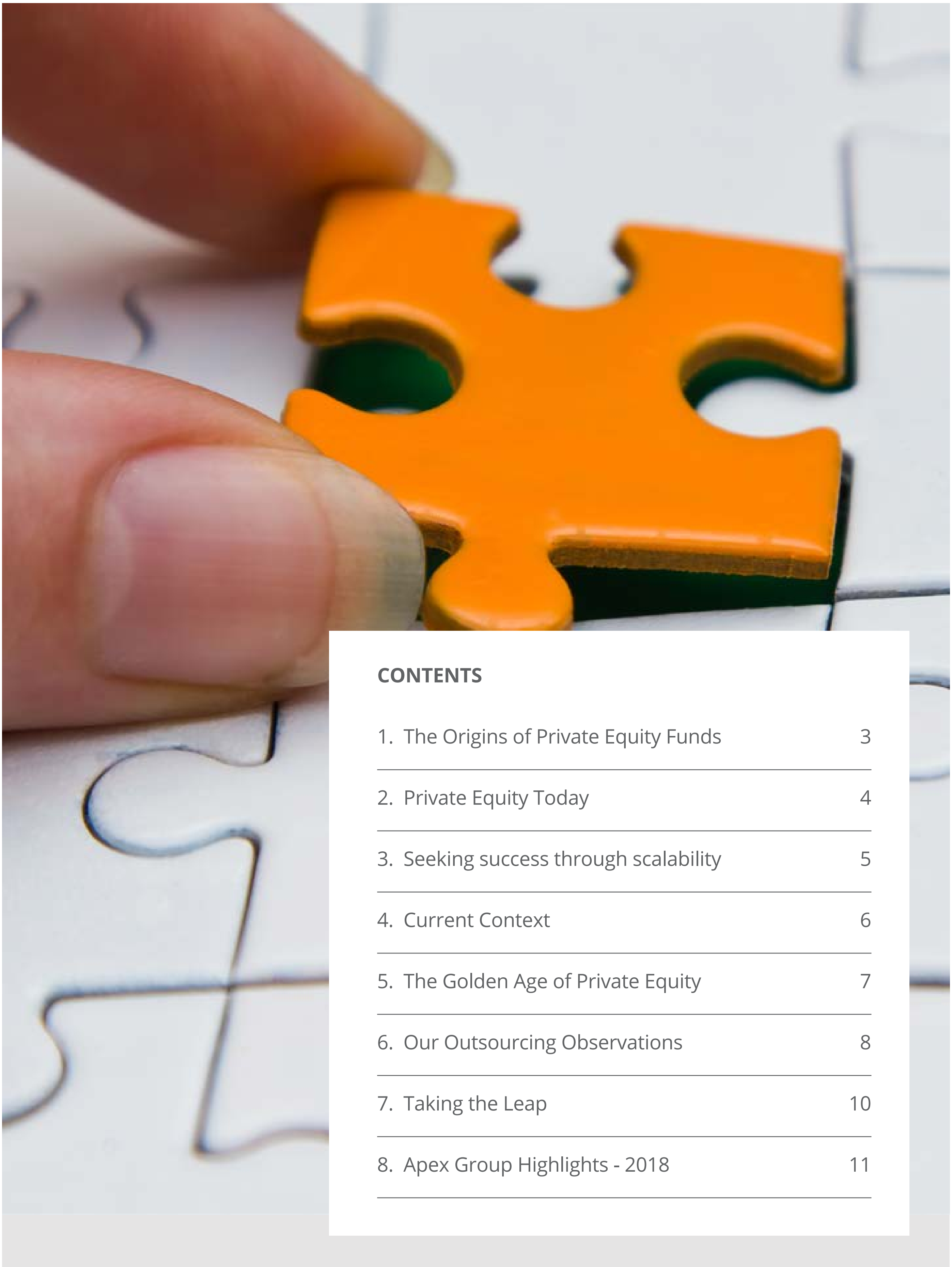
ACHIEVING OPERATIONAL EXCELLENCE –

PRIVATE EQUITY 2019 OUTLOOK

APEX



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1. THE ORIGINS OF PRIVATE EQUITY FUNDS

The origins of what is now commonly known as a private equity fund are somewhat debatable. Some say the private equity fund was created in 1901 when J.P. Morgan bought the privately owned Carnegie Steel Company for $480 million. Following the sale of the company, Andrew Carnegie's partner, Henry Phipps, went on to found the Bessemer Trust in 1907 to use as a vehicle for investing his proceeds from Carnegie Steel in private businesses and other exclusive holdings. Others say the first private equity firms were founded around 1946 with the emergence of companies like the American Research and Development Corporation (ARDC) and J.H. Whitney & Co.

Ultimately, whatever the beginnings of private equity, the investment methods used by these firms were not created by one single clearly identifiable moment. Societies and settlements across the ages and across the world have long utilised whatever means they have available to generate further profits and this is evidenced throughout history.

The real start of growth for the private equity fund started with Leveraged buyouts (LBO's) in the 70s and 80s. LBO's have throughout history produced impressive returns, and sometimes spectacular losses. As a result, these transactions have also been highly publicised, even further so following the occasional scandal. The real establishment of the LBO came when investment bankers started to use them as a method of leveraging a company with debt equity and equity capital in order to buy it. Now a developed market place, and a well known investment asset class, private equity funds have become the LBO's of today – a universe that is estimated to have reached around 7,000 firms worldwide: a number which is only expected to continue to increase into 2019 and beyond.

2. PRIVATE EQUITY TODAY

The outlook for private equity today is strong. EY's 2018 Private Equity Survey noted that with record fund raising in 2017 ($620+ billion), commitments were up 5% year on year, exceeding the previous peak in 2007/08 prior to the financial crisis.

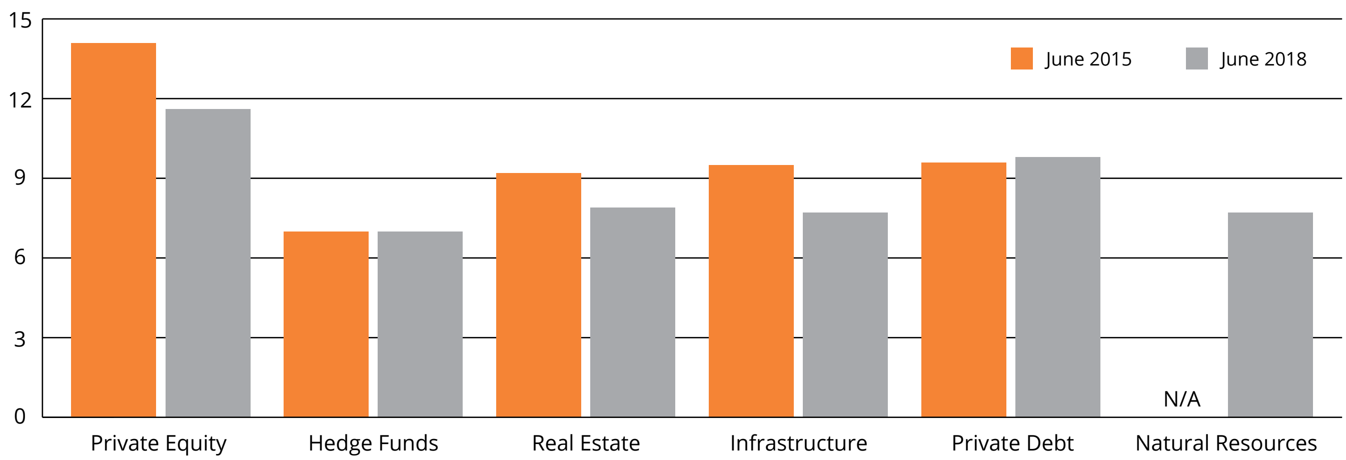
Yet with great success and growth, comes further scrutiny and competition. Private equity now sits within a complex political and regulatory landscape. An intensified gaze from investor's and increased pressures across the board on fees is changing the face of private equity operations and driving Managers to look for more efficient methods for operating their funds and portfolios. Perhaps not surprisingly, the two core elements for focus that have moved up the agenda for COOs and CFOs are Technology and Outsourcing.

In a highly competitive market, operational efficiency and excellence has become tantamount to the success of the firm. There is now a real opportunity for private equity managers to create additional value through their operations decisions and frameworks, whether internal or outsourced. The European market has bought into the idea of achieving operational value and best practices through utilising third party providers, with PwC estimating that some 70% of European private equity firms are now outsourcing, something that has seen much slower uptake in the US with only 30-40% of those funds doing the same. There is certainly an eye toward seeking valuable operational partners to offload some of the operational burden in the private equity market globally, as firms increasingly look to implement scalable solutions in the most efficient and cost effective way possible.

3. SEEKING SUCCESS THROUGH SCALABILITY

Technology is a key driver across all markets and industries. With the emergence of Fintech and transformational technologies such as Blockchain and AI, technology as a tool to develop the operations of an asset manager is important - and private equity operations are no exception. Although the private equity space lags somewhat behind its peers in terms of technology advances in the areas of reporting and administration, there is certainly now a clearer focus on scaling up in this department. The increasing interest from investors, plus the demands for more visibility and clarity on the operations of a fund, forces this to the top of the agenda. The once standard "2 and 20" fee structure has come under scrutiny and managers need to seek greater efficiencies and savings across the full spectrum of the fund, especially in light of the trend on returns decreasing for investors (see Table 1). Private equity as an asset class is arguably under some of the most pressure to perform and generate returns for its investors, therefore ultimately what we are seeing more and more of is firms looking to leverage technologies outside of their internal scope to become more operationally and cost efficient. For small to mid sized private equity houses, the answer is to outsource. In order to avoid a large capital outlay while accessing the best-in-class technologies, the more viable route is often through outsourcing to a specialist service provider.

Table 1: Average annual returns sought by investors for each asset class, 2015 vs. 2018



Source, Preqin Investor Update: Alternative Assets H2 2018

Concerns around losing control or agility within the portfolio has historically stood up as one of the major barriers stopping private equity funds from outsourcing some or all of their operational requirements. Many managers have questioned why, if they remain ultimately responsible for the governance and performance of their funds, they would entrust certain aspects of this to third party service providers. Yet many managers that have now moved to an outsource model are reporting that their communication with LPs can be hugely improved through this shift in focus. Naturally, service providers must have agility and flexibility in their service framework as each private equity firm has a slightly different requirement. Yet through partnering with the right provider, a tailored service can and has delivered genuine benefits and greater efficiencies implemented. The value of independent oversight is now beginning to be more widely recognised as outsourcing grows in popularity.

4. CURRENT CONTEXT

While there is some speculation that the Trump era will see further rolling back of transparency in the US private equity market, following the suggestion of a Dodd-Frank reform and the review of the fiduciary rule, generally investor scrutiny and regulation is increasing globally. The Trump administration has so far not executed on its legislative agenda and the cross-jurisdictional nature of the asset management space means that regardless of what ultimately happens in the US, regulation accross other regions can not be ignored.

Investors are acutely aware of changes within the markets and as such are naturally concerned about how their funds will be used, they are therefore demanding increasing transparency with managers across all asset classes. Private equity managers are now increasingly focused on the strategic activities of the fund and this is starting to demonstrate that they are less inclined to keep the hold on in-house resource for some of the more routine activities such as fund accounting, if it is more efficient to outsource these functions.

Although there is some latent resistance remaining from larger PE firms who still often prefer to inject capital internally and keep operational functions in-house, there has been a notable general trend toward the outsource model in many areas. A 'Summer Survey' released by Coller Capital shows that three out of four of the world's investors believe that their private equity programmes could be significantly improved through the better use of "external data sources". Effective outsourcing of administration functions can be developed for the manager of a small team just as effectively as they can for a manager employing hundreds of staff. Interestingly, although the larger firms tend to focus more on investing in technology than outsourcing, the increasing demand from investors asking for more customised portfolio analysis might mean that even the bigger managers start to look outside their own internal functions to fulfil these needs. A popular topic emerging across all asset classes currently is the trend toward ESG (Environment, Social, Governance) investing, which presents a requirement for ESG reporting across the portfolio. Perhaps it would be these more customised reporting developments that begin to encourage larger managers to consider outsourcing to avoid having to spend too much time customising reports and adding new functionalities.

5. THE GOLDEN AGE OF PRIVATE EQUITY

Private equity has reached a new high. Table 2 shows just how well the industry has performed in 2017 alone. Never have there been so many private equity firms, new launches or dry capital. The average private equity fund size now reaches $1.3 billion and funds continue to outperform other asset classes consistently. The more competition creeping in to the market, the more diversification is warranted. Private equity managers are adding to their portfolios launching distressed debt funds, credit funds and infrastructure products. With this diversification has come a requirement to outsource more elements of the business operations.

Table 2

PRIVATE EQUITY: 2017 IN NUMBERS

$453

Aggregate capital raised by 921 private equity funds closed in 2017.

$2.83tn

Private equity assets under management as at June 2017, an all-time high.

95%

of investors felt their private equity investments met or exceeded their expectations in 2017.

53%

of investors plan to increase their allocation to private equity over the longer term, a record proportion.

$233bn

Total capital distributed in H1 2017, following the record $520bn distributed in 2016.

$182bn

Aggregate value of 11,145 venture capital deals completed in 2017, an all-time high.

4,191

Number of private equity-backed buyout deals completed in 2017, for an aggregate $347bn.

88%

of investors consider valuations to be the greatest challenge facing the private equity industry in the year ahead.

**Source: 2018 Preqin Global Private Equity and Venture Capital Report.*

6. OUR OUTSOURCING OBSERVATIONS

Apex's experience and observations with fund managers mirrors that of the general market trends aforementioned. Managers with more liquid, higher volume trading strategies have been readily outsourcing their administrative functions for a lot longer than managers trading less liquid strategies, such as private equity. We also find that there has traditionally been a disparity between the percentages of US vs European private equity and real estate managers that outsource, predominantly due to the legacy of regulation in Europe, something that is also changing. As a global business, we note that the increasing number of multijurisdictional new launches is also reducing that gap and we anticipate this will continue to decrease over time.

In our experience, the four main drivers for outsourcing fund administration:

1) Resource: Focus, Control and Experience

By outsourcing to a specialist Managers can focus on performance and strategy, benefit from control and third party oversight and experienced industry experts.

a) **Focus –** Managers can focus on their firm's core value-added strategies, communications with Investors and is not distracted by functional day to day operational requirements.

b) **Control –** The Administrator adds an extra layer of oversight. As a third party they can ensure that the appropriate valuation and reporting practices are applied. More and more we are seeing investors mandating the requirement for an external fund administrator for additional layers and security.

c) **Experience –** Hiring the right kind of resource can be costly and time consuming; it can also be difficult in terms of staff turnover due to employees often seeing a limited career path within a smaller team. Outsourcing to a specialist immediately benefits the manager with a large support team, particularly if that partner is a global provider. Managers can leverage the scale and experience of a third party provider to gain confidence from investors and benefit from a well trodden path and an easily scalable model. At Apex we have seconded some of our own employees to client offices in order to provide a soft introduction to the benefits of outsourcing and to provide face-to-face support to their internal team.

2) Regulation: Increasing Complexities

Outsource partners have the time to spend working directly with Regulators and understanding the regulatory environment across multiple jurisdictions and asset classes. With increasing diversification and regulation, this is an invaluable insight benefit to the manager.

a) **Proactive Awareness** - often service providers are more acutely aware of regulatory requirements and dedicate investment and resource to keeping at the forefront of any changes in order to remain competitive. This saves the Manager time, resource and investment but means they are aware of changes in advance and can adapt to face regulatory and compliance changes with the support of their outsource provider.

b) **Size and Connectivity** - A global fund administrator will have a strong experienced regulatory team. This ensures they have a global view of regulation as well as local understanding and local relationships with regulators. They are in turn able to service funds across all regions providing valuable insight in to changes impacting their clients in advance.

3) Technology: Scalability

a) **Ongoing Development** - Investment in technology is an on-going commitment and can often require a substantial capital outlay in order to be scalable. Data protection, cyber-security and similar factors impacting funds on a daily basis can be managed much more effectively by an outsourced provider. In addition, outsource providers often help to influence the direction of software enhancements and focus the software firm more closely on their client's specific needs.

b) **Cost Efficient** - The high costs of "best in class" private equity fund accounting software platforms are more easily absorbed by an administrator. With hundreds of clients and thousands of funds, the administrator has a cost advantage simply through the nature of its scale. Administrators are able to get more for less, which ultimately benefits their clients.

4) Investor Scrutiny: Additional Support

a) **Security and Confidence** – Increase in transaction volumes brings greater complexity and a multi-layered environment which can leave investors feeling uneasy. The comfort that the additional oversight a third party administrator adds can help investors feel more confident and secure around the subjects of transparency and security when it comes to their investments. The fund administrator can focus on the necessary controls and in turn streamline processes as a result of its extensive experience with thousands of funds and clients globally.

b) **Reporting Transparency** – Fund Administrators can put dedicated teams in place to specialise in the analytics around asset management reporting. These teams can create custom reports for clients in addition to sharing knowledge on similar reporting requirements put in place for other similar clients. Customisation of reporting and communications may be more easily accommodated with a focused administrator.

7. TAKING THE LEAP

In making the decision to select an administrator as an outsource provider, Managers need to consider the effectiveness and how best to set up this arrangement. The administrator should be able to provide the support and expertise the Manager requires and the reputation and scope of services that give confidence to investors/LP's.

The administrator should become a valued business partner and an extension of their Manager's team, strengthening the investment proposition of the Manager, enhancing oversight and transparency and creating the right environment for operational excellence.

Evaluating your Administrator:

- **Turnover** - Assess the level of turnover at the administrator; high turnover could impact your investment objectives.
- **Client Service Levels** - Investigate the administrator's performance in 'client voted for' surveys ie. Global Custodian's Private Equity Fund Administration Survey.
- **Experience and Expertise** - Consider the administrator's level of expertise in your particular asset class. What is the firm's AuA for private equity specifically?
- **Capabilities** - What level of global connectivity does the firm have? In an increasingly globalised asset management space, it is important to consider the knowledge of the administrator across all jurisdictions.
- **People** - Speak to the team – an administrator that is focused on client service above all else will provider better service and work with you to scale alongside your business.

8. APEX GROUP HIGHLIGHTS 2018

STAFF

2,000+

FUNDS

4,500

CLIENTS

1,500

JURISDICTIONS

26

GLOBAL LOCATIONS

40+

LANGUAGES

20

15 YEARS IN BUSINESS

5TH LARGEST FUND ADMINISTRATOR **GLOBALLY**

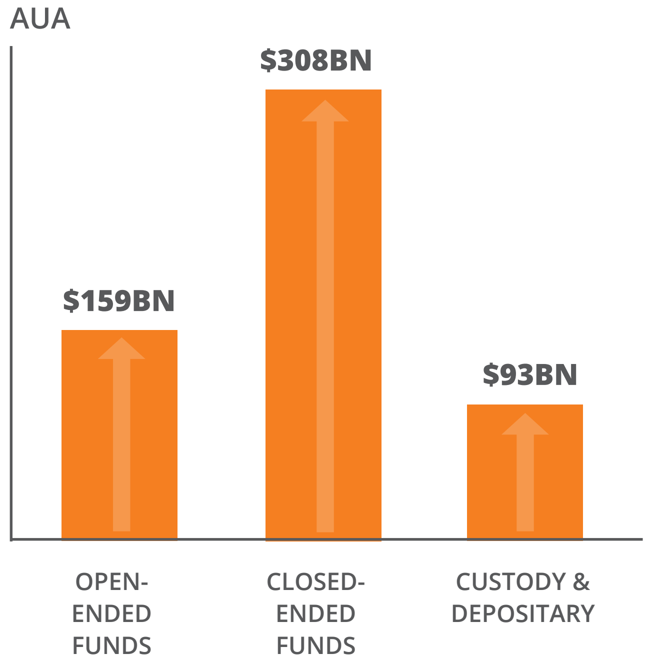
6 AVERAGING **MAJOR INDUSTRY AWARDS** PER YEAR

ASSET CLASSES

- PRIVATE EQUITY
- REAL ESTATE
- HEDGE FUNDS
- HYBRID FUNDS
- MANAGED ACCOUNTS
- FAMILY OFFICE
- FUND OF FUND

SERVICE CAPABILITIES

- FUND ADMINISTRATION
- MIDDLE OFFICE
- BANKING & DEPOSITARY
- CORPORATE SERVICES



TOTAL AUA

$560BN

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