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GP Operations

Private Equity CFO Conversation Series

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Complexity Forces CFOs to Stretch

A conversation with:

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Key Observations

- Private equity CFOs must expand beyond 'traditional' roles
- Tax structuring is increasingly important
- Amid regulatory uncertainty, document everything

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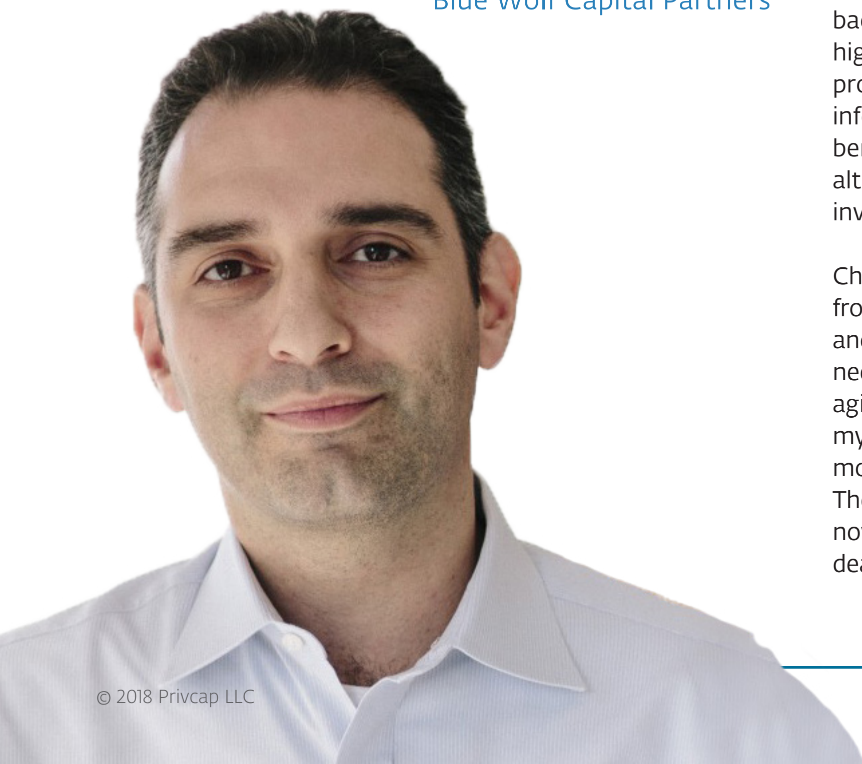
Complexity Forces CFOs to Stretch

When NASA first went looking for astronauts, it was unclear what kind of a profession would give someone the skills needed to fly in space. Today's private equity CFO must often feel like those original astronauts, armed with skills learned in one environment but rapidly accelerating into the unknown.

Whether the alien territory is a new tax regime, a fundraise, or a visit from the SEC, CFOs must move well beyond the "traditional" accounting and audit expertise that serves as the bedrock of many of their professional developments. This mandate for professional expansion came up repeatedly in a recent conversation between Joseph Dashuta and Colin Sanderson, partners at RSM, and Joshua Cherry-Seto, CFO and CCO of Blue Wolf Capital Partners.

Joshua Cherry-Seto
Chief Financial Officer &
Chief Compliance Officer,
Blue Wolf Capital Partners



New York–based Blue Wolf Capital is a middle-market private equity firm that seeks out the kinds of highly complex transactions that many other firms avoid. The firm's embrace of nontraditional investments also extends to the talent they seek out—Cherry-Seto joined the firm with a résumé that looked decidedly different than other private equity CFOs. But like many other CFOs, he is finding himself more and more on the deal front lines, helping his partners navigate an increasingly challenging regulatory and tax landscape.

What follows are three key observations from the conversation:

1. Private equity CFOs must expand beyond 'traditional' roles

The increasing complexity and competition in the private funds market has led to the creation of many more responsibilities—compliance, tax structuring, investor reporting, investor due diligence, even IT security—that often fall into the lap of the CFO. As such, when in 2013 Blue Wolf was looking for a CFO, they wanted a professional who would be comfortable venturing beyond accounting and audit.

"I wasn't the most typical CFO candidate," Cherry-Seto said. "I was not a CFO in a prior role, and I didn't come out of the big four audit firms. But they were looking for somebody who could work more closely with the investment teams, particularly around tax structuring. We don't have an IR department, and so they also wanted a CFO that would feel comfortable in front of investors."

On the issue of investor relations, Dashuta observed that in recent years many private equity firm CFOs have been forced to deal with a tsunami of ad hoc reporting requests from their investors. This has created stress on the typically thinly staffed back offices of middle-market private equity firms, and also highlighted the need for better technology in the reporting process. In many cases, LPs want direct access to portfolio information so they can run an analysis themselves. A number of technology platforms allow for this direct connectivity, although industry participants debate how important it is for investors to access such granular information.

Cherry-Seto highlighted a key challenge that many CFOs confront when taking on more outward-facing roles—their training and professional backgrounds haven't fully prepared them. "You need to think about my role as adding value rather than managing a cost center," he said. "But that requires that I get outside my office and engage with people. CFOs have traditionally been more focused on accounting and are sort of inward-thinking. There could be a personality challenge for some CFOs. There now needs to be a level of coordination between the CFO and deal teams, and that's new for both sides."

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2. Tax structuring is increasingly important

Recent U.S. tax reforms have meant change and uncertainty across the business landscape. In private equity, new rules regarding capital gains and the treatment of pass-through entities are of particular importance.

Colin Sanderson of RSM said of CFOs: “Given the new changes in the tax code, CFOs are revisiting their tax positions, deal structure, and investment strategies to determine the most efficient way to structure future deals.”

Dashuta noted that CFOs are getting involved in the tax implications of deal structures at both purchase and exit. “There are so many different potential exit opportunities that CFOs need to evaluate, given significant tax consequences,” he said. “Having a CFO who is aware of those nuances and who understands how an exit route could potentially impact the return is becoming more and more important.”

A major change to the tax code involves carried interest—the gravitational center of the private capital business. New rules stipulate that an investment must be held for three years to qualify for the lower capital gains treatment. While most private equity investors would argue that three years is less than an average hold period for a portfolio company—and conforms to the vision of private equity as long-term capital—Cherry-Seto noted the new rules add to the complexity of “buy-and-build” plays.

Sometimes called a “roll-up,” this strategy of adding synergistic companies to the original corporate platform through M&A is among private equity’s most frequent routes to value creation. The challenge, for example, is when a portfolio company that has been held for six years might complete an add-on acquisition one year before exit, complicating the returns projection. “I don’t think we appreciate the three-year capital gain treatment and the impact that will have on structuring and exiting portfolio companies,” Cherry-Seto said. “Many of us do add-ons that are within that three-year time horizon.”

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>
> —Joshua Cherry-Seto, Blue Wolf Capital Partners

3. Amid regulatory uncertainty, document everything

A longstanding complaint in the medical profession is paperwork, which keeps doctors at their computers instead of with patients. GPs feel the same way (they’d rather spend their time with their deals), but most of the work of documentation falls to the CFO’s office.

Our three experts identified a dangerous trend—many new rules governing the management of a private funds firm are unclear, but can involve serious penalties. In particular, an SEC examination gone wrong can pose a monetary and reputational threat to a private capital firm.

According to Sanderson, a key to protecting the firm from this threat is the ability to provide context. What was the firm thinking at the time it made the decision? Was it clear that it was assiduously following its written policies and attempting to stick to the rules as it understood them?

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"From a compliance perspective, it is easy for regulators to look at decisions that were made and in hindsight say, 'Oh, this is what you should have done,'" said Sanderson. "Therefore, it is really important for CFOs to provide that context and to document what the considerations and rationale for a specific decision were...whether it was allocating insurance expenses amongst multiple funds and the manager, or allocating an investment opportunity in accordance with the manager's policy."

Dashuta agreed: "Documentation has always been important. You need to show policies and procedures were in place as part of your compliance structure. You need a compliance manual and to adhere to the manual. What are you disclosing to your investors within your reports? Is this within your compliance manual and within your documentation? Does the way you've allocated a deal match what you are disclosing? And if there's a disconnect there, it's important to identify it and why it happened."

Especially with regard to the IRS, anyone who thinks that the enforcement agency will be able to clear up the many uncertain tax policies will likely be sorely disappointed. "People are looking too much to the IRS for clarity on many open questions," warned Cherry-Seto. "In the case of the IRS, they won't be able to tell you, 'We know that reference in the law was a typo, so just ignore it.' A legislative cleanup is required, as regulatory bodies can't give clarity on half-baked rules."

Cherry-Seto saw more of an effort from the SEC for engagement with private funds, although a "gap" in regulatory clarity will "continue to loom large for years to come."

He continued: "Though the dysfunction in government has made the prospect of modernizing legislation for the SEC unlikely, there is increased interest under Chairman Clayton for our industry to engage constructively with the agency. Through the ACG Private Equity Regulatory Taskforce [PERT], private equity managers have been able to work together with the SEC towards more practical application of the existing statutes for the protection of investors, limiting unnecessary time and expense where there is no investor benefit."

Private capital's high-class problem is that the industry has grown tremendously, and naturally drawn greater scrutiny from regulators. As the growth continues, the trend will be toward greater business complexity, and the importance of a talented, dexterous and meticulous CFO will only grow. ■

About the experts

Joshua Cherry-Seto is responsible for fund and management company reporting to limited partners, as well as to the SEC and other regulatory agencies; the coordination of finance operations and the reporting of Blue Wolf's portfolio companies through their CFOs; and the investment and tax structuring of potential platform, add-on, and co-investment opportunities.

Joseph Dashuta is a partner with the financial services group in RSM's New York practice, with over 10 years of experience. Joe has advised clients such as business development companies, venture capital funds, hedge funds, private equity funds, fund of funds, registered investment companies, and small business investment companies.

Colin Sanderson is an audit partner with RSM in the financial services practice focusing on private equity fund audits. Colin also serves as the national director for private equity fund services, coordinating RSM's fund service offerings to private equity funds and serving as concurring reviewer for many of the firm's key private equity clients.