raise the majority off their capital from existing investors. And they normally get to that position through having had a very stable team, a consistent strategy that they're able to articulate well, and consistently outperforming their peers.

Investors look very carefully into the track record, and into the allocation of the track record, and then investigate how the team succeeded and whether the strategy can be successful again. Then they'll try to understand whether the key individuals will remain motivated to replicate that strategy together through the next fund cycle.

Are there particular strategies that are struggling to raise funds?

Jolly: It's always been difficult to raise funding for venture strategies in Europe, particularly compared to those in the U.S. That said, we've had probably our strongest venture fundraising market in many years in Europe.

What are you seeing in particular geographies within Europe?

Jolly: Funds that are focused on Central and Eastern Europe have had a tougher time than elsewhere because of issues with foreign exchange rates. It's a difficult region to invest across because a lot of the markets within it don't have a great deal of critical mass; managers need the flexibility to invest across the whole region. But then you have to deal with multiple currencies and very different economic conditions and cultures.

How are the AIFMD regulations progressing? Is it impacting fundraising?

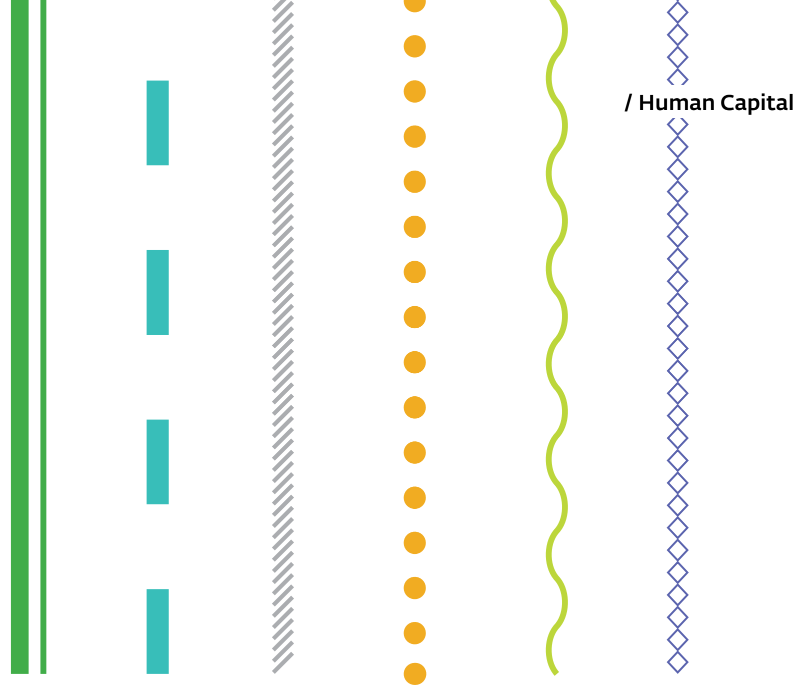
Jolly: AIFMD has caused headaches for managers; however, to put it in context, fundraising across Europe has been rising quite significantly in the last couple of years. So although there's a difficult regulatory landscape, it hasn't stopped general partners from raising considerable amounts of capital and amassing a lot of dry powder.

AIFMD was originally designed to create a single European market. Yet in reality many of these regulations have been written differently in each country. Although there's a single "passporting" system, you still have local regulations that need to be abided by as well.

From that point of view, it hasn't necessarily achieved what it set out to achieve. It doesn't mean it won't in the future, but at the moment, there are still a lot of regulatory hurdles to get over if you're marketing across Europe.

How would you describe the European market opportunity to an investor outside the region?

Jolly: The European markets themselves are reasonably complex. Because you're operating across a continent with different languages and different currencies, industries may be more fragmented and the markets can be comparatively inefficient, and perhaps offer more opportunity, than in a market like the U.S. A general partner that's able to expand a platform investment internationally can grow a large business through acquisition in Europe quite effectively. And you have some very strong management teams in the region that are capable of making a success of that strategy. ■



How GPs Can Increase Diversity

Expert advice from KKR, The Carlyle Group, Scale Venture Partners, and Broadway Angels

Private equity and venture capital firms are increasingly re-examining their hiring and retention practices to ensure that they build diverse teams.

Suzanne Donohoe, member and head of client and partner group at KKR; Matthew Wells, principal and global head of learning, diversity, and inclusion at The Carlyle Group; Kate Mitchell, partner and co-founder at Scale Venture Partners; and Sonja Perkins, founder of angel investment group Broadway Angels and former managing director at Menlo Ventures, spoke to Privcap about ways to increase diversity in the space.

Find Best Practices and Copy Them

Carlyle modeled its diversity strategy after portfolio companies like Nielsen and large financial firms like Goldman Sachs, says Wells, whom Carlyle hired in 2013 to jump-start its diversity and inclusion effort.

Kate Mitchell, co-chair of the National Venture Capital Association (NVCA) Diversity Task Force, says her board recently held an "unconscious bias" training session with diversity strategy experts Paradigm, which is also advising Pinterest and numerous other Silicon Valley firms.

Expand Your Network

"Like hires like—it's easy for people to hire others who are like them," says Sonja Perkins of Broadway Angels. "They need to plan for a diverse workforce."

Scale Venture Partners committed to a minimum of 20 hours a month to participate in educational programs for women and minorities.

"Networking is one of the most important skills a venture capital professional needs to have to find good deals," says Mitchell. "Use it to attract diverse candidates, as well."

Focus on Retention

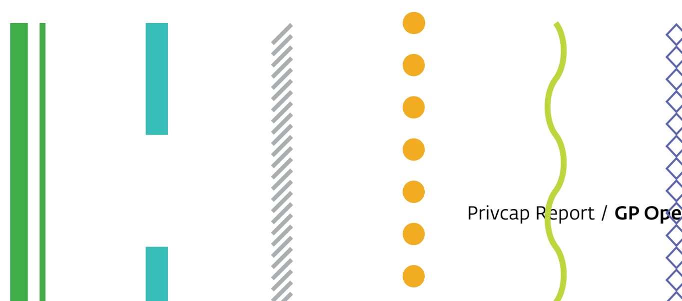
To retain these candidates, "you need to build an inclusive and supportive culture," says Carlyle's Wells.

KKR recently extended its maternity leave to 16 weeks and unveiled a "forward-leaning" childcare travel policy that allows the parent to bring an infant one year old or younger, along with the caregiver, on an expenses-paid business trip.

Help Women Bridge the Confidence Gap

"Women tend to discount their own abilities," says Donohoe. "You've got to lean in and try."

Perkins adds, "VC is a great job for women who are naturally good at research and finding solutions. It is also an apprentice job, so we need to make sure we attract enough women at the entry level." ☐



Avoiding Co-investing's 'Third Rail'

Co-investments might woo LPs to a fund, but crafting a policy that's flexible enough for large LPs, while also clear and consistent for small investors, is no easy task

Not so long ago, a co-investment might have begun with a phone call to a few key LPs when a particular opportunity arose, often at the same "2 and 20" terms of the main fund. Now, co-investments are frequently offered without any fee or carry, giving investors the potential to lower the cost of playing in the private equity sandbox.

Given growing investor demand for co-investment opportunities, GPs anxious for that first close or that big check are using such access to help hit fundraising targets. And even well-established funds that can raise money at their whim are providing access to co-investments as a matter of course.

While the maturing of the co-investment market is largely viewed as a positive, it isn't without its complications. Managers must tread lightly when crafting co-investment policies, as they need to juggle complex, and often conflicting, investor and regulatory demands.

"Some LPs don't want anyone to know they're doing co-investments," says Raj Marphatia, a partner at the law firm Ropes & Gray. "Other LPs want real transparency, but often they have very rigid confidentiality restrictions regarding their own participation." Then there are LPs who want full transparency, even if they never intend to co-invest—they simply want to ensure that they're being treated fairly.

To complicate matters further, the SEC recently weighed in with its own view of proper disclosure of co-investment agreements. Not surprisingly, secrecy isn't on their wish list.

HUNGRY FOR THE ACCESS

According to a recent report from Preqin, more than half of LPs are either actively or opportunistically co-investing, while another 22 percent of LPs that have never co-invested are considering it. One LP Privcap spoke with explained that it was an integral part of its private equity approach, not just because of cost, but for greater exposure to a geography or a strategy they already like.

Given that demand, sorting out a co-investment policy is no small matter, particularly when you want to satisfy your largest LPs—who are typically in the best position to make a co-investment—while not antagonizing smaller investors, who are essential to meeting fundraising targets.

Large LPs now expect certain privileges commensurate with the size of their commitments. "After the financial crisis, you saw these large institutional investors insist on

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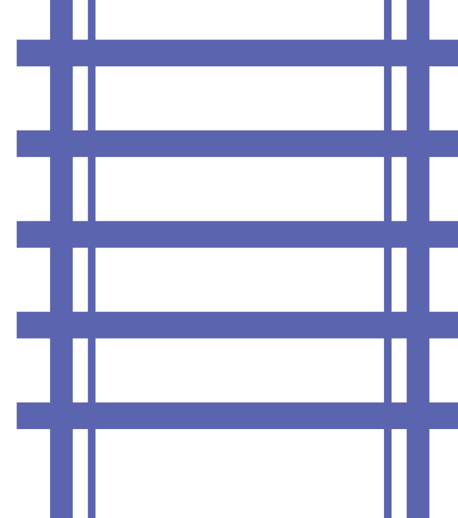


better terms than were being offered to the smaller LPs in a fund," says Tom Bell, a partner at the law firm Simpson Thacher & Bartlett LLP. "Now it's standard practice that rights and benefits are linked to the amount of capital committed."

"Consider baking any capital-commitment-based 'break points' into the PPM and the LP agreement as early as possible, rather than waiting for a second or third closing or on some other ad hoc basis in side-letter agreements," says Ted Ughetta, a partner in the private equity and investment funds group at Nixon Peabody LLP.

Things get more complicated when GPs go beyond the straightforward commitment-based model.

"Perhaps there's a carve-out for a strategic co-investor who might bring the deal to the GP or have industry experience or relationships that make a difference," says Erica Berthou, a partner at Debevoise & Plimpton LLP. "We also see access to co-investment as an incentive to commit before the first close."

But no matter the strategic assets an LP brings, or how early they commit to a fund, GPs should be wary of letting any LP see a co-investment deal before an investor who committed more to the main vehicle. One major institutional LP noted they would take great offense if a smaller LP saw a co-investment opportunity before they did.

THE SEC WEIGHS IN

While most investors accept basing co-investment access on the size of an investment, GPs don't relish reminding smaller investors of their lesser status. Yet if GPs take the SEC at their word, it's all but required.

Last May, Marc Wyatt, the acting director of the SEC's Office of Compliance Inspections and Examination, reiterated the regulator's concerns that some LPs were unaware that other investors had priority rights to co-investments.

Wyatt noted that certain GPs had responded by disclosing even less about co-investment terms to avoid being taken to task for any promises made. So Wyatt clarified: "I believe that the best way to avoid this risk is to have a robust and detailed co-investment allocation policy, which is shared with all investors. To be clear, I am not saying that an advisor must allocate its co-investments pro rata or in any other particular manner, but I am suggesting that all investors deserve to know where they stand in the co-investment priority stack."

THERE'S ALWAYS A GRAY AREA

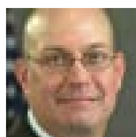
Of course, things are always open to interpretation. "GPs should fully disclose their co-investment allocation policy to each and every LP before they invest in the fund," says Howard Beber, a partner and co-head of the private investment funds group at Proskauer Rose LLP.

Others say that funds in high demand might choose to keep co-investment disclosures vague, SEC scrutiny notwithstanding.

"It varies according to bargaining power," says Paul McCoy, a partner at Morgan, Lewis & Bockius LLP. "So a fund that has performed well for multiple vintages and is heavily oversubscribed can be in a position to have broad, flexible language in how they offer co-investments, provided they still allocate the full amount of an investment to the main vehicle before offering any portion as co-investment to co-investors."

But for the average GP who might not be turning away investors, co-investment terms need to be hammered out with greater specificity. Several lawyers mentioned that even the smaller LPs with no interest in co-investments still wanted to verify the terms, to learn how expenses were allocated and ensure co-investments didn't limit the main vehicle's exposure on a given transaction.

> **"I am not saying that an advisor must allocate its co-investments pro rata or in any other particular manner, but I am suggesting that all investors deserve to know where they stand in the co-investment priority stack."**
>
> Marc Wyatt,
> SEC' Office of Compliance
> Inspections and Examination



THE BALANCING ACT

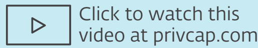
Even if GPs aim for total transparency, some LPs actually prefer—or require—the opposite. "Some LPs don't want anyone to know they're doing co-investments," says Ropes and Gray's Marphatia. "Other LPs want real transparency, but often they have very rigid confidentiality restrictions regarding their own participation."

And still other LPs want as strict a guarantee of co-investment exposure as possible, even if that means sharing more of a transaction on a pro rata basis with other LPs. "For some reason some LPs won't take access to co-investments on faith," Marphatia says. "They need something in writing to take back to their committees."

As a result, some GPs launch stand-alone co-investment vehicles to avoid such conflicts and controversy altogether. But while the co-investment may offer the same fee breaks, these vehicles ignore the other key attraction co-investments offer LPs.

"The downside is that if an LP commits to a blind pool for co-investments, they give up the ability to do their own due diligence," says McCoy. And the large institutional LPs able to commit to both the main vehicle and subsequent co-investments often have the resources and sophistication to make their own investment decisions.

"Many LPs want to be more active investors," says Jennifer Choi, managing director, industry affairs at ILPA. "They're taking a more curated approach to assets, where they may want to outsource the deal origination and structuring, but are seeking to more closely manage their exposure to a particular geography or strategy." ■



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Room for Generalists and Specialists

Performance Equity's Marcia Haydel explains what's in her portfolio

Marcia Haydel
Performance Equity

Privcap: Do you have a preference for specialists over generalists?

Marcia Haydel, Performance Equity: We invest across the spectrum of managers, in venture, buyout, distressed, and, to a lesser extent, some other private credit strategies. We've learned over the years that a generalist portfolio is fantastic, but we need to fill it out around the edges with specialist managers. So what we've done is we have a broad universe of top-performing generalist managers. Then, we lean in to certain sectors like healthcare, IT, financial services, and consumer, where we think the managers need a certain focus and a certain number of deals under their belt before they can do it right.

We don't believe you could build a whole portfolio with just specialists. If you look at the benchmark numbers, the benchmarks consist of about 20 percent, by number, of the managers who are what you would consider specialists. About 10 percent by capital under management are considered specialists, defined as a manager who puts more than 70 percent of its capital into any one sector.

How does your broad focus—from venture to LBO—result in better opportunities and better returns for investors?

Haydel: We think there is a distinctive benefit to investing across the various sub-asset classes, due to information we receive. It makes us better investors in certain spaces.

For example, in the late 1990s, when venture was performing quite well, we saw a lot of buyout managers develop a tech practice and open offices in California. Some of them were very successful, but we were able to look at what we learned from our venture managers and better evaluate which buyout managers would be successful in that space.

You've been active in co-investing—what have you learned about how to do it "right"?

Haydel: The way we build our portfolio is we draw from our top-quality managers. We select the best managers, the best partners within that manager team, and then we dive into the details of the underlying transaction. We're leveraging off our very talented GPs, and they do a tremendous amount of diligence. We take that and we round out the diligence around the edges.

How, specifically, do you "round out" due diligence?

Haydel: We have managers who invest in a variety of spaces. So, over the years, we have various contacts in these spaces. It would be very unusual if a deal would be in our shop where we haven't, in some way, dealt with another manager or consultant that has expertise in these areas. We explore industries, and that gives us some insight into how a company may be positioned within the industry and the future prospects. ■

5 Ways to Predict a 'Loser' Fund

Research from Pantheon finds that a fund's early performance and clearing a carry hurdle are great indicators of success

Private equity has always suffered from Lake Wobegon syndrome—ask any manager about their fund's performance and you'll find that every fund is "above average."

While investors know that can't be true, it doesn't make picking winners any easier. But based on research from Pantheon, it does appear that after an investment, it's possible to make a good guess about a fund's performance based on its early success (or lack thereof) and the speed with which it clears a carry hurdle (if it does at all).

Pantheon's findings take on particular significance given the maturation of the secondaries market, which makes pruning a portfolio of underperforming funds more efficient than ever. And the quicker you can identify a long-term loser, the quicker you can identify another investor to take it off your hands.

Here are the five key findings from the report, which Pantheon based on historical performance data from 700 PE buyout and venture capital funds:

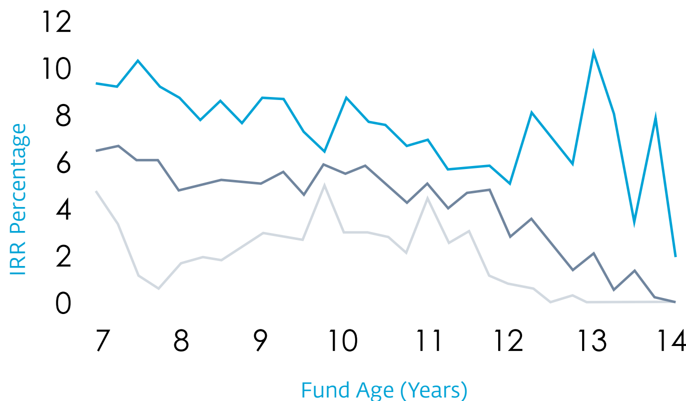
1. For funds between seven and 10 years old, the median incremental IRR of those that had cleared the carry threshold was statistically higher than those that had not. Specifically, those in carry at year nine generated at least an extra 3 percent of incremental IRR.

2. A fund's vintage has little bearing on the outcome—when separated by vintage cohorts, "in-carry" funds still statistically outperform.

3. By year five, buyout funds in the top quartile have less than a 13 percent probability of final performance below that of the median fund.

4. By year five, a top-quartile fund has a 60 percent probability of remaining top-quartile by the time it crystallizes all—or a majority of—its aggregate returns. Even at year four, which is still within most funds' investment periods, the probability is 50 percent.

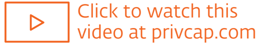
5. By its third anniversary, a buyout fund in the bottom quartile has less than a 27 percent probability of performing above the median.



Incremental IRR

From residual portfolio NAV, over time, subject to carry status of the fund

Key
- Median
- Median for funds "likely to be in-carry"
- Median for funds "likely not to be in-carry"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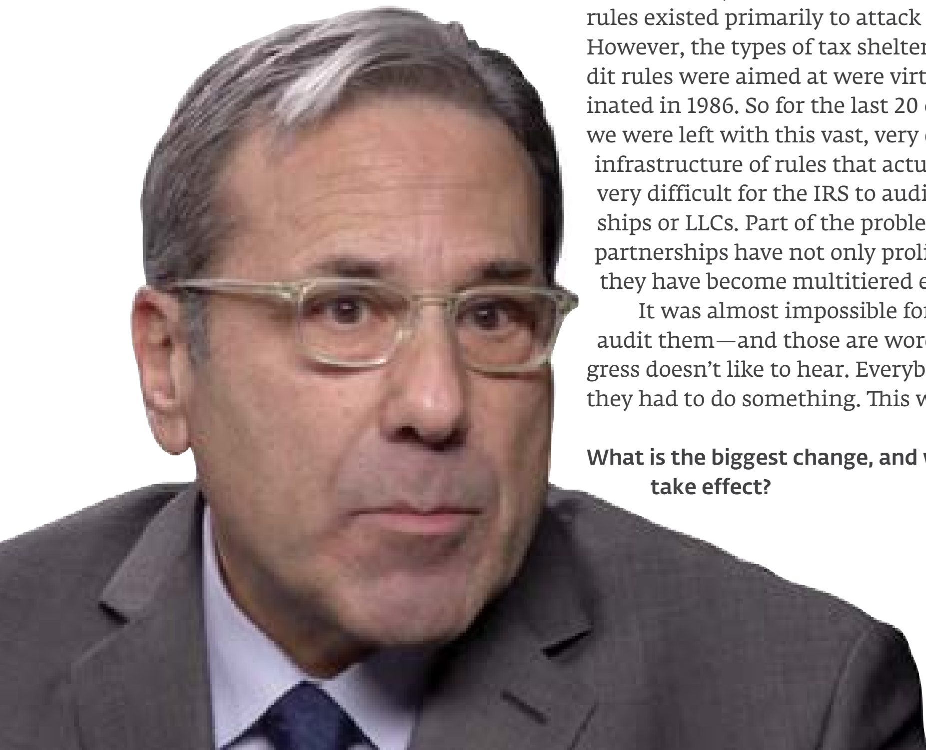
Why Every PE Partnership Needs to Be *Rewritten*

Changes to U.S. tax law likely mean more audits of private equity and real estate partnerships. Don Susswein, principal in the Washington National Tax office of RSM US LLP, talks about the consequences.



Privcap: Partnership tax law has undergone significant changes. What's the background?

Don Susswein, RSM: Partnerships and LLCs, or what we call pass-through entities, have really gone through incredible transformation over the last 30 years. Back in the early 1980s, they were a backwater. The only people who were set up as partnerships were either professional service corporations—lawyers, accountants, because they had to be—or tax shelters.

And a very cumbersome set of audit rules existed primarily to attack tax shelters. However, the types of tax shelters these audit rules were aimed at were virtually eliminated in 1986. So for the last 20 or 30 years, we were left with this vast, very complicated infrastructure of rules that actually made it very difficult for the IRS to audit partnerships or LLCs. Part of the problem is that partnerships have not only proliferated, but they have become multitiered entities.

It was almost impossible for the IRS to audit them—and those are words that Congress doesn't like to hear. Everybody knew they had to do something. This was the year.

What is the biggest change, and when does it take effect?

Susswein: Beginning with the 2018 tax year, the cost and burden to the IRS of initiating an audit of a partnership has dropped precipitously.

Until the new law takes effect, the hurdles for the IRS to successfully and efficiently audit a partnership remain formidable. In theory, the partnership has always been subject to one set of tax rules and there was only one right answer. But in practice, every partner could take a different position or could hire their own attorney or accountant to negotiate on their behalf.

Beginning with audits of the 2018 tax year, that is no longer the case. The partnership must speak with one voice. It must be represented by one party, and any settlements made with the IRS by that representative bind the partnership and every one of its partners.

The law will require simple technical changes to existing partnership agreements. But are there more fundamental changes that members of partnerships, particularly investors, should consider?

Susswein: There's a whole new set of business issues that are presented, because not only do you have a single representative of the partnership, but that repre-

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> "In some respects, this legislation is a tremendous win for the private equity community, for the investment-management community."
>
> Don Susswein, RSM

Partnership Tax Law Changes

- On Nov. 2, 2015, the Tax Equity and Fiscal Responsibility Act partnership rule was repealed as part of the Bipartisan Budget Act of 2015.
- The repeals affect the ease in which the IRS can audit partnerships and LLCs, as well as the special rules for electing large partnerships.
- The new rules will govern IRS audits of partnerships after 2017.
- The first audits under the new rules will likely start no earlier than 2019 or 2020.
- An affected partnership or entity can elect out of the new rules under certain conditions.
- The IRS will only have to deal with a single partnership representative for any audits or related judicial proceedings.
- A new rule will theoretically impose an entity-level tax at the top individual rate on any understatements of partnership income.

sentative may have different interests than you do as an investor.

Let's say you leave the partnership after a couple of years. [Looking at] the interest of current investors and the interest of former investors, it may be the former investors who are going to be hit with a tax bill, if the partnership is audited today, because you're audited for past tax years.

So if there's an audit in 2020, they're looking at whether the 2018 tax return was done. You may no longer be a partner at that point, and yet somebody is there making decisions, cutting deals with the IRS as to what your ultimate tax liability is going to be.

In addition, that partner representative most likely is going to also have duties to the current partners. Let's say the IRS says, "We think you did this wrong." The lawyers and accountants say, "No, we think it was right, but it's going to cost you $500,000 to contest the issue, and it may cost more if we want to go into court." Well, who's going to pay for that? If it's done by the current partnership, it's either going to come out of the current partners' capital accounts or perhaps the managers will dig into their pockets, but maybe not.

Is this all bad news?

Susswein: In some respects, this legislation is a tremendous win for the private equity community, for the investment-management community.

This could have been much worse. The original bill imposed an entity-level tax on the partnership. So even if all the people whose tax liability was an issue were no longer in the partnership, and we were only dealing with current partners who never got any benefit from the position that's challenged by the IRS, the current partners would still have to bear the cost.

In addition, the early legislation said, "What if the partnership has distributed everything, so the current partnership can't pay?" It had a provision that if the partnership didn't have the money, the IRS could go after any of current and former partners individually. And making matters worse, the IRS didn't have to go after each individual for their allocable share. If they wanted to, they could go after one partner for everybody's share and then leave it up to the individual partner to seek indemnification or contribution from other members.

If that provision had been put in effect, there's a very good chance that the investment markets could have been frozen. Fortunately, it was killed.

How do you expect GPs to respond to this new reality?

Susswein: With a partnership, it was an immensely complicated matter to have a tax controversy, particularly in the private equity, real estate, and investment-management field with very large partnerships that were mainly focused on making money. The management simply did not want to have any kind of a problem.

In fact, the Government Accountability Office did a study, and they found that when the IRS did finally conduct an audit of similarly sized entities, they actually found far fewer errors or mistakes than they found in corporations.

It sounds counterintuitive, but now that the IRS is going to be much more aggressively auditing, some partnerships may decide to take more aggressive positions than they had before, so they have some bargaining chips during any subsequent investigation. ■

The Three PE Hiring Trends You Need to Know

PE hiring has taken off. Here are the trends driving the market.

> "I have received more requests in the last 12 months to help increase diversity than I have received at any time during the previous 16 years."
>
> Jonathan Goldstein, Heidrick & Struggles

The market for private equity investment professionals is red hot.

"Demand for investment professionals has taken off like a hockey stick in the past 18 months to two years," says Jonathan Goldstein, a partner at executive search firm Heidrick & Struggles, who heads the business' private equity practice in the Americas. "The need is extraordinary."

Yet the robust market doesn't apply to everyone, with demand concentrated in three key areas: senior-level managers, midlevel staffers with advanced skills, and minority candidates.

Two Tiers of Hiring

Activity is driven by fundraising trends. Not only do firms continue to raise larger investment vehicles, but that has been coupled with spinouts raising first-time funds.

Once you get below the partner or managing director level, the best candidates demonstrate skills that used to be required only of their superiors, particularly the ability to consistently source and close deals, Goldstein says.

Team Diversification Is Popular

Another trend that has gained significant steam is the push to diversify firm management and investment teams.

"I have received more requests in the last 12 months to help increase diversity than I have received at any time during the previous 16 years," Goldstein says.

He cites two reasons for the increased focus on diversity. Management teams recognize that a team of varied backgrounds, experiences, and perspectives helps to both source and execute deals. Another is that limited partners are exerting increasing pressure on general partners to diversify. After all, institutional capital often comes from a diverse pool of employees, and, as investors, they would like the team putting their capital to work to reflect their interests.

Goldstein says that, for their part, candidates are increasingly focused on upward mobility. As the industry matures and, in some cases, firms struggle, the path to advancement is less clear. Couple that with the desire of most firms to have new hires, particularly at the senior level, stay on for a full 10-year fund cycle, and successfully finding the "right" fit takes on even greater importance. ■

The Spinout Chief

A conversation with Ridgemont Equity Partners' Ed Balogh

Ridgemont's chief operating officer discusses how he built the operational side of the firm from scratch when the group spun out from Bank of America

Ed Balogh
Ridgemont Equity Partners

Privcap: How did you end up launching Ridgemont out of Bank of America?

Balogh: Our firm's genesis within Bank of America and its predecessors, NCNB and NationsBank, dates to 1993. I was a CPA at PriceWaterhouse before joining NationsBank in 1995 to support the firm's private equity business. I quickly became the controller for several corporate finance and investment banking lines of business, but I really gravitated to the private equity business, Banc of America Capital Investors. I joined BACI in 1998 and later became the CFO. After Bank of America acquired Merrill Lynch, the BACI platform merged with the Merrill Lynch Global Private Equity business. During this time I became the COO of the combined BAML Capital Partners. That experience served me well, as the former BACI partnership spun out of BAC to form Ridgemont Equity Partners in 2010.

What did that spinout require from you?

Balogh: As the CFO of BACI, my responsibilities were similar to my counterparts at independent private equity firms. As Ridgemont was formed, we felt good about our finance functions, but systems still needed to be implemented. While I managed operational elements during the integration with Merrill Lynch, after the spinout I became a COO in every sense. While I certainly had ideas of my own, I sought advice from our attorneys and my peers at other private equity firms of a similar size. My team and I went about putting into place Ridgemont's middle and back office. This included the HR department, with a payroll system, a health insurance benefit program, and 401(k) plans. We also implemented online treasury management, travel and entertainment expense reporting, and financial reporting systems.

I wore a general counsel hat as well. While I'm not a lawyer, I am in the weeds with these documents, coordinating with outside counsel. During fundraising, while keeping our senior partners apprised of the negotiations with our LPs, I negotiated all the partnership agreements and side letters. I'm also one of four senior-level members on our valuation committee, which approves all the valuations for our portfolio companies in a certain fund on a quarterly basis.

When we were required to register with the SEC in 2012, I also became our firm's chief compliance officer. In terms of IT, we use an outsourced service provider that charges by the hour, which by the end of the year adds up to the compensation for a seasoned, if not senior, tech executive. This also eliminates the risk of an in-house CTO not staying abreast of technology changes or leaving the firm.

You don't outsource your fund administration. How did you build your in-house team?

Balogh: I don't feel comfortable with a third-party administrator, given the complexity of some of our vehicles. I am also concerned that an outside administrator may have turnover in their staff, which may lead to inconsistent levels of service. We have a great team, and we use an industry-leading financial-reporting-technology platform. Our controller joined us from Bank of America's tax department when we formed Ridgemont. We later added an assistant controller out of a public accounting firm before we closed our first independent fund in 2012.

In 2013, we continued to institutionalize Ridgemont by hiring a vice president of investor relations. She came to us having had experience at two middle-market firms, and she was instrumental in helping us raise our second fund that we closed at $995M in 2015, up from our debut fund of $735M. ■

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Privcap Game Change events bring together an ecosystem of private equity market participants to network and discuss the profound changes driving opportunity in major economic sectors. Delegates to these full-day conferences include leading LPs, GPs, corporate executives, and other influencers.

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How to Build a Cybersecurity 'Threat Model' for PE

By performing a fund-level threat assessment, a private equity firm can get a little closer to knowing the unknown enemy behind a potential breach, says RSM's Daimon Geopfert

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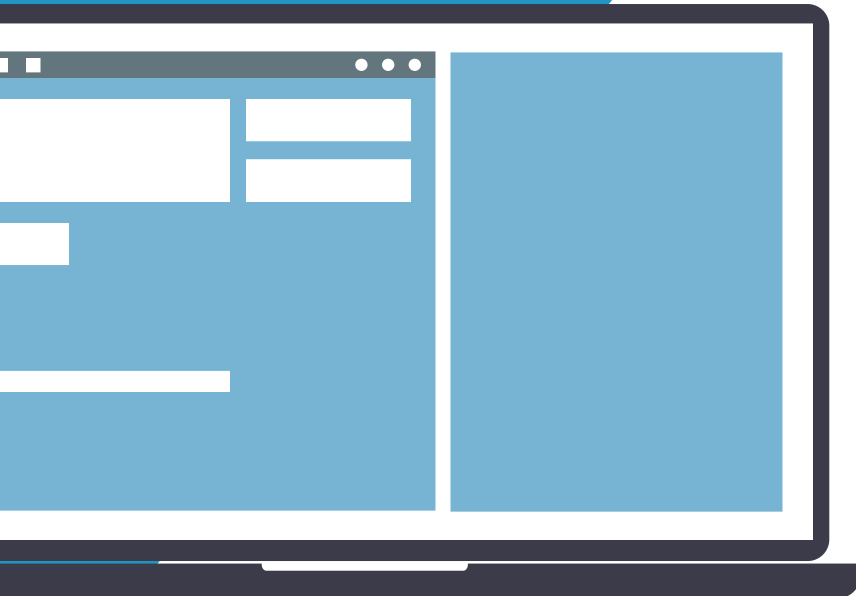
Daimon Geopfert
National Leader of
Security and Privacy Services,
RSM US LLP

Cyberthreats aimed at a private equity firm are coming from two directions, and each requires different due diligence.

A cyberattack can hit the PE fund itself, explains Daimon Geopfert, national leader of security and privacy services at RSM US LLP, compromising the information of investors and portfolio companies. Attacks can also target a portfolio company directly, impacting day-to-day business and customer data. "If it's breached at the portfolio company level, it can lose a ton of value," he says. He terms the portfolio company "intellectual property. Private equity is an industry, but also a conglomeration of other industries."

PE firms are experiencing increased pressure to increase cybersecurity preparedness efforts. The Securities and Exchange Commission recently issued regulations intended for private equity firms, following in the footsteps of the payment card industry, says Geopfert. "You're going to the see the SEC move away from guidance that is very generic and starting to move towards full security monitoring and effective incident response systems."

The challenge is that each cyberthreat or attack requires different strategies depending on the firm or portfolio company, and no two situations are alike.



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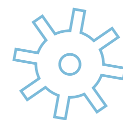
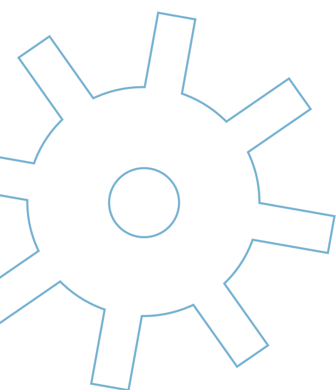


> "You have to sit down with someone who hacks and have them tell you, 'If I was going to hack you, here's how I would do it.' If you can force the attacker to get out of their comfort zone, if you can defeat their first two to three attempts, they will move on."
>
> Daimon Geopfert, RSM US LLP

Get Out in Front of a Threat

One of the most important things a PE firm and its portfolio companies can do is a fund-level threat assessment. Geopfert says it's important to delve into how someone would attack a fund, how someone would go through a portfolio company to attack a fund, or how someone could reduce the value of a company through a cybercrime.

"You have to sit down with someone who hacks and have them tell you, 'If I was going to hack you, here's how I would do it.' If you can force the attacker to get out of their comfort zone, if you can defeat their first two to three attempts, they will move on."



Monitor Your Portfolio Companies

"The biggest thing with portfolio companies is to make sure they're compliant," he says. "We deal with a lot that aren't compliant with the basics of their industry." In many cases, Geopfert says, when a portfolio company is breached, it's through simple ways: via an email or phone call asking for financial information, or a fake executive or vendor asking for an employee to wire them money. It may be a breach of a small company where they get to its bank account and do wire transfers. "They're more concerned about protecting customer data," he says, referring to the companies. "The most common issue is these low-tech hacks."

For these kinds of low-tech hacks, actively monitor the company's financials so you can act quickly should a suspicious money transfer occur, Geopfert says. "If you can move fast enough, you can get the money back. They try to move the money, and the second it hits, they have someone waiting to withdraw it. It's a race between you and the attacker."

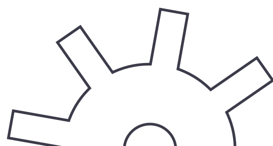
A firm can make sure its portfolio company is taking steps such as frequently changing passwords and setting up two-factor authorization. "Anything to make the attacker work for it," says Geopfert. For larger hacks that access customer data, and that involve law enforcement being contacted, he notes that a firm should be prepared to be told that they can't help because it's out of their jurisdiction. Other steps involve calling the insurance agency, if there's a cyber insurance policy, and having someone on retainer to manage the response for the firm.

Get the Right People and the Right Tools

Cybersecurity threat assessment can be bolted onto a firm or portfolio company's existing risk management policies and actions, but security expertise that goes beyond the basic knowledge is required. Specifically, a firm needs professionals who understand the technical dimensions of threat planning, detection, and response.

"How do you control third parties? How do you do vendor management? When you share data, how do you protect it?" asks Geopfert. He notes that PE groups often complain that the cybersecurity people they do find often have a very narrow focus and are only interested in selling tools and software rather than helping proactively prevent a breach, or mitigating fallout when one occurs. "They often say, 'Stop trying to sell me a thing, and tell me how to actually control security over time.' The pool of people to do that is very shallow."

Technological preventive measures still include old standbys like firewalls and anti-virus products, but PE firms are being pushed hard to move to newer solutions such as network-level malware detection, egress controls, and security monitoring solutions that flag abnormal behaviors. "For attacks targeting employees, make sure you are constantly updating security awareness training, spam filtering, and controls around how corporate bank accounts can be accessed," says Geopfert. ■



Why PE Needs Data Standards

The CFO of HarbourVest Partners outlines the progress toward standardized reporting—and why it matters

Karin Lagerlund
CFO,
HarbourVest Partners

Privcap: What are the current operational challenges in private equity?

Karin Lagerlund, HarbourVest Partners: For a lot of the events during the last year [2015], the articles and the headlines in the press about fees—and do we know what all the fees are?—really brought light to different fees and costs associated with doing private equity. I think it's important for our investors to be able to know the total cost of their private equity investments.

Just reducing the overall cost of gathering that data is a topic for firms like HarbourVest as well as the other general partners. To be able to gather the right amount of data and report it to your limited partners, we need to improve the way we transmit the data—not just what we're collecting. Some of the fees that people want to collect aren't things that automatically flow through our current systems. So these things require system changes and report changes, and all of that takes a lot of time and effort to get to the point where we're able to easily transmit the right information to our investors and clients.

What will an improvement in data standards allow the industry to do?

Lagerlund: If the industry really wants to grow up and be an institutional asset class and attract additional investor classes, maybe the 401(k) plans are individuals to a larger degree. We're going to need to have good data, and to have good data, you need to have data standards so that we all agree on what the data points are. There's one set of definitions, and we're all using those same standards. I also think it needs to be transmitted in an easy format to transmit. So, consistency and then ability to transmit that data amongst ourselves needs improvement.

How important is it to streamline reporting and transmission of data?

Lagerlund: It's important for us to be able to know what the complete cost of an investment is, as you would look at your mutual-fund statement when you're doing your 401(k) allocations. Some people like to pick an indexed fund because it's the lowest cost. Some people like a higher return, are willing to pay a little more, and will pick a fund that has a higher expense ratio. But I think we need consistent expense ratios so that we can compare them. Other countries have regulated this. It's important as an industry that we maybe try to get ahead of that, being required to do something and self-regulate and be able to give a good, comparable expense ratio for each one of the funds that people are investing in.

What's needed to get GPs to adopt new standards?

Lagerlund: We've been making a little bit of progress with some of the efforts out there. You've got ILPA, or the Institutional Limited Partnership Association, coming up with templates and adding to those templates and revising them. They've had a recent fee-transparency initiative where they've expanded their current template to include more of those fees we're talking about.

We need to get to a spot where we're able to actually implement and the industry as a whole picks it up and adopts it. That requires maybe a little more head-to-head negotiation with the GPs and the LPs than we've had to date.

Where we need to get to as an industry is something that's adoptable by GPs so that we can have one standard. I think there are a lot of GPs that would love to have one standard. ■

Hamilton Lane, **Trilantic Talk Succession Planning Strategies**

Experts explain why prolonging a decision could doom a firm

Private equity succession planning and execution can be make-or-break—just ask the handful of well-known funds who have shut down or struggled to raise funds after bungling the process.

It doesn't have to be that way, says Christian Kallen, a managing director on the fund investment team at Hamilton Lane. The key to a successful transition, Kallen says, is setting the wheels in motion far earlier than many managers think.

"Saying you want to retire in three years is probably five years too late," he says.

In fact, the changeover process should begin in earnest by the third fundraise, Kallen says. By a third fund, the fund and its track record is established enough for investors to start thinking about longer-term management.

"The best-in-class private equity firms provide clarity on succession planning early as a matter of good business practices," he says. "This helps to strengthen the team and culture of the firm."

For Charlie Ayres, the 56-year-old managing partner and chairman of Trilantic North America, the planning has started years before he anticipates giving up the reins. He says senior-level leaders are in the early stages of designing a smooth transition to a group of more junior executives. The next generation of Trilantic leadership will include multiple executives, he says, each of whom has strengths that bring out the best in the group.

"We are setting up the firm to have a legacy," Ayres says. "We are structured to have longevity."

Having a clear plan in place early on will also help motivate those junior-level staffers. Kallen also says that when the time for transition does come, make it quick—a process that takes between 12 months and 24 months is simply too long and risks frustrating those junior staffers. Senior management should also aim for an exit strategy that does not include a long-term role reduction for senior leadership.

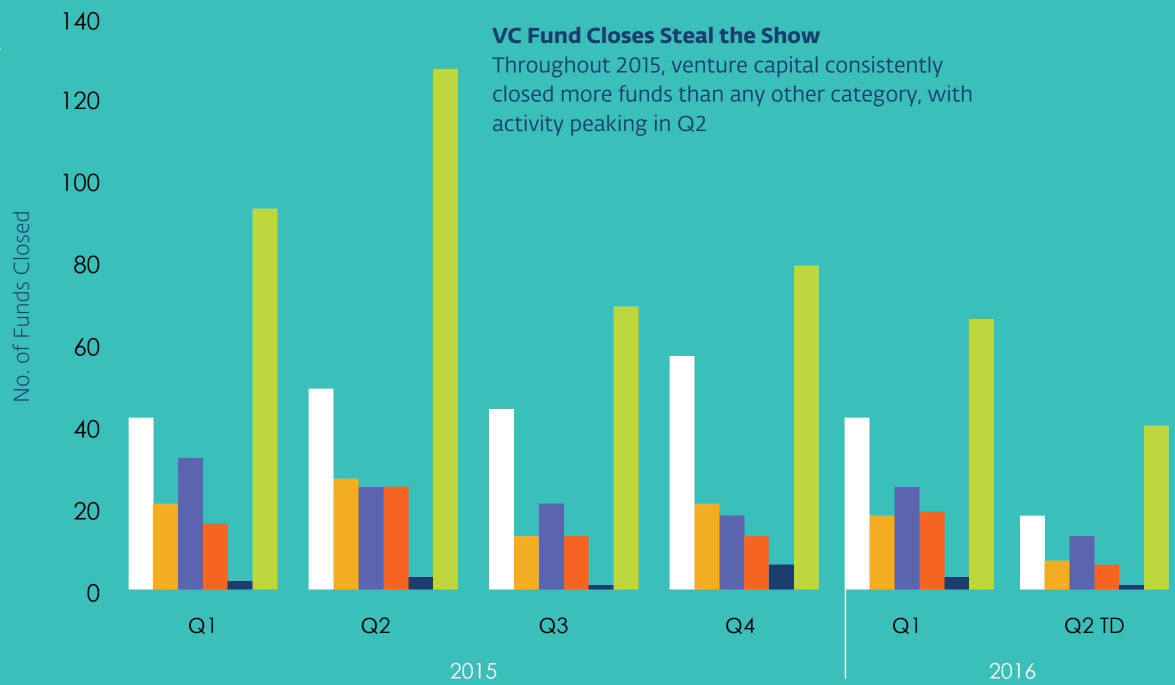
Defining a plan early also assuages investor concerns. Ayres estimates that 80 percent of investors are very concerned about the composition and stability of a firm's investment team. As such, Trilantic spends a significant amount of time with its LPs discussing organizational charts, contingency plans, and the depth of its talent pool.

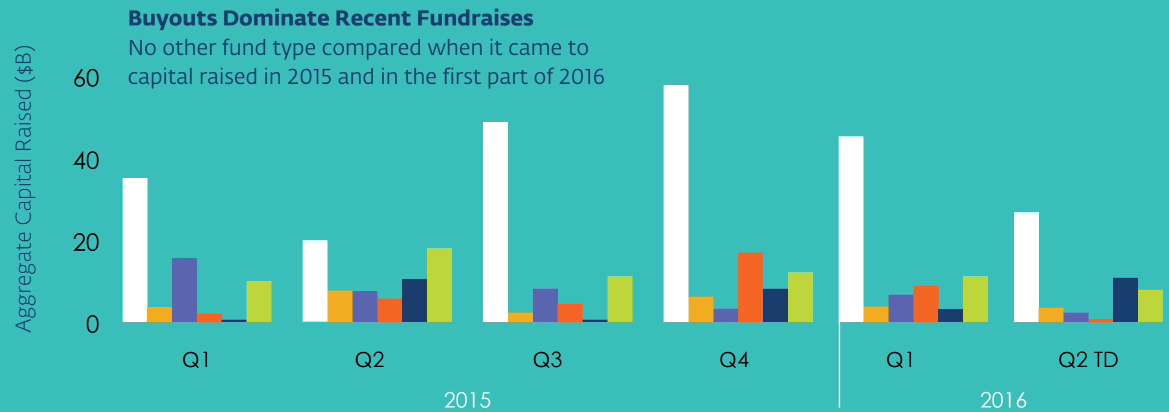
"We go out of our way to make sure LPs get a great sense for the talent we have below," Ayres says. "The firm definitely does not go down with one person. LPs take a great deal of comfort in knowing that." ■

By the Numbers:
Private Equity Fund Activity

A snapshot of GP fundraising activity by fund type

Source:





KEY

- Buyout
- PE Fund-of-funds
- Growth
- Other PE
- PE Secondaries
- Venture Capital

Fund Type	No. of Funds in Market	Aggregate Capital Targeted ($B)
Buyout	313	221.2
Fund-of-funds	136	68.3
Growth	288	80.2
Other	119	36.9
Secondaries	40	22.2
Venture Capital	821	87.3

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How the IRS Fee Waiver Crackdown Affects PE

Last year the IRS issued a proposed rule change meant to stifle supposed abuses of how private equity fund management fees are claimed for taxes

David Peck
Partner, Tax,
Vinson & Elkins LLP

Buzz started building in private equity firms about a proposed rule from the Internal Revenue Service that would target management fees being claimed as capital gains rather than as ordinary income.

This proposed rule change from the IRS is almost all that David Peck, a tax partner at Vinson & Elkins LLP, had been talking about with private equity clients in the latter part of the summer. And the management fee waiver—i.e., the practice of turning the normal 2 percent management fee into carried interest, contingent on the profitability of the fund—dates back at least 15 years, he says.

No one is certain exactly why the IRS suddenly took an interest in the management fee waiver, as the agency has been aware of it for as long as it's been in play. The Obama administration has made no secret of not being a fan of private equity getting favorable tax breaks, and Peck says that starting in the middle of 2013, he started hearing IRS personnel informally making statements about the management fee waivers and PE using tax rules to convert management fees into capital gains.

After the Treasury Department wrote the proposed rule change for the management fee waiver, there was a period for comments that closed towards the end of October 2015, with a hearing held in February 2016. At that hearing, comments were heard from professionals, including a representative of the Connecticut Bar Association Tax Section and a principal at RSM US LLP. Government officials said that the final rules should be issued by midyear.

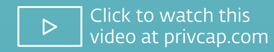
Peck says the possible outcome of the proposed rule change includes "a huge range of things," including the IRS incorporating acceptable comments and issuing final regulations in short order; taking some time and issuing an amended proposal reflecting comments; or else never implementing the rule at all.

"The thing about this that is a little tricky is, the rules don't say you can't convert the management fees into capital gains," says Peck. "The conversion just needs to be done in the right way." The proposed rules require that the recovery of waived fees be conditioned on the profitability of the fund, with the definition of profitability being relatively narrow, he adds.

"What's going to happen is, the PE world is going to have to decide 'Do I take the risk?'" Peck says. "'Do I put my management fee on the table and roll the dice, hoping my fund is profitable—in which case I can get the conversion to capital gain, but risk losing the fees altogether if I don't achieve profitability—or do I take the lower risk, lower reward position and pay the ordinary income [rate] on my management fee?' In the past, people were trying to have it both ways."

Peck says there likely won't be a lot of immediate action from PE players and that firms are going to digest how the rule change could impact them, particularly with the threat of carried interest legislation looming. "The carried interest is what makes millionaires into billionaires," he says. ■

5 Valuation Trends in Private Equity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Richard Brekka
Managing Partner, Co-founder,
Second Alpha Partners

Chris LaDue
Principal,
RSM US LLP

Kevin Vannucci
Partner,
RSM US LLP

Max Wolff
Managing Partner, Chief Economist,
Manhattan Venture Partners

As a PE firm seeks to improve its valuation skills, there are a variety of ways it can go about the process. Privcap gathered four experts who outline some valuation trends and ideas to make the process go more smoothly.

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1 When it comes to valuation policies, the more robust and transparent, the better

Valuation is an art and a science—and GPs who fudge the math could be history. The SEC is looking hard at valuations, as are limited partners and audit firms, and GPs who are tainted with any implication of fraud or misdirection might soon be looking for a new career. This is why valuation policies must be robust and transparent.

"For us, the more robust, the better; the more transparent, the better," says Kevin Vannucci, a partner at RSM US LLP. "And we're seeing that limited partners want that kind of valuation policy as well. If they're going to invest in your firm, they're going to ask to see that valuation policy, because limited partners are out in the forefront of trying to understand how you're marking to market. Obviously they have their money to allocate, and they look at asset allocations. So that's why fair value is so important to limited partners—because of that asset allocation."

And although a rigorous valuation policy may be more work up front for GPs, it pays in the long run. "It does a couple of things," says Richard Brekka, a managing partner at Second Alpha Partners. "It saves us a lot of time later on, when we're doing the audit. And it saves us money at the end of the day, because the less time we have to spend with our auditors, the less they get to charge."

2 A robust strategy helps GPs defend valuations against second-guessing

An important factor at play in the valuation space these days is the increasing amount of negative information that's available. A tough valuation policy provides GPs with an effective means of defending their decisions against second-guessing by armchair quarterbacks.

"There are a lot of outside forces pushing on a valuation that historically weren't there," says Max Wolff, a managing partner at Manhattan Venture Partners. "There are newspaper articles; there is a lot of active trading in the secondary market. It floods you with data points, many of which are bad. We need to have a robust strategy, because we need to defend why we're not necessarily pushing toward the latest news story or the most recently quoted—or not publicly quoted—prices in the secondary trade."

"There are a lot of outside forces pushing on a valuation that historically weren't there. There are newspaper articles; there is a lot of active trading in the secondary market. It floods you with data points, many of which are bad."

Max Wolff, Manhattan Venture Partners

3 'Calibration' is increasingly important in valuation methodologies

A buzzword that comes up now in a lot of conversations about valuation is "calibration." It's not a new term, but many in the PE industry still are not familiar with it.

Brekka explains it this way. "If you buy a company at eight times EBITDA at acquisition, at that time you should identify the comparable public companies and look at their unadjusted multiple—say it's 10x. Therefore, you have an 8-to-10 ratio or 80 percent calibration ratio." It's also important to look at the gross size of risk of those public companies versus the private company, he says, adding that, all things being equal, on the next measurement date the exact same thing would be done.

Calibration is useful in many ways. It takes uncertainty out of the picture. It benchmarks a company at date of acquisition and provides benchmarks going forward. It assures an audit firm and investors that a GP is looking at the true, fair value and specific market participants. It mitigates the concept of discounts for lack of marketability if a GP holds a minority interest versus a controlling position. "It takes away another level of subjectivity," Brekka says.

But calibration can be difficult in the case of early-stage companies, which often have a constantly evolving story. "The big issue is the pivot," Wolff says. "It's not infrequent to see a fundamental shift in business focus in the early stage or even midstage. And that changes the entire comps set. If you started out as a social media company and you're now an ad-tech company, there's no recalibration I can do. I've got to cut down the old forest and find a new forest to compare you to."

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LaDue, Brekka, and Wolff discuss valuations

4 When valuing a 'unicorn,' GPs should focus on fundamentals

Unicorns were once a rare, almost mythical beast. Now they're everywhere, and investors are taking a much closer look at their over-the-rainbow valuations. "Some of these horses are going to be glue in the next year or two," Wolff says. "Valuations got very aggressive. Part of what happened is that there is an inefficient price-discovery process in private markets. Part of what happened is these companies got hot and there was a lot of FOMO—fear of missing out on investing. And part of what happened is people lost sight of valuation."

The challenge for accounting firms is negotiating the gap between a unicorn's market value and the value a manager must report to investors. The solution is to focus on fundamentals, although there is still balancing to be done.

"We go back to income-based approaches, discounted cash flow, market-based approaches, with guidelines for public companies or transactions to try to substantiate the valuations that we see," says Chris LaDue, a principal at RSM US LLP. "But with regard to some of these unicorns and the anticipation of those valuations, we're trying to bridge where we sit relative to fundamentals and things that we can point to that the accounting firms, the auditors, are going to be looking at for substantiation—but being cognizant of the fact that the market is dictating the pricing of some of these companies, and they don't always make sense relative to fundamentals."

5 GPs should beware conflicts of interests in early-stage valuations

When early-stage investments don't do well, the spotlight turns to managers and the valuation stories they told leading up to the tragic ending. If the story turns out to be a fairy tale, the manager can get burned.

"There's a huge conflict of interest for the general partner, because GPs want to be able to show returns," Brekka says. "When they're making these investments, they're not getting cash out, so the only thing they can show is current market value of their portfolio and be able to reflect that to the institutional investors that are backing them. They also want to raise their subsequent fund—and since they're not delivering cash back in the near term, it's all about valuation."

But when a unicorn investment is marked up and eventually written down to almost zero—like, say, flash-sale companies Fab and Gilt Groupe—it can mean game over for the GP. "That can end it for a general partner in terms of being able to raise future funds," Brekka says.

It's not entirely the GP's fault, of course. Today's managers have fewer tools to bring to bear in the valuation process. "We've relied historically on a robust IPO market to help us back value," Wolff says. "And now our IPO market is gone, so we have a vacuum. Obviously we can see how last year's IPO crop is trading—although that's not terribly inspirational right now—but we don't have any new flow. That gap has not been great for price discovery." ■

In Depth With Harvard's Josh Lerner

The professor at Harvard Business School shares his latest findings on some of the PE industry's biggest questions

Why Partnership Economics Really Matter

One of private equity's biggest selling points has always been the relatively strong alignment of interest between a general partner and its investors. So the fund manager's "skin in the game"—its capital commitment to each fund and its typical 20 percent profit share—has received a lot of attention from those looking to explain the industry's relative ability to generate above-market returns.

Until now, however, few researchers have gone a level deeper to examine how a GP's distribution of its profits and ownership to the individual members of the partnership influences outcomes. Simply put: How aligned are the individual partners with each other, and how does that impact success?

In a recent paper, Josh Lerner and Victoria Ivashina of Harvard University show just how important the structure of a partnership's economics can be to its ability to retain talent, its ability to raise money in the future, and ultimately its overall success.

Talent retention at the GP level is of particular significance to investors—as the Harvard study notes, prior research has demonstrated that even when a departing partner is replaced with a "comparable" talent, performance suffers, at least in the short term.

GP Economics Key Findings

- **Past performance does not have a significant bearing on a senior partner's share of carry; being a founder has a significant one.**
- **Senior partners who leave during the course of a fund's life have significantly lower carry shares** (9 percent vs. 16 percent) **and ownership stakes** (13 percent vs. 23 percent) **than those who stay. The lower share of carry among departing partners is not explained by poor performance.**
- **Senior partners are more likely to stay at a firm with lower carry inequality** (at a level of statistical significance).
- **The loss of one senior partner at an average-sized firm** (one with four senior partners) **significantly impacts subsequent fundraising. The next fund is typically 17 percent smaller.**

Lerner's advice to LPs: "Many general partners do express concerns about situations where there are founders who may be less involved in creating value on a day-to-day basis but have a disproportionate share of the economics. Nonetheless, that's the rhetoric. But when you look at the reality of the investment decisions, one sees many cases where groups have been able to raise funds with quite skewed economics. My greatest, strongest prescription would be to have a greater alignment of rhetoric with the reality of the investment decisions and to more carefully looks at this, and have it have a greater weight in the decision-making process of whether to invest in or to re-up with a given partnership."

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2 Is the Co-investing 'Cure' Worse Than the Disease?

If private equity co-investing came with a warning label, it might read something like this: Easy to swallow, but may be hazardous to your long-term financial health.

Indeed, for the world's institutional investors, any elixir meant to kill high management fees goes down easy. With a huge pile of cash at their disposal, why not invest in individual deals and circumvent those greedy intermediaries? What could possibly go wrong?

Quite a bit, Lerner says. It's not that paying high management fees isn't a drag on performance, it's that when co-investing happens, it tends to happen in ways that are detrimental to the LP.

Lerner explains, "It's very understandable that the LPs are concerned about the deal they're getting with general partners. The question is whether the cures are, in some sense, worse than the disease."

> "It's very understandable that the LPs are concerned about the deal they're getting with general partners. The question is whether the cures are, in some sense, worse than the disease."
>
> Josh Lerner, Harvard Business School

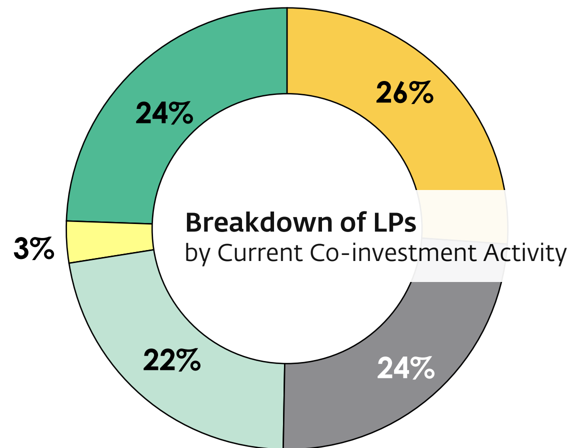
Ultimately, Lerner's study of investments by seven large institutions found that between 1994 and 2011, the mean return of co-investments—relative to the return of the corresponding PE funds in which those deals were held—was nearly 9 percent less. In other words, by co-investing, LPs earned a lower overall return than if they had simply maintained their "regular" fund investment.

Lerner says, "Had [co-investing LPs] simply created a basket of co-investments that replicated what's going on in the private equity portfolios in general, they clearly would have been better off, because they would have saved on fees and carry. But they've ended up sorting into a portfolio that's done significantly worse."

None of these findings have slowed the co-investing bandwagon. In a recent survey of 222 LPs, Preqin found that roughly three-quarters are, or are considering, co-investing alongside GPs.

Nearly 70 percent of those surveyed believed that co-investing could lead to higher returns than standard private equity fund investments.

As the PE industry and the practice of co-investing continue to mature, it may be that sophisticated institutional investors will win in the long term. But given co-investing's performance history and the long-established investing tradition of following the herd, LPs might be better off living with the chronic illness of high fees than taking medicine that may well make them sicker. ■



KEY
- Actively co-investing
- Opportunistically co-investing
- Have not co-invested previously, will consider in future
- Have co-invested previously, but no future plans
- Never co-invested, no plans to co-invest in future

Source: Preqin Investor Survey, September 2015

Co-investment Key Findings

- **Co-investing suffers from a "lemons" problem—LPs typically can't pick the deals they want to invest in.**
- **Co-investments are necessarily concentrated in big deals—GPs require more capital to close them—and big deals tend to underperform.**
- **Like many investments, co-investments follow the herd—deals are concentrated near market peaks.**

Does Private Equity Have an Insider Trading Problem?

"Selective disclosure" is on the SEC's radar, legal experts say. Privcap's David Snow weighs in.

Private equity deals with a ton of information, and depending on who you are, you get to see all of it, some of it, or none of it.

In public markets, rules governing disclosure abound, mitigating the prospect of selective disclosure—revealing actionable intelligence to certain investors but not others. Private equity has far less oversight, yet information asymmetry exists, and the Securities and Exchange Commission may ultimately consider it a problem that needs solving.

In 2000 the SEC adopted Regulation Fair Disclosure to restrict the widespread practice of company CEOs holding exclusive Q&A sessions with large shareholders. These investors would presumably gain deeper insight into the company's performance and possibly an unfair trading edge over smaller investors.

The degree to which selective disclosure in private equity is unfair or harmful is debatable. But a growing number of legal experts believe the SEC will take an interest in PE's version of selective disclosure because it is part of a broader concern—the unequal treatment of limited partners.

In many areas, private equity GPs have played favorites. It happens at the outset of a fund, when different terms and conditions are offered to different LPs based on size of commitment. It happens in the course of a co-investment when allocations are offered to strategic non-LPs, instead of to smaller current LPs with an appetite for direct exposure.

How GPs Play Favorites

- LPs are selected to make up the Limited Partner Advisory Committee, which holds sessions with the GP. An LP serving on this committee, typically chosen because of the size of their commitment to a fund, will naturally gain access to information that is not shared with the others.
- Many LPs are granted side letters allowing for customized supplemental reporting. This often means that the LP receives fund information more frequently and in a custom format. It can also mean that the LP receives additional information not shared with the rest of the investor base.
- LPs frequently join the GP in co-investing, which often means gaining extraordinary access to the inner workings of the firm's underwriting process and to the due diligence materials of the deal under review. If the deal goes through, the co-investing LPs have a great deal of information about the thesis and projections around the deal. Even if it doesn't happen, the LP has gained valuable insight about how the firm really works.

Does any of this inequality matter? An LP armed with additional information about the fund can't exactly trade on the information as they could with a public security. In theory, the LP would have an edge as a buyer or seller of fund interests on the secondary market, but these "trades" take considerable time to close.

An LP with sustained superior access to a fund's information would presumably be better able to decide whether or not to re-up to the next fund or back a spin-out team. But here again, the ability to monetize superior insights takes so much time that it becomes hard to measure the value of the "inside" information.

Ultimately, the appearance of impropriety may be enough. While it may be harmless to, say, regularly provide leverage-level information to a big, important LP but not to a smaller one, or to reveal partner economics to an important gatekeeper but not to other LPs, such asymmetries can create a suspicion of unfairness that can make investors, and the SEC, think there may be further inequalities worth looking into. ■

More Than 'The Numbers Guy'

Stephen Hoey explains how his role evolved over the last 12 years from a traditional CFO to a leader of the firm's operations

A conversation with KPS Capital Partners' Stephen Hoey

Stephen Hoey
Partner and CFO,
Administration,
KPS Capital Partners

Privcap: You joined KPS in 2004 as CFO. How has your role changed since then?

Hoey: When I joined, the firm was still raising its second fund, which closed at $400M. We were about 10 or 12 people in 6,000 square feet of space.

Now we have 23,000 square feet here in New York, an office in Frankfurt, and a portfolio operations team member in Hong Kong. And we're investing in our fourth fund, which closed in 2013 at $3.5B. So it's a very different business.

I came in as CFO, but I'm more of a chief operating officer and administrative partner these days. I brought one controller with me from my Soros days who is still with me. She's now VP of finance and doing a lot of things that I was doing when I first started. As we've grown, I've taken on more of a leadership role. When we first registered with the SEC, I was the chief compliance officer, and we didn't have any in-house counsel. Even though I didn't have a law degree, I still wore the lawyer's hat. Then in 2011, I hired an in-house counsel, who's since become our CCO.

HR is a much bigger piece of my role than it was before. With almost 50 employees worldwide, that's become an area of focus—making sure we continue to bring in the best and brightest people who fit with us culturally and who understand what we're trying to do.

"As we've grown, I've taken on more of a leadership role. When we first registered with the SEC, I was the chief compliance officer, and we didn't have any in-house counsel. Even though I didn't have a law degree, I still wore the lawyer's hat."

In terms of staffing, what drives when and how you add to the team?

Hoey: From a finance and accounting perspective, we continue to run a very lean operation. It was just my controller and me until 2007; when we started raising Fund III, we added an assistant controller. We didn't hire another person until around 2010 or so, when we added a supplemental fund. So we've only hired two finance staff since growing our AUM from the $600M we had when I began to the more than $5B we manage today, and we do not outsource fund accounting.

Beyond finance, what other operational staff have you hired during that time?

Hoey: Back in 2011, we hired an IR person. Prior to that, I was writing the quarterly and annual reports from scratch and answering every LP request. But when we brought our IR person aboard, that took a lot of the LP reporting burden off my plate. While I'm still reviewing those reports, I'm not drafting them and working with deal teams to produce company-by-company updates.

Have regulators changed the nature of your job?

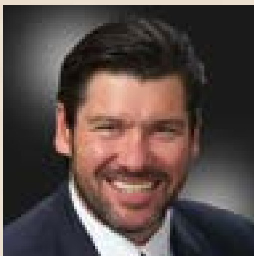
Hoey: Without a doubt. One of the biggest changes was registering as an investment advisor. We had a presence exam back in 2013. They came in for a day and had follow-up questions for the next four months or so. But honestly, it wasn't that bad, since we were prepared.

Nowadays, my CCO and I are focused on cybersecurity in light of the guidance from the SEC. We're not a trading business, so we're not as vulnerable as a hedge fund, but there are some measures we are looking to put in place, like two-factor identification being required to log on to our databases.

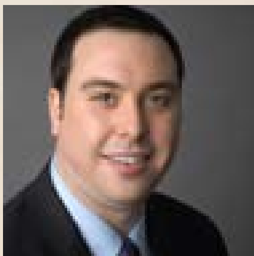
There's no question this slows things down and can frustrate folks at the firm, but the SEC is focused on that now, so we're taking it seriously. ■

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

Private equity firms have increasingly asked the question, what should be in-house and what should be outsourced? Experts from Korn Ferry and Hamilton Lane weigh in.



Joe Healey
Senior Client Partner,
Korn Ferry



Matthew Herzog
Principal,
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 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 switch was mark-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.

Given the risk-management issues that many of these funds face, broadly speaking, as well as the efficiency that they'd like to establish on deals and fund formation, firms have quickly found a justification for a general counsel, [who] usually dovetails with a chief operating officer. And you have a chief compliance officer in that mix as well.

Many firms have a head of talent management—almost an operating partner with a talent orientation—for their portfolio company leadership issues.

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] 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

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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 a 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 in a modest-size 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 in smaller firms.

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, they're really hard to outsource. If anything, you could argue that there's a trend for insourcing 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—that's actually been more insourced, 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 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.

> "No longer is it acceptable for the CEO and partner to also be running deals and wiring capital out to the individual investments."
>
> Matthew Herzog, Hamilton Lane

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 an example. 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 firms, [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. ■

How PE Firms Are Differentiating—by Staying the Same

Bucking a trend toward diversification, some middle-market firms are sticking to their pure-play roots

Charlie Ayres
Trilantic North America

As many private equity GPs seek to attract LPs by moving into new investment platforms and asset classes, others are consciously choosing a very different path—differentiating by staying the same.

"There are advantages to being a pure-play fund, namely that it is very easy for your LPs to understand who you are, what you are doing, and to believe that there aren't going to be distractions," Charlie Ayres, managing partner and chairman of Trilantic North America, explains.

Another argument for the pure-play model is to better support GP-LP interests, particularly as it relates to fees.

"They eliminate the risk of incentive misalignment between GP and LPs," according to the Boston Consulting Group. "Some LPs are concerned that management fees are so high for large multi-asset-class firms that performance fees become a secondary objective." Some investors today fear committing capital to the large multi-asset-class alternative investment managers, because management fees become so high that they mitigate the motivation of performance fees to generate alpha.

During a speech, Guy Hands, chairman of one of Europe's leading PE firms, Terra Firma, predicted a bifurcation within the asset class where the mega-sized firms will become institutionalized. As they move along this road, the largest firms will essentially become asset managers and resemble old-time investment banks.

"They will not be able to create much alpha when they employ thousands of people and manage hundreds of billions of dollars," Hands said in the speech. "Their funds will continue to create beta, and they will attract investors looking for 1.5x returns."

On the other hand, he said, smaller firms will become increasingly more specialized, allowing them to focus on their areas of expertise. As the other firms become larger and transform into slower-moving behemoths, the middle-market firms will exercise increasing flexibility and the ability to be nimble. A significant portion of the industry will return to its roots as strictly private equity deal-makers, just as it was 40 years ago. That kind of narrow focus also attracts LPs looking for greater control over exposure to certain strategies that cannot be obtained by a highly differentiated platform.

"You just have to be true to yourself," says Ayres. "If that is who you are and what you need to be, there is no question that LPs respect that and they are comfortable with that." ■

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