

GP OPERATIONS COMPENDIUM

Managing the complexities of today's private equity firm

Including:

- Blackstone
- Audax Group
- HGGC
- ...and more

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About Privcap

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Colin Sanderson

Audit Partner,
Financial Services Practice,
RSM US LLP

Making the Complex Simple

If one word describes the nature of running a private equity firm today, it's complexity.

It was never simple, of course, but a range of forces have conspired to make it increasingly difficult to make great investments and run a great firm.

Yes, regulation has made life more unpleasant, but that's just one part of the story. I've seen increasing challenges concerning issues well beyond red tape. Taxation, succession planning, employee relations, selling management interests, technology adoption, and cybersecurity are just a few of the issues that are quickly expanding the job description of today's C-suite executives.

This report is meant to help you navigate those challenges. With insights from your peers and industry experts, we've sought to capture the range of issues that confront managers today. The best practices contained in these pages can help all of us do our jobs better and faster and, we hope, make the complex simple.

Enjoy the report,

Colin Sanderson
RSM US LLP

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OVERSUBSCRIBED FUNDS

The Art of Saying “NO”

As GP problems go, having your fund oversubscribed is a good one to have. When investors are clamoring for an allocation, it's an endorsement of managerial talent, a reputation booster, and often a chance to think a little bigger. But it's also the start of a delicate balancing act. Some LPs, even the most desirable ones, must be turned away. And GPs must carefully consider the requests of existing investors for bigger allocations.

As investors seek out established performance, there's usually not enough space to go around, says Robert L. Greene, president and CEO of the National Association of Investment Companies, which tracks minority-owned private equity firms and hedge funds. In the past 18 months, he notes, 14 firms his group tracks have raised 16 oversubscribed funds, a trend mirrored by the wider private equity industry.

“Generally, if you've had success raising one fund, you increase the size of the second one 30 to 50 percent,” Greene says. “Once a firm proves in fund one and fund two that they have the wherewithal to being in the top quartile or top decile of performance, there seems to be a given that they will be oversubscribed. If you do well, you've generally doubled the demand from the LPs you already have.”

Les Brown, chief operating officer and a managing director at HGGC, a \$4.25-billion private equity firm focused on middle-market companies, confirms the multiplier effect. In December the Palo Alto-headquartered firm closed HGGC Fund III at \$1.84 billion, beyond its \$1.5-billion target, after just three

months. He says the experience of both raising a larger fund and addressing LPs' interest—and sometimes disappointments—reinforced his firm's approach of frequent, open communication and disciplined planning.

“When you go out for your next fund, LPs want to know how big are you going to be, so it's important that they understand your vision of what you do and what you do well,” he says. For HGGC, that meant keeping a strict limit on the increase of their latest fund, which was still an 84 percent increase from the firm's \$1-billion debut fund, raised in 2008 in a much more difficult investment environment.

Brown says the firm places a premium on upfront communication with current and prospective investors. And clear expressions of interest from LPs are not just welcome, but help the firm spend less time fundraising and more time generating returns on investments.

“Managing this on the front end eliminates a lot of difficult conversations on the back end, because you've already got the dialogue going,” he says.

There were disappointments in the last fund close—investors that didn't meet deadlines were turned away, and some LPs didn't get to increase their commitments—but Brown says the firm tries to recast the situation as the basis for future opportunities.

“Some LP relationships may take a pause, but both sides know this is a long-term relationship,” he says.

Greene says the unstinting demand for PE performance is compressing the fundraising process across the industry.

“The only way to guarantee a place is to be in that first close,” he says. ■



Robert L. Greene
President & CEO,
National Association of
Investment Companies



Les Brown
COO & Managing Director,
HGGC

Case Study: Investing to Mitigate Environmental Impact

A conversation with Elliott Bouillion of RES and Robert Antablin of KKR



Elliott Bouillion
President & CEO,
RES



Robert Antablin
Member & Head of Americas Energy
Private Equity,
KKR



Elizabeth Seeger
Director, Public Affairs,
KKR

Resource Environmental Solutions (RES) is dedicated to offsetting the environmental impacts that usually occur in large-scale development projects. RES often leaves an environment in better shape than before development began. The company has planted 10 million trees; it preserves habitats and restores streams and wetlands, among other services. RES also helps streamline the permitting process, saving developers time and money by tapping a highly credible ecological team. The company found an eager partner in KKR, which not only has a mandate for ESG improvements across its vast and varied portfolio, but is seeking to back businesses for which ESG is core to the business plan.

Elizabeth Seeger, KKR: Before KKR had the opportunity to invest in RES, what was the firm's view on the ecological services opportunity?

Robert Antablin, KKR: We have a focus on ESG as a theme and thesis. The energy sector, obviously, deploys large assets on sites, which have an impact. And so we spend a ton of time thinking about different ways we can deliver better environmental performance. Ecological services are basically premised on facilitating economic development in a responsible way.

Roughly half the demand in this market relates to mitigation that's required to facilitate new or [replacement] road and highway construction in the United States. And so there's a very, very robust demand outlook.

Seeger: Elliott, why did you think private equity would be a good partner to help your business grow?

Elliott Bouillion, RES: We were looking for a way to scale up our company. We had spent almost eight years proving out our business model, and really understanding how to manage it and how to grow. But to scale it up to do it nationwide or to do it globally, we really had to reach out and find a partner. We spent about three years getting

prepared to attract someone that could help us grow globally. We were able to find that in KKR. It's not all about capital—it's about people who can understand your business, people that help your business.

Seeger: What trends are you seeing that make you optimistic about the future growth of your business?

Bouillion: Take coastal restoration, for instance—we're seeing a lot of capital set aside for this. Most of our coastal communities along the East Coast and also the Gulf Coast have done a lot of planning over the last 10 years, and it's now time to get projects in place. Our country has many infrastructure challenges, and there are a lot of new projects out there, including rail, roads, ports. And we're planning to provide solutions in those areas as well.

Antablin: Another area of focus is water quality. We have a number of issues with legacy infrastructure. One good example is the Chesapeake Bay, which essentially has too much contamination from storm water runoff—phosphorus and nitrate. So there are opportunities to provide green infrastructure to essentially eliminate or create catch bin areas for storm water runoff before the nutrients are conveyed from urban areas. ■



With the enactment of the Bipartisan Budget Act of 2015, the private capital industry should expect major changes to the way the IRS conducts taxpayer audits. Donald Susswein of RSM and noted tax attorney Fred Witt outline these changes and what they mean for managers of private funds.

Privcap: Why does the private funds industry now find itself in the cross-hairs of the IRS?

Donald Susswein, RSM: There's a huge divide politically and culturally in this country related to issues of fairness or perceived fairness in our economy, with a particular emphasis

The Experts



Donald Susswein

Principal, Washington National Tax, RSM US LLP



Fred Witt

Certified Tax Law Specialist, Fred Witt PLC

on what people pay or should pay in taxes. Partnerships of all kinds have become the poster child for that conflict. Congress basically sent the IRS a message: "You better go audit some partnerships." That is coming. The new rules are going to take effect for any items of partnership income or deduction arising after the end of 2017. The enhanced audits probably won't begin until 2020, but the new rules begin to apply only a few months from now, and the IRS is really gearing up to go after partnerships.

Fred Witt, Fred Witt PLC: In the last 10 years, there's been a sea change away from regular corporations and S corporations to the use of LLCs taxed as partnerships. The IRS and Congress perceive themselves to be a little bit behind the curve, and they are reacting to this dramatic shift in the marketplace.

Susswein: Fred, once the IRS does start auditing partnerships more, what are they likely to be focusing on?

Witt: Let's talk about LLCs taxed as partnerships. LLCs need to file Form 1065 annually. The first question will be: Who can sign the tax return? You might think, "Gosh, isn't that just assumed?" The answer for LLCs is no. For an LLC, the IRS tax return specifies that a "member manager" should sign the return. The term "member manager" is found nowhere else in the law. It's a creation of the IRS. This has important and critical consequences, because if the wrong person signs the return, it's the IRS' position that the return is invalid. If it's invalid, the statute of limitations never

begins. Every business owner and operator needs to drill down and check their documents to make sure that these matters are being addressed.

Susswein: I was recently having a conversation with an attorney representing another party. The attorney said, "Surely the IRS will recognize that this is just a foot fault. They're not going to hang a taxpayer out just for missing a technicality." I laughed, because that's the lifeblood of the IRS, right? If you violate a technical rule, that's one of the great ways they can get you!

Witt: Don, that's exactly right. The IRS has proposed these technical rules and has made the change for the first time in 30 years with the idea of increasing audit activity. They are going to want to collect whatever additional taxes are due. If they can do it based on a technicality, such as "The wrong person signed the return, and the statute of limitations never began," that, to the IRS, is a benefit. It makes it easier if they can get you on a technicality rather than trying to dive into the very complex, as they say, spiderweb of partnership tax.

Susswein: I've also heard there's a lot about fee waivers, carried interest, and profits interests in the private capital industry. Are those also areas that the IRS is going to be looking at?

Witt: They are. Carried interest has gotten a lot of discussion because of the legislative attempts to change the treatment of carried interest. As for fee waivers, the IRS and

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policymakers have a hard time having a lot of sympathy for a taxpayer who gives up \$1 million of ordinary fee income in exchange for \$1 million of somewhat speculative capital gains, even if there is some risk the gains won't arise.

Can you talk about the new partnership procedure rules intended to make it easier for the IRS to audit private partnerships?

Susswein: Let me try to give you a little bit of a summary: Partnerships file a single tax return, and the positions on that tax return are generally applicable to all of its partners in the partnership. They take their share of the partnership's income and put it on their individual return. However, a partner, if he or she wants to, can take a position that's inconsistent with the position of the rest of the partnership. That has been the law for many, many years. If the IRS wanted to audit the partnership, they would audit the partnership, but almost every partner in the partnership had the right to take an inconsistent position on his or her own personal return.

The IRS had to deal with potentially hundreds of different positions on the same tax issue. It was very, very complicated. It was one of the reasons why they generally avoided auditing partnerships. The big change that will be effective for 2018 is that henceforth the partnership is going to have to speak with one voice. The partnership is going to appoint somebody to have the authority to bind all of the partners in the partnership to a single tax position. This is a huge change. It's a simplification for the IRS.

What are some of the implications for a partnership when a single person can bind the whole group to tax positions?

Susswein: It means that somebody running the show, as far as the audit

is concerned, may not have your best interests at heart as a partner. You might be a private equity fund, and you're holding a 40 percent interest or a 50 percent interest in a portfolio company, and somebody else may be controlling what that portfolio company does if they're audited, even though the impact of the adjustment may be on your fund as the investor.

Witt: The thrust of these rules is to treat the partnership like a corporation and take all of the power, all of the decision-making, and make the partnership like a corporation for purposes of auditing and determining additional taxes due. This means that the personal representative of the partnership has a very powerful position, and the person selected needs to be carefully identified and carefully monitored or controlled.

Susswein: There are circumstances in which a tax change that's proposed on an audit may affect the general partner in a way that's different from the rank-and-file investor. This is a potential morass of conflicts of interest. It doesn't mean they can't be resolved, but it means that unfortunately you can't just go to a lawyer or a CPA and say, "What's the magic language I put in my agreement? What's the 'boilerplate' I can add to protect me?" It isn't a matter of magic language. There are real business issues, real conflicts, that need to be resolved as a business matter. For example, are certain decisions so simple that we can trust the manager to do it, or are all of the decisions on dealing with the IRS going to have to be put to a vote? If they're put to a vote, does everybody get the same type of vote?

Witt: I've spent the last two years in my practice drafting sample forms of the so-called boilerplate language that Don referenced. I think that section now has to be put into the trash can, because for the reason you just

described, there isn't really going to be any boilerplate that will fit.

Susswein: All of this doesn't necessarily mean that there's going to be an elaborate redrafting of the partnership agreement. It may be a one-sentence addition. The difficult part is thinking it through. That's the hard part. In most cases, it may not even have to be in a partnership agreement, it may just be a side agreement, or it may just be a handshake or an understanding, but the point is, if you don't resolve these issues before 2018, they're going to be much more difficult to resolve later, if a real controversy develops.

Do you have clients who have said to you, "Gee, why don't we just wait until we get audited, and then we'll deal with this?"

Susswein: That is the normal reaction: "I don't want to do anything until the regs come out" or "I don't want to do anything until the technical corrections are resolved." But just think about your private equity fund and you're considering investing in a partnership. When you invest in that partnership, are you taking a risk for your own investors that maybe you haven't thought through? Maybe there's some claim that you were negligent in making an investment without your having made sure that that partnership had checked all the boxes, dotted all the *i*'s, and crossed all the *t*'s. And it's not as easy as just finding your tax advisor and asking them to do the work. He or she doesn't have an "easy button." There isn't any magic language or "simple button" they can press and all your problems are solved. It isn't an insurmountable problem, but it's a business problem that has to be worked through by the parties with a trusted advisor who understands the tax and business issues, not a problem of finding the right technical language to make the problem go away. ■

HOW YOUR PE FIRM CAN STAY IN THE SEC'S GOOD GRACES

Pay particular attention to expenses and fees, says Clifford Chance's Steven Gatti

Steven Gatti
Partner,
Clifford Chance US LLP



In 2011, the Securities and Exchange Commission adopted amendments to the Dodd-Frank Act that eliminated the private advisor exemption and required scores of previously unregistered advisors—specifically in the private funds space—to register with the commission. The SEC has since paid particular attention to expense allocation and compensation issues.

“The main issue for the SEC is disclosure—does an investor have information available to them to make an informed investment decision?” says Steven Gatti, a partner with Clifford Chance US LLP in Washington, D.C., specializing in regulatory compliance and enforcement matters involving the SEC. “The second level is [whether] this particular expense is already, or should be, deemed to be covered by the management fee.”

Private equity firms that want to avoid negative outcomes in the event of an SEC audit should seek to update their disclosure to include additional information about new or existing expenses, he says.

Gatti emphasizes that “another level of analysis is whether the PE firms should remediate prior expense allocation by returning money to the investors.” To update the disclosures, firms should conduct an internal review of all fee and expense practices and then make adjustments.

“Review the expense policy, review the disclosure, and look at the disclosure versus the reality,” says Gatti. “Make sure that you are comfortable that the actual expenses are consistent with the disclosure and are reasonable compared with the evolving SEC precedent. This is worth undertaking, unless the firm has been through an SEC exam recently.”

One area that has been attracting particular attention is portfolio company monitoring fees.

In 2015, Blackstone agreed to pay \$39 million to settle charges that they provided inadequate disclosures about acceleration of portfolio companies' monitoring fees, and discounts on legal fees obtained by the firm but not offered to three of its funds. In April 2017, Apollo Global Management paid \$52.7 million to settle claims about accelerating future monitoring fees and failing to supervise a senior partner who charged personal expenses to the fund, among other things.

“Monitoring fees are a [standard practice] for private equity but can be problematic where accelerated in connection with an IPO or a sale of the portfolio company,” says Gatti. ■

A Bold New Era of Transparency



— How fund managers are addressing the competing demands of the SEC and their investors

Experts



Ian Cameron
COO,
Washington State Investment Board



Steven Millner
Managing Principal,
Gen II Fund Services

Key Findings

1

The SEC played a key role in creating an “awareness campaign” focused on PE fee allocations

2

PE firms must invest in people and infrastructure to respond to SEC and investor demands

3

Like hedge funds, PE firms are outsourcing key fund-administration functions

4

Timely, useful portfolio-level data is eagerly sought by LPs, but difficult to deliver

5

Creating a policy for sorting out expenses between the fund and the GP entity is critical

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1

The SEC played a key role in creating an “awareness campaign” focused on PE fee allocations

Who holds the negotiation leverage in private equity? For years, depending on the state of the economy, the pendulum swung regularly back and forth between investors and managers. For example, in the aftermath of the financial crisis, LPs could ask for—and get—a lot of concessions because GPs were struggling. Later, as many funds grew to be oversubscribed, LPs lost leverage.

Then the U.S. Securities and Exchange Commission came along and grabbed the pendulum. A primary thrust of the SEC’s PE regulation campaign is to educate investors about the diligence that they are due from firms.

And as investors get smarter, managers are getting more transparent. GPs tend to be much more attentive to LP needs and concerns. “LPs want this information,” says Steven Millner, managing principal at Gen II Fund Services. “They deploy money with managers they feel are going to give them not only good performance on the investment side but also fiduciary responsibility.”

2

PE firms must invest in people and infrastructure to respond to SEC and investor demands

Investors now look closely at firms to see if they have the infrastructure they need to support robust compliance and due diligence requirements. Millner has seen private equity firms that have performed well in the market and lined up promising investors for their next fund. But then, suddenly, the LPs start talking about operating due diligence, and the PE firm realizes it has neglected these core functions.

That’s when Millner gets an urgent call from a GP who wants to talk—and wants to talk now. “Because we do check a lot of those boxes,” he says. “When you talk to our clients, they would tell you that a third-party administrator can bring people, process, and technology to the table in a private equity environment. And that enables a firm to scale.”

3

Like hedge funds, PE firms are outsourcing key fund-administration functions

Around the time of the financial crisis, hedge funds moved almost exclusively to outsourced fund-administration tasks. Private equity is now following suit.

Firms like Blackstone and Carlyle, of course, have sufficient resources to create high-level, high-quality back offices. Smaller and medium-size firms do not, so they turn to outsourcing to relieve a lot of their administrative burden. “You have a confluence of demands on a sponsor, and the sponsor now has to look and say, ‘Do I want to build something and think about scalability and attracting talent? Or do I hand this off to somebody who makes it their business?’” Millner says. “We’re seeing that process. It’s unfolding as we speak.”

Three or four years ago, there might have been resistance from firms in the old guard who think, “We’ve always done this ourselves, so why should we change?” But even they are now realizing that the job is expanding beyond in-house capabilities. “There is a clear recognition by most participants that, in order to be competitive in the marketplace, you don’t have a lot of choice anymore,” Millner says.

“Look at LPAs [limited partner agreements] now,” adds Ian Cameron, chief operating officer at the Washington State Investment Board. “Where you used to have a paragraph that discussed fees and how those were going to work and what they looked like, now you’ve got three, four, five pages. So when you sign up for that, you’re going to need an infrastructure that’s capable of producing that information and delivering it in a way that’s intuitively valuable for the LPs.”

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“We still don’t have good standards. ILPA and others are starting to think about it, but for large consumers of data, they’re actually putting out their own requests and saying, ‘Here’s what we’d like to see, and here’s when we’d like to see it.’”

- Steven Millner, Gen II Fund Services

4

Timely, useful portfolio-level data is eagerly sought by LPs, but difficult to deliver

Demand for data about portfolio companies and many other aspects of private equity is exploding. But it is a significant challenge for firms to gather it, process it, and share it with regulators and investors in a useful form.

Neither are there standards for the data that is collected. “We still don’t have good standards,” Millner says. “ILPA and others are starting to think about it, but for large consumers of data, they’re actually putting out their own requests and saying, ‘Here’s what we’d like to see, and here’s when we’d like to see it.’”

This demand for data is only going to grow, and when it comes to providing it, GPs have three choices: lead, follow, or get run over.

LPs will not relax their demands for data anytime soon, because they have very good reasons for wanting it. For starters, LPs like Cameron’s Washington State Investment Board need data to gain insight into their entire portfolio, all asset classes, and the risks that are spread across it. “Beyond the operational information, we need to get down to portfolio-level data,” Cameron says. “That has to be available to us so we can look at our concentration risk, so we can look at liquidity risk, leverage, all those different things. Private equity funds need to be able to provide that data in a timely way and in a common format that can be easily uploaded.”

5

Creating a policy for sorting out expenses between the fund and the GP entity is critical

Fee transparency is a very hot topic. ILPA has come out with standards, the SEC is continuing to look into fees—and, from the LP perspective, this is a good thing. “There’s a confidence and trust-building that’s going on,” Cameron says. “So the more they can be candid and show us how fees are going to be allocated, the better. What is going to be offset against management fees, what’s not going to be, so there aren’t any surprises.”

From the GP perspective, accurate reporting of expenses is a burdensome process. For example, expenses for a single business trip by a GP to visit a portfolio company in Asia might be sorted any number of ways, depending on where the GP goes and who they see. The GP might take an extra day or two to meet with investment bankers and investigate other opportunities. How should those expenses be billed?

It’s complicated. This is why solid guidelines for sorting expenses are critical for PE firms. ■

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Matthew E. Nelson
Head of Investor Relations,
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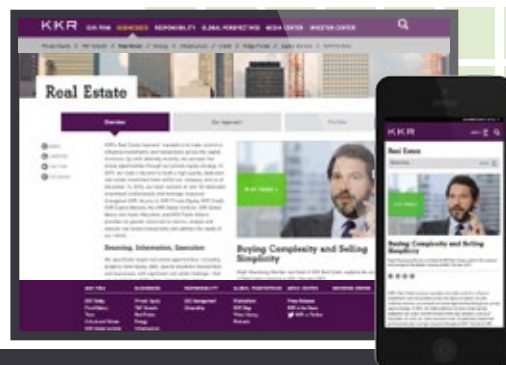
The Privcap Team

David Snow, former editor-in-chief of Private Equity International (PEI) Media, co-founded Privcap in 2010. Co-founder Gill Torren has extensive experience in online and trade media publishing.

Members of the Privcap team have previously worked for companies including Condé Nast, *The New York Times*, PEI Media, BBC, *The Australian Financial Review*, Pitchbook, Capital IQ, Haymarket Media, CoStar, Marcus & Millichap, and Grant Thornton.

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THE DEAL

That Made Audax's Geoff Rehnert Sick



Geoff Rehnert
Co-CEO,
Audax Group

**Geoff Rehnert,
the co-CEO of Audax
Group, tells the story
of an early lesson
in dealmaking**

Coming out of the blocks, we tried to do too much, too quick. Co-CEO Mark Wolpov and I delegated too much early on. We invested in a growth capital company called Indian Motorcycle. That was the worst single investment of my entire career, and probably the most painful business experience of my career. We lost about 20 percent of our first fund in that one investment.

When it was clear that Indian was not going to make it, that was very, very painful. I think I threw up every night for about a week straight. I absolutely couldn't believe that we had made such a mistake and had gotten ourselves in those positions. Mark and I had done deals at Bain Capital, but we had not led the organization. We had led deal teams; but running an organization—and some of the lessons learned about over-delegating to people that you haven't worked with long enough to know, trust, and understand—were all hitting in a very painful way.

We went and visited all of our key limited partners and said, "Look, we're going to make this right. We're going to do whatever it takes to make this right." And the thought of quitting never occurred.

Mark and I really stepped into the private equity business in a day-in, day-out basis, and for many years I spent an awful lot of time running the daily operations of the private equity business as we reorganized, rebuilt, and regrouped. And we put in place a lot of processes, systems, and a lot of team dynamics that make us the firm we are today. ■

From the CFO's Office:

Catching up with Gerry Esposito of Newbury Partners

Gerry Esposito is a managing director and has served as the chief financial officer and chief compliance officer of Newbury Partners for 11 years. Based in Stamford, Conn., Newbury invests in buyout, venture capital, special situations, mezzanine, and fund-of-funds in the secondary markets, and has approximately \$3 billion in assets under management.

Privcap: What are a private equity CFO's main concerns for his or her firm in the current market?

Gerry Esposito, Newbury Partners:

At a high level, the concern is the ability of a firm to fundraise and generate results for investors while the industry is undergoing a recalibration of investment returns across the asset class. That's happening worldwide. How you manage and recalibrate in a declining return environment should be front and center for most private equity CFOs.

How have the CFO's responsibilities evolved and expanded over time? What was the most challenging aspect of these changes for you?

Esposito: What's been happening is that it's getting more and more complicated to be a private equity firm, whether you're involved in buyouts or the secondary market. There's more regulatory pressure and more investor demands. For at least the last seven or so years, there's been a kind of job creep in the role. CFOs are uniquely positioned to be involved in every aspect of the firm—most CFOs are fixers, and there's lots of fixing to be done.

The only way to cure a lot of this is rearranging your workflow, which I'm trying to do and which can be hard. The best results come from empowering your lieutenants to make decisions, so that a lot of the more basic stuff never makes it to your desk.

Gerald Esposito
Managing Director,
Newbury Partners



What trends in regulation and compliance are you watching most closely? Are there governmental or macro-economic concerns that have recently become more prominent?

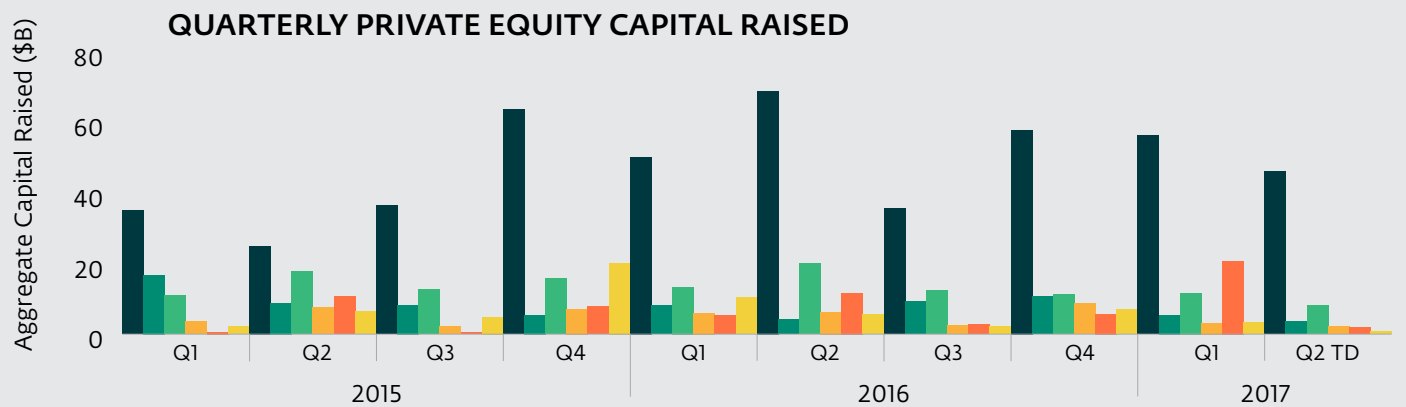
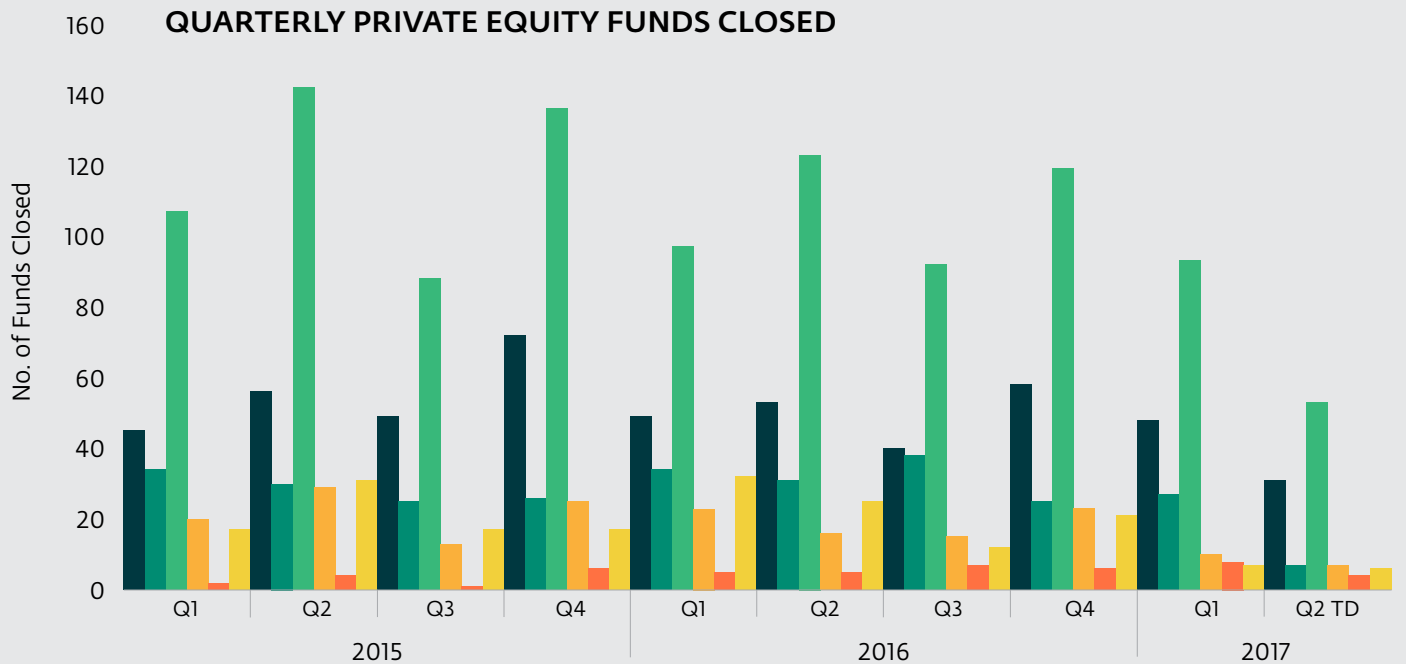
Esposito: I believe a lot of what's been going on in private equity since 2010 has been political. We have been an easy target as an industry, and more and more regulators are jumping on the bandwagon, making more rules and regulations that weren't previously applicable to private equity now applicable to private equity. The FinCEN [Financial Crimes Enforcement Network] "know your client" rule isn't finalized, for example, but that's part of the rules and regulations that need CFO-level attention.

Since the election, I don't think there'll be a wholesale furlough or release from regulations that have been passed in the last 10 years, but there will be more of a commonsense, businessman's approach from regulators. If you've taken steps and used your reasonable judgment, I think regulators may have a more reasonable response to issues.

What do private equity CFOs talk about when they get together?

Esposito: I'm always impressed by the level of camaraderie among private equity CFOs, even among competitors. There aren't that many of us, and it's useful to have a handful of people whom you really trust to bounce ideas off of. CFOs should take advantage of that. You can't do it from behind your desk. You have to get out there and meet people. ■

THE YEAR IN FUNDRAISING

The latest trends from Preqin

KEY

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

PRIVATE EQUITY FUNDS IN MARKET BY FUND TYPE (as of May 24, 2017)

Fund Type	Aggregate Capital Targeted (\$B)	No. of Funds in Market
Buyout	191.3	282
Venture Capital	135.0	1,009
Growth	114.4	317
PE Fund-of-Funds	27.1	155
PE Secondaries	25.6	38
Other PE	144.1	145

Blackstone's Culture of Compliance

THE CHIEF LEGAL OFFICER AT BLACKSTONE SAYS THE FIRM HAS MADE AN ENORMOUS INVESTMENT IN ITS COMPLIANCE PROGRAM, AND THAT MEANS HIRING AND TRAINING THE RIGHT PEOPLE

Having joined Blackstone in 2010 as the chief legal officer, John Finley has helped the firm manage risk as it has exploded in growth. A former senior M&A partner at the law firm of Simpson Thacher & Bartlett, where he was a member of the management committee, Finley has the complex job of overseeing the legal and compliance requirements for the largest alternative asset management firm in the world. In a recent interview with Privcap, Finley discussed his formula for compliance success, as well as his approach to the many risks the industry faces.

Privcap: Blackstone is such a large firm. How do you ensure that all your employees are focused on compliance?

John Finley, Blackstone: The foundation of a compliance program is culture. You can have great policies, but if you don't have the right culture, the policies are not worth anything. At Blackstone, the culture is set by Stephen Schwarzman, our founder and CEO. He establishes a culture of excellence, and that culture spreads to every part of the organization, including compliance.

How do you ensure that the culture of compliance is pushed throughout the entire organization?

Finley: In order to reinforce a culture of compliance here, we use training, talent, and technology. We try to have people focus on real-life problems, such as how would they handle a piece of confidential information and who could they talk to about it? We also use online training, which promotes consistency. Also, it's trackable. If a regulator comes in and says, "How do you know that everybody has gone through the training?" we've got that box checked.

The next important factor is talent. We have chief compliance officers

[CCOs] for each of our business units. And they all have at least 10 years of experience. We have roughly doubled the size of our compliance team over the past five years.

The next factor is technology. Technology is such a critical part of an effective compliance program. For example, we have proprietary software for anti-money-laundering client reviews. This process used to be done manually.

What kinds of skills do good compliance officers need?

Finley: What we want is not a traffic cop but an opinion leader. The problems of compliance are never black and white. Solving problems involves subtleties. Compliance officers need to establish standards that are principled and effective. At Blackstone, the ultimate insult is to be called mechanistic, because that means you're not thinking. You need to think about the purpose of a rule and how it applies to specific situations.

What are some key risks that you've been focused on?

Finley: When I first started at Blackstone, one of the compliance areas that was at the top of my list was FCPA [Foreign Corrupt Practices Act]. I knew that it was both a reputational risk and financial-damage risk. While the existing Blackstone anti-corruption process was good, I knew that we could make it better.

Large firms often can access multiple funds to do deals. How do you manage the risks associated with that allocation process?

Finley: As firms grow, they enter into different investment areas, and they need to be conscious of allocations. The risk is that allocations between



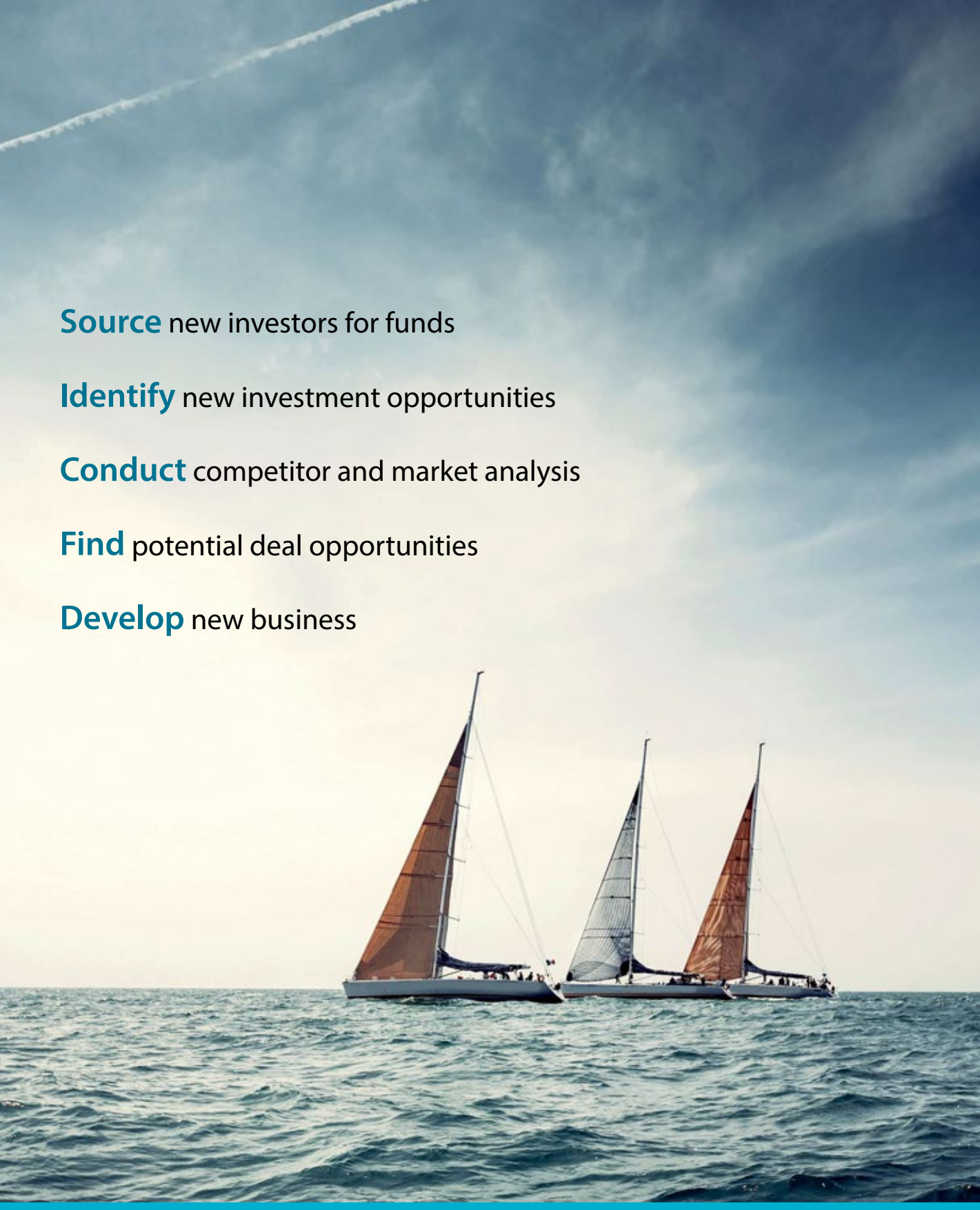
John Finley
CLO,
Blackstone

different business units are not fair and reasonable. This is also an area that the SEC is very focused on. There are several policies that can work. You can use an allocation policy that is formulaic. For example, two business units would split the deal along pre-defined percentages. You can also allocate based on policies that set forth factors such as the target returns of the various funds. Whatever the rationale, the policies need to be carefully disclosed and documented. When the regulators come in, they want to check and see how you make allocation decisions.

How important is cybersecurity at Blackstone?

Finley: Cybersecurity is clearly one of the most important risks that the firm and the industry face. Mary Jo White, the ex-chair of the SEC, said that cybersecurity is the biggest risk to the financial system. Blackstone is investing tremendous resources in protection. We also have to be mindful that the SEC has their own way of looking at this issue. I would advise anyone preparing to improve their cybersecurity to think about the framework of the regulators. Even if you think you're doing a good job, that may not match the framework that regulators are looking for.

The regulators will ask: What are the protections of your information networks? What are the policies and procedures that you're putting in place? What's the training for these networks? How are you dealing with your vendors? What access do vendors have? What about remote access? If somebody does breach your system, how soon do you know? It is reckless to not focus on this area. ■



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C-Suite on the Move

The comings and goings of private equity execs



Jörn Stobbe
Union Investment Real Estate

The Hamburg-based real estate investor hired the former Deutsche Bank managing director and Clifford Chance partner as chief operating officer. The appointment, Union Investment said, completes the overhaul of the firm's senior management team ahead of an anticipated real estate push next year.

Katie Solomon, Melissa Dickerson, and Ben Marshall
Genstar Capital

Genstar Capital has promoted Katie Solomon to managing director of talent management, Melissa Dickerson to chief financial officer and managing director of operations, and Ben Marshall to principal. Solomon joined the midmarket private equity firm in 2011, while Dickerson came on board in 2004. Marshall was originally hired in 2010 and then rejoined Genstar in 2014.

Craig Goos
GPB Capital

Goos, who has more than 20 years of experience in wealth management and financial services, joined GPB Capital as managing partner and chief operating officer. He will work closely with the GPB executive team to develop and implement plans for enhancing operations and meeting the organization's objectives for rapid growth.

Stephen M. Johnson
First Capital Real Estate Trust Incorporated

First Capital Real Estate Trust Incorporated has hired Stephen M. Johnson as chief financial officer. Previously, Johnson worked at DRW Holdings LLC, where he served as head of equity volatility trading Asia.

Russell Proutt
Charter Hall

The Sydney-listed fund manager Charter Hall hired Proutt, who spent 11 years at Brookfield Asset Management, as chief financial officer.

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Dörte Höppner
The Riverside Company

The Riverside Company appointed Höppner chief operating officer of the Riverside Europe Fund. Previously, she was managing director at P+P. Höppner is the former chief executive and secretary general at Invest Europe as well as the ex-managing director at the German Private Equity and Venture Capital Association.

Larry Marsh, David De Luca, and Bryan Sekino
Vesey Street Capital Partners

Vesey Street Capital Partners, a middle-market healthcare-focused private equity firm, hired Marsh and De Luca as general partners and named Bryan Sekino as chief financial officer. Previously, Marsh was executive vice president of new market development and strategy officer at AmerisourceBergen; De Luca worked at Morgan Stanley as managing director and head of U.S. institutional equity sales in New York and other regions. Sekino worked at Brant Point Capital Management.

Alec Stais
**Rhode Island Employees’
Retirement System**

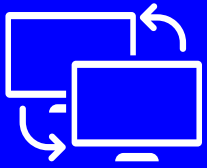
The state of Rhode Island hired the former senior Goldman Sachs Group executive as chief investment officer to oversee its \$7.9-billion pension fund.

David Melina
Simon Group Holdings

Simon Group Holdings has hired David Melina as chief investment officer. Melina’s work background includes serving as chief financial officer at Sentry Investment Partners and chief operating officer at Costa Kondylis & Partners. Also, he advised The Carlyle Group on the reprogramming of five completed residential buildings valued at more than \$500 million.

Molly Murphy
OCERS

Orange County Employees Retirement System has hired Molly Murphy as the new chief investment officer. Murphy was previously CIO at Mercy Health, a \$5 billion-healthcare system based in Ohio.

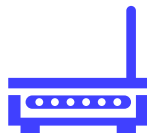
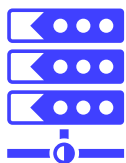


DON'T BE A "HACKER SNACK": CYBERSECURITY DONE RIGHT



CODE RED

"We had one engagement recently where the client was running Windows ME."



True cybersecurity isn't about preventing every threat; it's about properly handling the inevitable

Cyber thieves have a name for a firm that mistakes prevention for comprehensive threat planning—a "hacker snack." Hard on the outside, soft and goey on the inside.

Unfortunately, too many firms are satisfying those illicit cravings.

The problem, says Daimon Geopfert, national leader of security and privacy consulting at RSM US, is that many firms started from the perspective that if their systems got breached, they did something wrong. The reality, Geopfert says, is that no firm can prevent all attacks.

"This is a basic 80/20 problem. You can address 80 percent of your issues with 20 percent of your effort. Fixing that last 20 percent requires significant effort and expense and will never reach zero," Geopfert says.

Well-managed firms spend lots of effort to detect and correct breaches once the inevitable happens. That requires a holistic approach that goes well beyond efforts to protect every point of entry. Not only will it eventually fail; it often costs more than necessary, Geopfert says.

Ultimately, the prevent-at-all-costs approach starts with the wrong question: How do I keep everyone out? Instead, Geopfert says, firms should first ask: What am I trying to protect?

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Know Your Data

The holistic cybersecurity approach is based on three core efforts: Protect, Detect, Correct.

Protection goes beyond the traditional concepts familiar to anyone with a laptop—firewalls, anti-virus, and keeping software up to date. Instead, it first requires understanding the types of data your firm handles and figuring out what requires the greatest level of protection.

“You want to think in terms of ‘layers of trust,’” Geopfert says. He says the best example comes from the physical world—an office building. When you enter a building, there’s typically some form of security in the lobby, and then additional security protocols in place for sensitive areas like a data room.

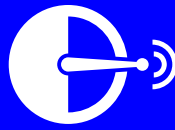
Yet that isn’t how it often gets structured in the virtual world of data.

“It’s like once you get past the security desk, everything is in the lobby,” Geopfert says.

The layering approach acknowledges that some data is more sensitive than others and therefore should be sectioned off from less critical information. And only those who need access should have it, and only the systems that need it can actually reach it.

WARNING AHEAD

“I asked one client where their IT infrastructure was. They laughed.”



Know What’s Normal

Once you’ve prioritized and protected your data, you need to plan for the inevitable breach. Doing that requires pairing internal knowledge with software to define the normal and abnormal. Without that, there’s no way to identify suspicious behavior. Geopfert says that a Verizon study found that 87 percent of firms that experienced a breach had access to the information needed to detect it, but were incapable of identifying it.

Luckily, he says, much of the most critical data is often relatively static, so it’s easiest to get a handle on it. Segmenting the critical data and systems away from day-to-day user systems and data, which is typically “noisy” but less critical, helps bring the real issues into clearer focus.

“There are some very binary use cases—if thing ‘X’ happens, it’s bad,” Geopfert says. “To get to the point where you can detect nuanced issues, such as changes in user behavior, there’s much more you have to do.”

Doing more involves using a combination of behavioral, trend, and heuristic information to define and trigger warnings. For instance, Geopfert says, picture a user who has never logged in before 7 a.m., never later than 7:30 p.m., has only touched five systems in the network, and only from three geographic locations. If that user logs in at 2:30 a.m. from a fourth location and proceeds to access other systems, then that should trigger an alarm. But a system can only be set up to “listen” for such events through careful study of existing patterns.



Know What to Do When Disaster Strikes

How a firm reacts when a breach occurs is as important as the steps meant to prevent and detect it. In fact, in combination with the layering approach detailed above, incident response is a key target of regulators, state attorneys general, and insurers—in other words, the groups that can make life after a breach particularly miserable.

The simplest advice, Geopfert says, is don’t go it alone. Internal teams should not be tasked with cleaning up an attack once it occurs. They should be technically capable of identifying a breach and then putting a response in motion—calling law enforcement, shutting down systems, alerting the public—but shouldn’t do the forensic work.

“Unless they’re a *Fortune 50* company, they probably don’t have the budget to have that staff in-house,” he says. “Most organizations that try to do this themselves throw up their hands after a couple of weeks and call in an outside firm. There have been cases when insurers won’t pay fines because the firm didn’t properly handle the fallout, and while they were attempting to do the right thing, they actually extended the duration and damage of the event.”

The best firms will put together a great plan, often with a consultant, and then run through it a few times a year. A practical approach works best.

“Don’t overthink it,” Geopfert says. “One of my clients has everyone on the team bring in news articles of breaches. They throw them on the table, go through them and discuss how they would respond. It’s extremely effective.”

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The 8 Signs You Really Need IT Due Diligence



For private equity firms, assessing the vulnerability of a prospective portfolio company's information technology infrastructure is essential, no matter how small the target. The *2016 NetDiligence Cyber Claims Study* found that nearly 90 percent of claims submitted were from companies with less than \$2 billion in revenue.

Yet some businesses require more scrutiny than others. Here, Daimon Geopfert and Dan MacAndrew of RSM share the biggest red flags for any potential acquisition.

1 The team can't answer basic questions

It seems obvious, but even companies that appear extremely sophisticated often fall short. If you start asking simple questions—what type of sensitive data does your company possess, and how does it handle it?—and answers aren't forthcoming, dig deeper.

2 It's young and high-growth

New high-growth companies don't just outgrow office space—they often strain existing infrastructure, controls, and processes.

3 It's in a highly regulated industry

Is the business in healthcare, consumer and retail, or financial services? Don't think twice—investigate deeply. At some point, a regulator is going to pay a visit.

4 It works with government agencies

Privatization has been a boon for private equity investors, but doing business with government also means grappling with legacy or specialty government systems and rigid government standards and contracts.

5 It's dependent on cloud infrastructure

As cloud infrastructure has grown in popularity, so have the risks. The company should have a clear understanding of not just its own data management practices, but those of third-party providers as well.

6 It's grown through aggressive acquisition

The more a company is the sum of multiple acquisitions, the greater the risk of a "rat's nest" of systems, policies, and procedures. Make sure the integrations were performed well, or you risk unpleasant surprises.

7 Its main product is based on valuable intellectual property

If the company's core product is based on a "secret sauce," you'd better make sure it's behind impenetrable lock and key.

8 It has service-level agreements (SLAs) with its clients

Commodity businesses may not handle sensitive data, but their ability to stay online and make good on their agreements is critical.



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The Data-Driven CFO

How technology is transforming the role of today's finance chiefs

Key Takeaways

1. Armed with game-changing data tools, CFOs can be key partners in adding value
2. During due diligence, gap analysis should also be applied to the finance team
3. Keep in mind that when the deal is done, the finance team is exhausted
4. GPs should collaborate with CFOs on the value-creation plan
5. Planning prevents wrong turns with new technology platforms

1. Armed with game-changing data tools, CFOs can be key partners in adding value

Many CFOs now play an important role in value creation at private equity portfolio companies. Equipped with powerful new tools for data analysis, they're helping make vital business decisions and drive their companies toward success.

CFOs can now be "more strategic and savvy, thanks to a proliferation of very sophisticated tools, from corporate performance management to business intelligence—even tools to help with little things like consolidations and closed process management," said Dave Noonan, a principal at RSM US.

Shahriyar Rahmati, managing director at Comvest Partners, called today's CFO "the quarterback of the portfolio company in a lot of ways," noting that the CFO is often the eyes and ears of the CEO and a key partner in planning strategy based on data. "Organizations have lots of data," he said. "Payroll, ERP, CRM systems—they spit out data all over the place. The question is: Is there somebody sitting in the middle of that data who understands the business, understands what everybody is trying

to get done, can think about it in a rigorous way and then drive it using the technologies that are out there?"

And shift gears as the company accelerates. At the early stages in a company's evolution, CFOs have to pull the levers to fuel growth. Then, as a company matures, the CFO's focus turns to profitable growth and helping management make informed decisions, not only around opex but around sales, resource deployment, and other functions.

At this point, good CFOs kick it up a notch and become "data ninjas," said Kevin Masse, chief portfolio officer at TA Associates. "They're sitting at the nexus of all these different points of information, pulling it together, analyzing it, and teasing out the key takeaways so the rest of the management team can be more productive and impactful to the business. That's where I'm seeing the CFO role evolving, and it's driving a ton of performance."

2. During due diligence, gap analysis should also be applied to the finance team

These days, when GPs partner with the management team of a portfolio company to form a plan for value creation, the plan should involve the CFO's access

to data. GPs should look at the CFO's current data practices and figure out ways to optimize them so that the management team can gather and analyze the data they need to compete better.

"Step one is traditional gap analysis," Rahmati said. "It's figuring out what the financial team does today and how effective it is, and then what they need. What are the key levers in the business? What does our investment thesis hinge upon? How do we work backward with management from that thesis to the few very key levers that the management team needs lots of insight and visibility around? It's usually connecting those that give us a framework that we drive to over time with that management team."

Often a company's data capabilities are all over the board. "Typically, they're not very sophisticated," Noonan said. "Typically, they're disjointed. Over time, they add third-party applications to solve point needs, and those are difficult to integrate and harness data from."

Fixing these problems is an efficient way to add value, Noonan added. "We try to map where all the gaps are, and once the deal closes, we get into a deeper assessment phase and come up with a road map that lists solutions to close the gaps and meet the investment thesis, then a budget and timeline to execute against."

3. Keep in mind that when the deal is done, the finance team is exhausted

Before embarking on any new initiatives, GPs might want to give the finance department a few days off: In the weeks leading up to the close, the CFO and team have been running flat out.

"There's not a lot of sleep going on," Rahmati said. "Then the deal closes and in comes the firm, resources ablaze,

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energy there, capital invested and ready to go. And what about the finance team? They're tired, right? Now think about all the different initiatives we're trying to execute—whether it's a plant reconfiguration, investment in new products, a commercial enhancement, enablement of new strategies—all of those touch the finance team. So one of the arts of our role is to find all the things that stack on top of them and not kill them, because the risk-management element of this is huge. If you can do something over the course of six to nine months, you have a much higher probability of getting it right than racing to get it done in an arbitrarily short time frame."

4. GPs should collaborate with CFOs on the value-creation plan

A successful value-creation plan requires buy-in. The way to get it from the finance team is to give them input. "We share diligence reports with our CFOs," Masse said. "We're very candid. And then we ask them to do an assessment on their business—strengths, weaknesses, what are the areas of need from a technology perspective, team perspective, workflow perspective? We collaborate with our teams. We're not prescriptive."

Management teams, including finance people, work better when they have

at least part ownership of a plan. They also have to understand it. "Think about something as simple as debt," Rahmati said. "A lot of the family-owned companies we buy are low-leverage, cash-rich businesses. Then we apply leverage post-transaction, one or two tiers of debt, sometimes a revolver, different reporting requirements, covenants, a definition of EBITDA that they have absolutely no understanding of necessarily. So we go to them bearing gifts, condensing that 163-page credit agreement into the five to 10 pages that really matter and walking them through it."

New technologies help here as well. For a reasonable cost, a PE firm can now implement web-based tools that link to any number of databases, pull disparate data together, and deliver simple, elegant visualizations to the management team. Better still, having this sort of rigor in place adds dramatically to the value of the company.

5. Planning prevents wrong turns with new technology platforms

It's one thing for a private equity sponsor to come into a portfolio company and install a world-class data system for the financial team. It's another thing for that team to actually adopt that new data platform and get the most out of it. Fortunately, there are steps the sponsor can take to promote success.

"It's a pretty preventable mistake," Rahmati said. "If you built the system or you explained why the system was being put in place and did it in conjunction with your management team, you almost inevitably go through the why as you're putting it in. You don't wake up on day three of the investment and there's a terrific ERP system for them under their Christmas tree. It took a lot of work to get there."

Another important step is to get the functional line leaders involved in the implementation process early. "Make sure they see the changes that are being made and they understand how the system is going to be utilized and operated, whether it's ERP or some sort of a BI solution," Noonan said. "If they understand how it's going to be used and their role in accessing data, by the time you go live it's not a big bang, it's not a two-week training exercise to teach people how to get an invoice out the door."

Every new system is also an opportunity to assess how a company is doing what it's doing to make recommendations, and to import new potential, Masse said. "We get excited when we implement new systems, not only because it's going to enable a new capability for a company but because it's an opportunity to drive performance improvement in the business." ■

Panelists



Shahriyar Rahmati
Managing Director,
Operating Advisory Group,
Comvest Partners



Kevin Masse
Chief Portfolio Officer,
TA Associates



Dave Noonan
Principal, National Leader,
Private Equity Consulting,
RSM US LLP

Insights from RSM

Big Revenue Recognition Changes Are Coming— ARE YOUR PORTFOLIO CO.'S READY?

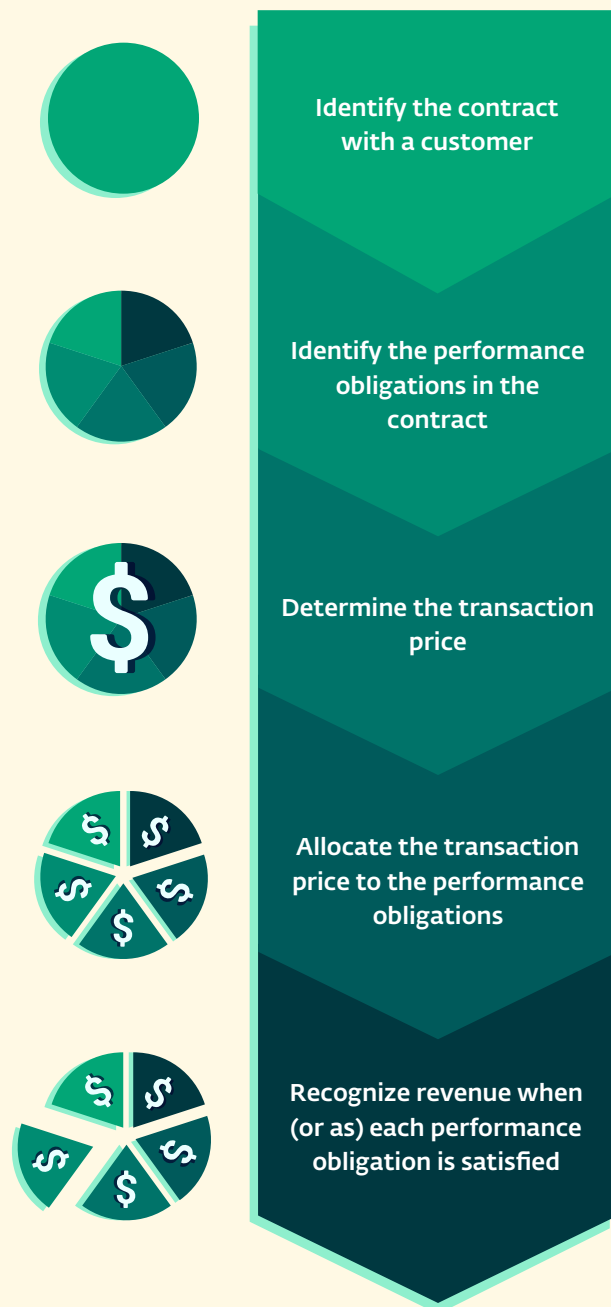
New comprehensive revenue recognition guidance brings monumental change to how many middle-market companies account for revenue and disclose revenue-related information

Over the next two years, implementation of new accounting guidance for revenue recognition could significantly change both the timing and amount of revenue recognized by an entity, and will significantly change the nature and extent of the entity's revenue-related disclosures.

Here's what you need to know

- 1 In May 2014, the Financial Accounting Standards Board issued new guidance on revenue recognition, which replaces almost all pre-existing revenue recognition guidance.
- 2 Public entities with a calendar year end must comply beginning January 1, 2018. Private companies with a calendar year end must comply in the year ending December 31, 2019.
- 3 The degree of change to a specific entity's revenue recognition policies and the effects the changes have on the entity's financial statements will vary depending on the nature and terms of the entity's revenue-generating transactions.
- 4 Some of the major changes affecting the accounting for customer contracts result from the new transfer of the control model, as well as new models to address variable consideration, significant financing components, collectibility, licenses, multiple-element arrangements, and contract costs.
- 5 Significant changes to reporting systems will likely be required and may come at a high cost, particularly for resource-constrained middle-market businesses.

Want the fine details? Check out the RSM Revenue Recognition Resource Center at www.rsmus.com/revrec.



WHAT GPs SHOULD KNOW ABOUT

Carried Interest

AND

Wealth Transfer

—
Changes to tax and other regulations could affect how carried interest is treated; three experts explain the road ahead

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Privcap: How complicated—and widespread—is gifting points of carried interest?

David Stein, Withersworldwide: People have been doing it for quite some time. From a tax planning point of view, there are a number of technical rules that come into play, so it can be a bit complicated. But the structures themselves, at the end of the day, can be relatively simple in terms of implementation. In terms of why people do it, it's really about taking an asset that has high growth potential and the ability to be valued on a current basis at a relatively low number relative to where it might go in the future. And carried interest is a perfect example of that kind of asset.

Is gifted carried interest typically placed in a trust? And is there anything unique about the way this trust is set up that people contemplating this process need to understand?

Thomas Wright, RSM: A very favorite technique of estate planners is the use of a type of trust where we include some language in the document that makes it what we refer to as a grantor trust for income tax purposes. The significance of that is the donor—the senior generation who creates the trust—gets the pleasure, so to speak, of getting to pay the income tax on the income and gains reported by the trust

that, absent the grantor trust provision, would otherwise be a tax-paying trust. Trusts are normally tax-paying animals, so they pay their own income tax.

But this grantor trust feature that we all like to use shifts the income tax burden back to the donor and allows the donor to report all of the income and gains of the trust on their personal tax return—and therefore allows the trust to grow tax free. The assets are growing tax-free because the senior generation, the grantor to the trust, is paying the tax liability.

Stein: The grantor trust status also affords one other benefit, which is that a fund principal looking to transfer assets into a trust—if they have a more significant current value—may be able to do the transfer through a combination of a gift and an installment sale. And the installment sale to that trust from an income tax point of view would not be a recognition event, because the trust is essentially ignored for income tax purposes. So the carry can be moved into the trust even if it's at a level above what the principal can gift tax-free through a sale mechanism.

And then, that current value will be paid back over time on an installment note. But the upside above the current value, plus a small interest factor, would be retained in the trust.

If a fund is wildly successful and the corresponding carry is substantial, would the grantor find him or herself paying all of the taxes on that carry, but receiving none of the benefit of those points of carry?

Stein: We have seen that actually happen in a couple of cases. The way that's typically addressed is there are a couple of different ways that grantor trust status is achieved in the first place. One of the ways is through a specific power that's given to the grantor. And if the grantor relinquishes that power and if none of the other grantor trust attributes are present, then the trust would become a non-grantor trust and start having to pay its own taxes.

Let's talk about an important step that takes place at the outset of the gifting process, and that is assigning a valuation to the points of carry. Lindsay, can you walk us through that process?

Lindsay Hill, RSM: There's a lot involved in the valuation process, and it's pretty complex. We all know that private equity funds, hedge funds, and the related carry are not like a manufacturing entity. We're not just projecting volume and sales prices.

We're dealing with a lot more uncertain inputs, market performance being one



David Stein
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RSM US LLP

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of them. And the best way that we capture that in a valuation setting is through simulation. So in the case of a private equity fund, we would be using Monte Carlo simulation to come up with the exit proceeds for each planned portfolio company or expected portfolio company.

And that's really where our task becomes labor intensive, because we need to have extensive upfront discussions with the private equity principals or with their finance teams to develop the expectation for when the investments will be made.

David, let's say you had a client who is badgering you for a ballpark of what the value of carry in a brand new fund might be. What would you say?

Stein: After all the hedging and caveats and so forth, if I had to put a number or a range on the table, I would usually tell people our experience has been that the valuations will often come out expressed as a percentage of the fund size at some low single-digit percentage. So in a \$1-billion fund, the carry might be valued somewhere between \$10 million and \$40 million or something like that. And then, each individual principal is only going to have a portion of that.

Tommy, in transferring points of carry, is there a recommended maximum valuation amount?

Wright: Every individual has a lifetime transfer exemption that they can use to make gifts during their lifetime. Or they can save it and use it as an estate tax exemption. But the idea with estate planning is to get appreciation out of your estate. So if you can financially

afford it, then the recommended course of action is to use your exemption—or most of your exemption—during your life and make gifts.

Under current law, a single person can gift almost \$5.5 million and not pay any gift tax. And then let that asset grow outside of their estate so that they've shifted that future wealth. You might ask, who pays the gift taxes, the donor or the [recipient]? Most people are under the impression that gift tax is paid by the recipient, and it's not. Gift tax is paid by the donor, the grantor—the PE executive or principal, in this case.

When there is gift tax payable because you transferred an asset in excess of the \$5.5 million, then there is a 40 percent gift tax paid by the donor. The recipient always receives the gift income-tax-free.

In many cases, principals of funds will gift points of carry to nonprofits like charities. And, of course, the charities will want to tap the money if it comes in. How would that work? Are there penalties, and does it change the dynamics of the trust?

Stein: What we see probably most often is that charities will be included as permissive beneficiaries under a trust that's otherwise for the family, so that it's one of the possible vent-offs if the trust ends up growing to a very large size and there's more than enough there.

And there may be a view that develops that it would be better for some of that to be shunted off to charitable causes. So that can be done through the same trust that is used for the family. There are specific charitable planning techniques where the carry might be gifted, to charity or into a so-called split-interest trust like a charitable lead trust.

Wright: In the area of transfers of carried interests, we walk a little tight-rope to avoid a technical tax issue. And

in the industry, we refer to it as the "vertical slice." So in transferring carried interests, we have to scoop up and carry along with it a little bit of everything we own.

Is there any pending regulatory change, legislation, or reforms that you are watching that will impact this process?

Wright: As we all know, the world has changed a little bit as a result of the outcome of the [presidential] election. And I think it's safe to say that the environment that exists today is fairly ripe for comprehensive tax reform. That could be fairly extensive in terms of income tax and possibly estate tax as well. One of the things that the Trump plan outlined prior to the election... included the taxation of carried interest as ordinary income. There've been numerous bills proposed for the last eight, nine years on taxation of carried interest, none of which has ultimately gone anywhere.

Stein: There's one other regulatory development we're keeping an eye on, which is regulations under a code section called 2704 that have been proposed. Those would potentially cut back on valuation discounts based on certain state law restrictions. They're targeted at family enterprises and family-owned entities and wouldn't necessarily affect the typical, more broadly held private equity fund carry structure.

The good news from the private equity side of the world is that so much of the valuation discounts that are achieved on the carry planning happened through the discounted cash flows and Monte Carlo simulations. And there is an overlay for illiquidity and lack of marketability and so forth that are the targets of these regulations. But I think there would still be, in the wake of almost any reasonable regulations, very significant discounts achievable for folks in this. ■

From the CFO's Office:

Catching up with Evelyn Pellicone of Crestview Partners

Evelyn Pellicone is the CFO of Crestview Partners, a value-oriented private equity firm focused on the middle market. The New York firm manages funds with over \$7 billion of aggregate capital commitments and invests in several specialty areas: media, energy, financial services, and industrials. Pellicone has been CFO for 10 years.



Evelyn Pellicone
CFO,
Crestview Partners

Privcap: As CFO, what are your biggest concerns and responsibilities in the current market, and have they changed much in the last several years?

Evelyn Pellicone, Crestview Partners: For us, the middle market is being more broadly defined, and when I joined Crestview, there were only a few private equity players in the space. There are now many more, and larger firms are also working in the middle market, so our range of deals has changed. But as CFO, there's always the need to focus on our portfolio companies and how they are doing and to focus on our limited partners and the need for high-quality reporting and cash management. CFOs are now compliance officers and stewards for their firms.

How have the CFO's responsibilities evolved, and what has personally been the most challenging aspect of these changes?

Pellicone: Over my tenure, the role has changed, in that I spend more time managing a [finance] team. As tax structures and regulations have gotten more complex, there's more time and effort devoted to managing those issues. There are different silos, new kinds of co-investment vehicles, and more complex limited partner agreements. Limited partners have evolved, and particularly over the last five years, there's been a much greater focus on reporting and providing them additional transparency. When I first started working in private equity, you had traditional institutional LPs—pension funds, endowments, and the like. Now there are family offices, fund-of-funds, various vehicles for offshore investors, and the general partnership has to evolve to meet their needs.

Have there been any particular breakthroughs or recent changes that make it easier to do your job?

Pellicone: We spend a lot more time thinking about compliance, and the documentation is more granular than it has been. We've been able to automate some of these functions, and the less we rely on spreadsheets, the more accurate that reporting is. It's been more and more the CFO's job to drive technology on the front end, putting in databases and eliminating spreadsheets. And on the back end, management of information technology and infrastructure now fall more and more to the CFO and COO. You need to make sure you have backups, a disaster recovery plan, and other contingency plans.

How significant a role do data security and cybersecurity issues play in your job responsibilities?

Pellicone: The CFO is now heavily involved with cybersecurity and compliance. The huge increase in, for example, fraudulent email requests for wire transfers, the proliferation of ransomware—it's a constant concern. We are always looking at the systems we have in place, bringing in consultants, and looking for ways to improve. I don't click on a single link [from email], and we are constantly making sure the firm gets security measures like dual-factor authentication and training in keeping data secure. Security issues I now focus on daily were things I might have thought about only briefly 10 years ago. ■

Is “Deal-by-Deal” All It’s Cracked Up to Be?



James Almond
Partner,
Duke Street Private Equity

Deal-by-deal structures are on the rise, but what are the risks?

After struggling to raise a traditional commingled fund, London-based Duke Street Private Equity in 2012 transitioned into a deal-by-deal model and found investors took to the new strategy.

“There are no external distractions, and that means we can fully align interests of the company, our investors, and our firm,” explains James Almond, a partner at the firm. “We are able to fund each deal on a bespoke basis.” According to Preqin, in mid-2014 there were 136 firms actively executing this strategy. Roughly half were in North America, with one-third based in Europe; half of those were UK-based.

Investors find the deal-by-deal, “fundless sponsor” model attractive for a number of reasons. When deals are presented individually, they get direct access to deal flow while being able to pick and choose where to allocate capital. Often those transactions come with lower fees than those charged for traditional funds.

The structure is particularly attractive for new managers. They raised \$83 billion globally last year, 49 percent of which was done on a deal-by-deal basis, according to Palico.

For the manager, the deal-by-deal model can, of course, pose significant challenges. Signing up investors for each

deal can delay closings and, at worst, cause good deals to slip away. GPs must also absorb the upfront cost of sourcing, diligence, and negotiation.

While closing each deal can be more onerous for the managers, the hope is that those costs are less than the time and expense of raising large commitments of long-term capital. The ultimate returns can also be greater, because more flexibility means carry can be earned significantly faster.

Earlier this year, Duke Street, which focuses on mature middle-market businesses in Western Europe, evolved its strategy into a hybrid structure that includes 50 percent in a traditional fund and 50 percent investment coming from a club of co-investors on a deal-by-deal basis.

“We continue to execute our investment strategy,” explains Almond. “That has not changed.”

While Almond doesn’t foresee the deal-by-deal structure overtaking the traditional 10-year fund within private equity, he senses investors will continue to appreciate more flexible models that include shorter-life funds and those offering increased transparency within the asset class and across the broader investment world. ■



Tyler Newton
Partner,
Catalyst Investors



Isaac Schlecht
Senior Research Analyst,
Catalyst Investors

SAAS IS HOT— PROCEED WITH CAUTION



Private equity firms have gone after deals in the software sector at an impressive pace over the last several years, but deal counts appear to have peaked, and target valuations remain challenging, particularly for software-as-a-service (SaaS) companies.

As SaaS deal flow ebbs, year-to-date transaction numbers are much closer to 2012 levels. Catalyst Investors partner Tyler Newton and senior research analyst Isaac Schlecht believe it's time for buyers to acknowledge the volatility and ignore the "growth at any price" mentality of their targets.

It's still possible to make good investments in SaaS companies and profit from long-run trends: stable, above-average revenue growth; increasing levels of profitability; and improving economies of scale.

"Software-as-a-service is an industry that is very private-equity-friendly," says Newton. "It's a recurring revenue business and still has a decent amount of growth in it on an organic basis. Now that many companies have gotten to scale and

new levels of maturity, it has graduated from the pure venture capital market to more of a late-growth stage or mature space that's more appropriate for buyout firms."

For a little context, consider this: Since 2013, private equity software deal counts surged 67 percent by the end of 2016. FactSet reported that three of the five largest software deals of 2016 were take-private transactions by private equity firms, in a year when private equity did 1,009 deals in the sector. Those three deals, for Qlik Technologies, Marketo, and Cvent, had a combined value of \$6.5 billion.

Catalyst has honed in on SaaS investments as well. The growth equity firm is now investing from its \$377-million fourth fund. It invested in 2000, "before SaaS was even a recognized term in the industry," through a company called MessageLabs, which Symantec bought for \$695 million in 2008. About a third of its portfolio companies, past and present, are in the SaaS sector.

Newton and Schlecht say investors like the proprietary technology and recurring revenue characteristics of SaaS companies, but warn that these same attributes can have a downside when it comes to valuation. The consequence? Bubbles, with expectations leapfrogging reality and producing inflated purchase multiples. ■

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