

## Calling in the administrators

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The past year has given the lie to the idea of fund administration being just a cosy back-room business that deal-makers barely need to keep in their peripheral vision. The new challenges crowding in on private equity, such as tougher regulation, globalisation and more demanding LPs, are bringing fund admin's role in private equity into a new light.

A straw poll of general partners suggests that around two-thirds of them still do not use external fund administration providers, preferring to handle matters in-house. However, according to George Sullivan, head of the alternative investment solutions group at State Street, the proportion of firms choosing the outsourced route has doubled from 15 per cent to 30 per cent during the past three years. It could, says the optimistic Sullivan, double again in the next three, reflecting the growing demand for outsourced services.

David Bailey, managing partner at Augentius Fund Administration, says his firm's business has grown 25 per cent during the past year. Other industry players report that businesses have been growing at a healthy rate despite – or perhaps because of – the troubles in the wider private equity market during the last 12 to 18 months.

Of course, third-party fund administrators have every reason to talk up their industry. Yet the business case for outsourcing is becoming ever more compelling in the light of the challenging issues which GPs face.

"The general level of sound and fury from regulators and multinational bodies, as exemplified by the Alternative Investment Fund Managers directive, should be very helpful to administrators," notes David Williams, a partner at law firm DLA Piper. "That is both in terms of specific regulatory roles for administrators and, more importantly, changing the LP landscape such that a third-party administered fund looks more attractive from a risk perspective."

The credit crunch and recession has accelerated a trend that was already apparent – for LPs to demand more information from GPs, and more often. They want more details on leverage and performance issues, both about the fund as a whole and, significantly, about individual portfolio companies.

### Third party, first choice

So it is no surprise that more private equity houses are turning to third-party administration. "Fund administrators can do primarily two things," says Bela Schwartz, chief financial officer of the Riverside Company, a private equity firm focusing on the lower end of the middle market. "They can reduce the overall GP costs because their services can be charged to the fund, while employees hired to do such work are not usually chargeable to the fund. They can also take a burden off more senior members of the administrative team by having a third-party deal with much of the grunt work necessary to manage a private equity fund."

Such benefits are not to be ignored in a climate where fund admin is becoming more complex. But some fund administrators believe that one of the greatest future arguments in favour of outsourcing will be the reassurance it provides to LPs that the regulatory and compliance aspects of fund management are being correctly handled.

Fund administrators which burnish their credentials in this area could perform well. For example, earlier this year Aztec Group, an independent fund administrator with offices in the Channel Islands, Luxembourg and the UK, achieved AAF 01/06 accreditation. James Duffield, head of business development at Aztec, believes his firm is the first fund administrator to obtain such recognition.

According to Karl Halron, director of PricewaterhouseCoopers in Jersey, which conducted the independent review of procedures and processes at Aztec, an AAF 01/06 report "provides an independent assessment of the service controls in operation with a service provider, and goes some way to providing investors and regulators with the assurance they seek". He adds: "Such reports are a differentiator for providers and, in time, as the investment and regulatory landscape continues to evolve, could become an essential requirement for doing business."

Duffield points out that AAF 01/06 digs behind each process to make sure it has the depth to work effectively. He explains: "For example, it's not enough to say you have a head of risk. You have to show how the way he works effectively mitigates risk – for instance, by ensuring there is 'four-eyes' oversight before releasing documents."

It seems possible that other fund administrators might choose to seek AAF 01/06 accreditation, but Duffield warns that it's much more than a box-ticking exercise: "For us, it was a root-and-branch review of all our operations and procedures – looking at how those procedures work in practice."

### The divisive directive

The growth in compliance and regulation is likely to stimulate the need for more fund administrators to demonstrate that their processes and procedures are in good order. And, of all new regulations, the elephant in the room is the EU's AIFM directive.

"We are very concerned about the AIFM directive from an anti-competitive perspective," says Schwartz. "The potential portfolio company disclosure and transparency requirements could hurt competitiveness by requiring disclosure of the financial health of portfolio companies to the public."

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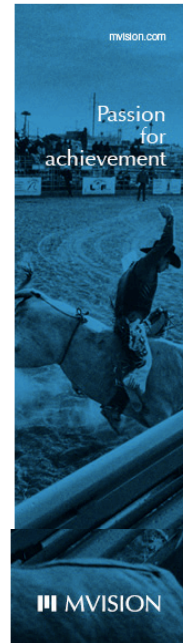
David Sherratt, founder of Ashridge Capital

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**44%**  
of private equity firms plan to increase the size of their teams in 2010.

Source: BDO

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The problem for administrators is that they tend to be located where the funds are established. If it becomes impossible (or even more difficult) to market funds established outside the EU, then administrators currently based in places such as the Channel Islands and the Caymans may find business looking less rosy.

No wonder that experienced administrators such as Bailey talk about "remodelling the business" to give more importance to EU jurisdictions, such as Luxembourg. "We're already administering three Luxembourg funds," he says. "We're ahead of the curve."

But Bailey adds that he believes the Channel Islands should maintain an important place in private equity fund administration, largely because it is expected to gain the AIFM's "passport" for those non-EU countries which can establish "equivalence" to EU regulations in the four key areas of exchange of regulatory information, reciprocal marketing rights, anti-money laundering measures and tax agreements.

Rob Short, partner and co-founder at fund administrators Langham Hall, agrees that the Channel Islands should meet the passport criteria. "I think they'll sail through," he says, adding that "some of the other offshore jurisdictions may find it harder to leap the hurdle. You don't find the top people in the peripheral jurisdictions."

But others are less sanguine about the impact of AIFM. "The lack of clarity on equivalency is unhelpful and offshore jurisdictions, as well as those within Europe and, ultimately, the industry, would benefit greatly from practical clarity," says Paul Everett, managing director of Fund Corporation, a Guernsey-based administration firm. "The AIFM directive is also potentially divisive and isolationist for Europe and, at a minimum, is producing short-term uncertainty."

#### **Ongoing concerns**

Although AIFM is the major new regulatory concern, there are also other issues which are wrinkling a few brows and posing fresh problems for administrators, such as the UK's Carbon Reduction Commitment, under which "groups" of companies are required to purchase annual allowances for each tonne of CO2 emitted.

Some private equity houses are looking at the possibility of restructuring their portfolios so that they don't qualify as a "group". But this is creating a fresh raft of problems for administrators who then need to reaggregate fund information from portfolio companies organised in a new, and probably more complex structure. "Systems will need to reconfigure consolidations," notes Short. "It's an ongoing issue with no firm resolution so far."

Another issue which could well have a fund administration dimension in the future is the set of Private Equity Principles that were adopted by the Institutional Limited Partners Association (ILPA) last October. Although they are intended to guide future investments and strengthen the long-term viability of private equity as an asset class, not everyone is convinced that a one-size-fits-all set of principles is relevant to all private equity players.

Some of it will work for private equity and some not, believes Justin Partington, commercial director at International Private Equity Services (IPES). In essence, the principles mark a further shift in the balance of power from GPs to LPs, and could lead to more complex admin requirements in areas such as reporting and share of carry.

"Private equity remains an intensely relationship-driven business where the GP and the LPs must develop trust, and the GP must perform to the LPs' satisfaction," adds Schwartz. "Now, LPs are requiring GPs to agree to measures that, in some cases, are beyond the capabilities of the GPs to actually manage, and put pressure on GPs to give the LPs much more 'authority' in running the GPs' business."

The problem is that all these extra issues have happened at a time when many LPs, mindful of the recession, were becoming jittery about their investments. In this climate, they have been demanding more information and putting pressure on their GPs to provide it.

"Though LPs have no option other than to sell their interest if they are not happy, this increased burden on the GP is becoming quite excessive with requests for various portfolio company financial information, including debt levels and covenant compliance," explains Schwartz.

Yet this demand for increasing information from LPs ought to be music to fund administrators' ears. It means that more private equity houses are likely to outsource the task to an organisation that specialises in it.

The problem for private equity players which have not yet done so is that they need to choose an administrator to meet their specific needs. And they must do this at a time when the shape of the youthful fund administration business is itself changing, with banks moving in and the smaller independent players under pressure as the business goes genuinely global.

Last year's State Street takeover of Mourant could be a harbinger of more bank acquisitions to come. Quietly, many fund administrators are predicting more consolidation in the industry. According to State Street's Sullivan, the acquisition of Mourant will enable the bank to establish a "large global footprint" in the fund administration business.

#### **Size matters**

Increasingly, some believe, the choice for those private equity players that want to outsource admin could be between a large administrator offering a standard service and one of the independents, which provide a more tailored approach – but at a price. Sullivan says that he wants to maintain the boutique feel of the admin service that Mourant provides. But some of the independents are complaining that a few of the bank-owned admin outfits are forcing down fees because they can afford to treat fund admin as a "loss leader".

Short says: "Some of the banks are coming here almost at cost. But we're still winning business charging higher amounts." The question is, for how much longer?

Short contends that there will always be a place for the smaller independent, because in a relationship-driven business there will be private equity players that want a tailored service rather than something off the shelf. His

argument might stand up in Europe and North America, but it could be a weaker play in Asia, which is said to be culturally less aligned with the tailored relationship approach.

Even so, with all the extra problems crowding in on the private equity agenda, administrators are predicting that there will be plenty of work to go round for quite some time. Indeed, some argue one of the biggest problems will be recruiting top-quality staff. GPs will want to outsource the ever-more complex admin work so they can focus all their efforts on deal-making in what is still a challenging economic environment.

Administrators firmly believe that they can offer assistance in this area as well. "We have been involved in cross-referrals of investment opportunities, and it appears GPs are looking for a much more co-operative relationship with administrators," says Everitt. "We think that as new funds get launched, there will be an increased focus on how best to retain and expand the investor base."

#### **Syntaxis arrangement**

When Ben Edwards and his colleagues set up Vienna-based Syntaxis Capital in 2006, they decided to outsource fund administration from the start.

Edwards, managing partner at Syntaxis, had seen the internal burden that fund admin can place on a small and growing organisation while working for previous employers

"Because we weren't a huge company, we thought outsourced fund administration would be more professional," he recalls.

"For a fund administrator, fund admin is 100 per cent of what they do. We benefit from that because they put together the kind of reports that investors want."

Syntaxis provides junior capital, usually in the form of non-amortising loans, but Edwards says that the firm shares many of the characteristics of a traditional private equity player. "We have some equity involvement, so there's an upside depending on how our investee companies perform," he explains. As a result, the kind of admin issues the firm deals with are similar to those faced by any private equity player.

Although it was easy for Edwards and his colleagues to take a decision to outsource fund administration, choosing which firm to handle it was a more difficult call. "We wanted to hire an administrator that was responsive to our needs.

We took up customers' references and got a feel by talking to other private equity firms," says Edwards.

There were three big issues in the selection decision, Edwards says. The first was that the administrator needed to be able to tailor reports in the way Syntaxis wanted them. "They needed to be very flexible when tailoring reports," he says. That meant the administrator needed to provide information in an electronic format, which Syntaxis could then pour into its own spreadsheets and work with.

The second issue was that the firm ideally wanted an administrator that could handle funds in several jurisdictions. Although its first fund was raised in Guernsey, it already had in mind that it might be operating funds from other areas in the future – so it needed an administrator that would be moving in the same kind of direction.

Finally, the costs had to be competitive. Eventually, Syntaxis chose Guernsey-based IPES. "Their long-term plans fitted broadly with what we wanted to do," notes Edwards.

Edwards believes that having a third-party administrator reassures LPs. "LPs like having a second set of eyes to look over the figures," he says. "And a third-party administrator provides a degree of specialisation, which basically means that we're getting the best of all worlds."

It is especially useful when Syntaxis signs up new investors. "The kind of due diligence and 'know-your-customer' that administrators do by law is crucial," he says. "I think investors in funds approve of that high degree of diligence."

With more regulation of private equity almost certain, Edwards is pleased that Syntaxis took the decision to outsource. "The new regulation that is coming down the road – and it's inevitable – means that it's great to work with someone that is very focused – and not just reacting to things, but a little more proactive."

Having an administrator to handle the day-to-day grind means that Edwards and his colleagues have more time to focus on providing LPs with reports tailored to their special needs. Edwards explains: "For example, if an LP wanted to know the weighted average leverage level in our portfolio companies, we get information from IPES and then, because we know the underlying leverages, tailor the information to what the LP wants."

Syntaxis held a first close on its second fund last December. The fund will be split between Guernsey and Luxembourg. "Having one entity that can administer the whole process for us is crucial," says Edwards.