Ready For The Change?
Private Capital Operations in the Digital Age

AssetMetrix Study

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AssetMetrix

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Introduction

It is difficult to name a sector that has not been affected by digitalization in recent years. Substantial parts of the retail sector have made the move to the internet, the music industry has had to reinvent its sales model, and banks and insurance companies are having to compete increasingly with successful “FinTechs” and “InsurTechs”. By contrast, the private capital industry[1] has been slow to embrace change. Somewhat ironically, the very capital providers whose investments in Tech-Startups or Manufacturing “Industry 4.0” companies are driving change in other sectors have hardly undertaken any steps to develop their own business models. Now, it’s the turn for private capital investors to step up to the challenge.

1 Challenges for private capital investors

Private capital investors benefitted for many decades from stable structures and high returns, but are now coming increasingly under pressure. Three factors are playing an important role in these developments:

Falling returns

The global surplus of available capital, combined with low returns, is resulting in a “battle” for the limited number of profitable investment opportunities. Private capital funds currently have around EUR 1,400 billion of “dry powder”[2], approximately 30% more than just before the financial crisis of 2008. Funds available for investment have therefore reached a new record high. At the same time, the number of deals is stagnating. In this situation, investors have therefore significantly scaled back the rates of return they expect to earn in the coming years[3]. The nearer private capital investment classes are to maturity, the farther away are the exorbitant “super” returns seen in the past. While the business of LPs is principally suffering from lower yields, that of GPs is beginning the feel the pinch of a trend towards lower fees. Since the financial crisis, large-scale LPs in particular have been able to influence market terms – albeit only moderately – to their own benefit.

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[1] The private capital industry for us comprises institutional investors (i.e. “Limited Partners” or LPs) as well as fund and fund-of-fund managers (i.e. “General Partners” or GPs) within the following investment classes: private equity, real estate, infrastructure and private debt.
[2] Source: AssetMetrix analysis, based on PREQIN data
[3] Source: PREQIN Investor Outlook - Alternative Assets (HY2 / 2016)

Greater transparency

The private capital market is becoming increasingly transparent. Only just a few years ago, the key to creating a profitable portfolio was having the right experience, an established network and access to relevant investment opportunities. Nowadays, investors are able to benefit from significantly greater market transparency. This trend is being driven by increasingly comprehensive commercial database offerings. Previously, these offerings were based mainly on information that had been collated indirectly, in particular on the back of Freedom-of-Information Acts, which require US pension funds to report publicly and comprehensively on fund investments. These days, many GPs pro-actively provide performance figures, coming-to-market updates or portfolio details for databases. Greater transparency and efficiency in the market gives a competitive advantage to those players with the deepest resources who can analyse and put mass-volume data to the best use.

Extensive reporting requirements

As a result of the continual increase in regulatory requirements, the expense incurred by investors for back- and middle-office activities is growing massively. Alongside tax, accounting and regulatory reporting requirements (such as FATCA, CRS, AIFMD/KAGB), some individual LP groups are finding themselves confronted by even more extensive reporting requirements. The Solvency II regime for European insurance companies for instance requires quarterly reporting based on a "look-through-approach" for all underlying investments, including looking through closed and open investment funds to individual portfolio entities and/or loans. Look-through reporting may also be mandatory for so-called "institutions for occupational retirement provision" (IORPs), depending on how the IORP II Directive is transformed into national law. It is normal market practice for many LPs to pass on responsibility for these extensive data requirements directly to the GPs. According to a study published by Ernst & Young, investors are coming to expect a higher standard of reporting, irrespective of regulatory issues. 77% of those participating in the survey see a need for greater transparency, e.g. by using the look-through approach for portfolios. Moreover, some 60% expect a more timely supply of information from their funds or portfolio companies[4].

[4] Source: Ernst & Young, "2016 Global Private Equity Fund and Investor Survey"

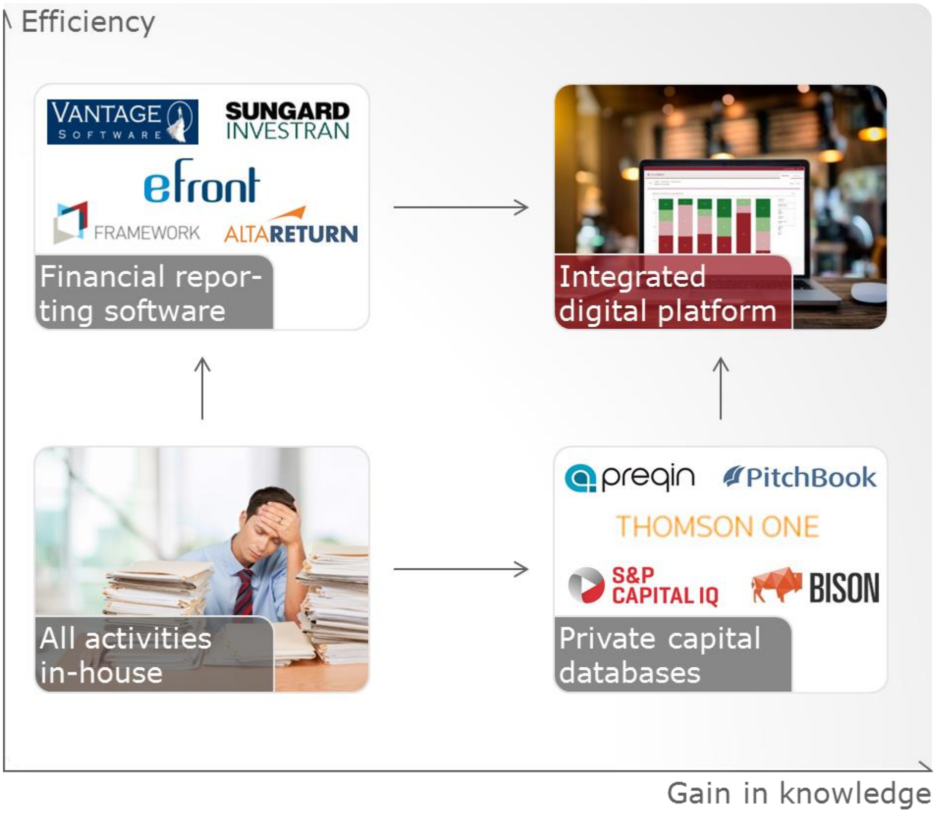
The combination of falling returns, transparency, easier access to information for all market participants and increasing reporting requirements are putting investors under pressure and forcing them to challenge established business models. LPs and GPs are having to adapt to more rigorous cost controlling procedures on the one hand, while striving for efficiency improvements on the other, particularly in the area of back- and middle-office activities. Does the digital transformation offer any solutions to this predicament?

2 Solutions: systems and outsourcing

2.1 Integrated digital platform

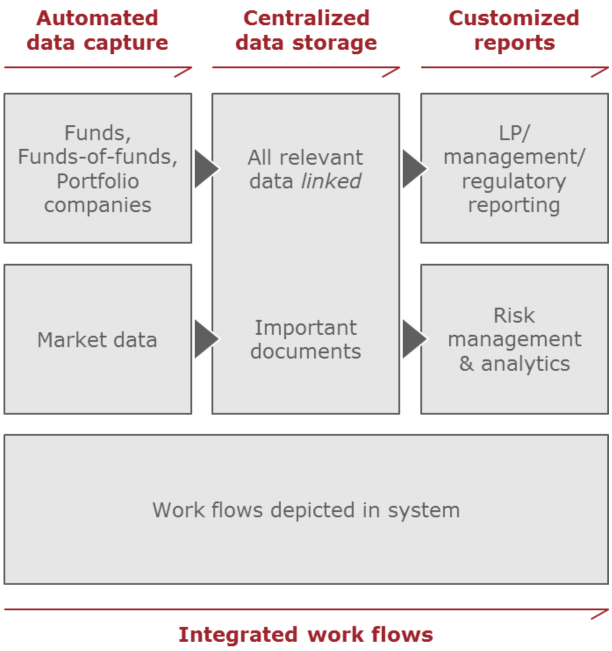
Nowadays, most private capital investors have access to commonly used market databases. They use financial reporting software or outsource the relevant activities relating to the administration of their funds and investment vehicles. Often, however, market databases and software solutions remain isolated from one another, thus missing out on the leverage for efficiency improvements and reduced costs provided by bringing data, information and related work flows into a single system.

Illustration 1: Development steps in private capital systems



Leading GPs and LPs are therefore turning to integrated digital platforms which are capable of storing all significant information in one place. Investment management, investor relations as well as the back- and middle-office all have access to a common system with unambiguous information that is free of redundancies.

Illustration 2: Components of an integrated digital platform



An integrated digital platform is characterized by four key aspects:

Centralized data storage

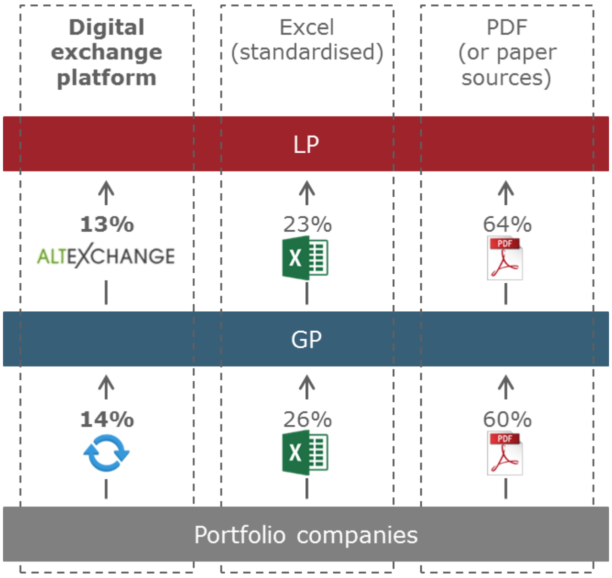
Instead of stand-alone Excel or other singular system solutions, all relevant data and documents are stored digitally at one central place. All teams work on the same set of data, the so-called "golden copy". Firstly, this eliminates redundant gathering of information. Secondly, it helps avoid errors and inconsistencies, due to the fact that all employees are using the same data basis to generate reports.

Centralized data storage typically covers accounting data, portfolio data (e.g. cash flows, performance data, master data pertaining to funds and portfolio entities), CRM information (e.g. fund managers, investors) and external market data (e.g. benchmarks, coming-to-market information). All entities (fund managers, funds, portfolio entities, investors) are linked on a relational basis, enabling any combination of drill-downs, aggregations and computations to be used to prepare analyses and reports.

Automated data capture

In order to assess a portfolio thoroughly, a vast number of data points needs to be captured with respect to the private capital investments made. As well as performance and financial data at fund level, it is also necessary to input detailed information pertaining to each of the portfolio entities and/or loans. The resulting huge volume of data then has to be transferred accurately and efficiently each quarter to the integrated platform.

Illustration 3: Data Exchange by GPs



An AssetMetrix survey covering more than 100 fund managers[5] reveals that 13% of the GPs questioned are already able to provide quarterly reports, capital account records and portfolio summaries to their LPs in standardized formats, such as AltExchange. A further 23% provide information on request using internally developed Excel formats, albeit still largely based on standardized formats. This data can be transferred efficiently to an integrated platform. By contrast, capturing data manually from PDF/paper sources is extremely time-consuming and susceptible to error. As a general rule, procedures for capturing information can be structured in such a way that each "data point" is only input once, thus eliminating the problem often encountered in stand-alone system solutions, namely redundant data capture at more-than-one location.

Customized reports

[5] Source: AssetMetrix Study covering 106 international fund managers from the Buyout, Venture Capital, Fund of Funds segments. The survey was conducted during the period from January to March 2017.

Centralized data storage and consistently applied procedures for recording information within the system provide a sound basis for well-designed, customized reports and analyses. Once the key points have been defined and fine-tuned, users are able to generate reports and analyses with automated precision. Reports can be accessed 24/7 via the internet or cloud services on state-of-the-art, integrated platforms. By creating dedicated LP portals, GPs in particular are able to keep their investors informed quickly and efficiently through convenient information channels – at the same time also creating a positive impact for sales and marketing.

Furthermore, the comprehensive set of data available provides the basis for a broad range of quantitative reports (so-called "Analytics") which can also be produced automatically. Various reliable statistically-based techniques are available to forecast cash flows and performance, to measure risks and to perform benchmark comparisons (i.e. against private capital investments or liquid indices). The analytics are generated in the related database without any additional effort and can provide useful insights for decisions involving the investment process, treasury, payments processing and risk management.

Integrated work flows

Many of the time-consuming work flows of private capital investors, such as handling capital calls and distributions, can be optimized by replicating them digitally in the integrated platform. Authorization procedures can be documented in the system for audit purposes and saved conveniently with electronically stored documents. The digital documentation of procedures performed also reduces key man risk. Instead of the opaque Excel solutions devised by individual employees, work flows are mapped out neatly, clearly and simply in the system.

2.2 Make or buy?

Before introducing new solutions, private capital investors have to go through the process of deciding whether to “make or buy”. At present, there are no comprehensive and easy-to-administer integrated systems on the market. Creating an integrated digital platform for LPs and GPs will generally therefore involve developing an entirely new system in-house or linking up existing stand-alone IT solutions (such as financial reporting/accounting software, market database and CRM systems) at great expense. Both the roll-out and long-term operation of such a system require appropriate IT capacities and experience to be maintained.

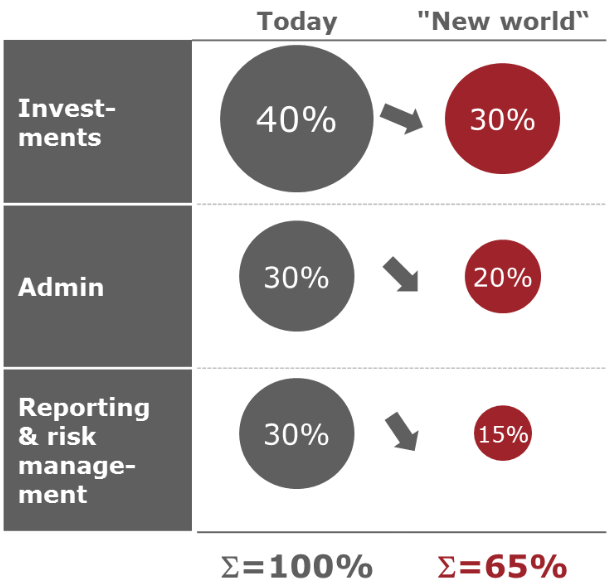
One possible alternative is to outsource these activities to an asset servicer. In comparison to fund administrators – which according to our survey are now being used by approximately one third of private capital investors – asset servicers provide significantly more than just support in the areas of accounting, taxes and administration. They also provide access to integrated digital platforms and take on some of back- and middle office activities of their clients, including data capture, report preparation and wide-ranging analytics.

Private capital investors benefit from access to tried and tested systems, extensive expertise and economies of scale passed on by the asset servicer, including the benefits of centralized, one-time data capture and digital processing. Outsourcing parts of the added value chain can therefore be significantly less expensive than creating and running a system with in-house resources. Reducing their workload enables private capital investors to focus on their core business: making investment decisions.

3 The new "Economics"

The potential benefits to be gained by freeing up in-house resources through rigorous digitalization and the optimization of work flows and reports are immense. We see opportunities for LPs to reduce expenditure on systems, staff and other items – depending on individual circumstances – by approximately 35%.[6] Given the fact that many institutional investors are understaffed, outsourcing provides an opportunity to free up valuable resources that are currently being used to perform manual and administrative tasks and increases the scope for value-adding activities. In the case of GPs, we see opportunities to reduce costs by up to 25%, mostly in the areas of data exchange, monitoring and reporting and fund administration.

Illustration 4: Resource requirements of LPs



Over the long-term and across all private capital investment classes, GPs have averaged gross multiples of approximately 2.2x [7] on their deals. For the institutional investor, investing in all investment classes via funds of funds, this implies – net of all internal and external costs – a TVPI of 1.5 to 1.6 and an IRR of 8% to 10%. Between gross deal level and net level for the institutional investor, the total expense ratio is 7% to 10% p.a. (calculated over a full fund-of-funds cycle and as a percentage of the average NAV).[8]

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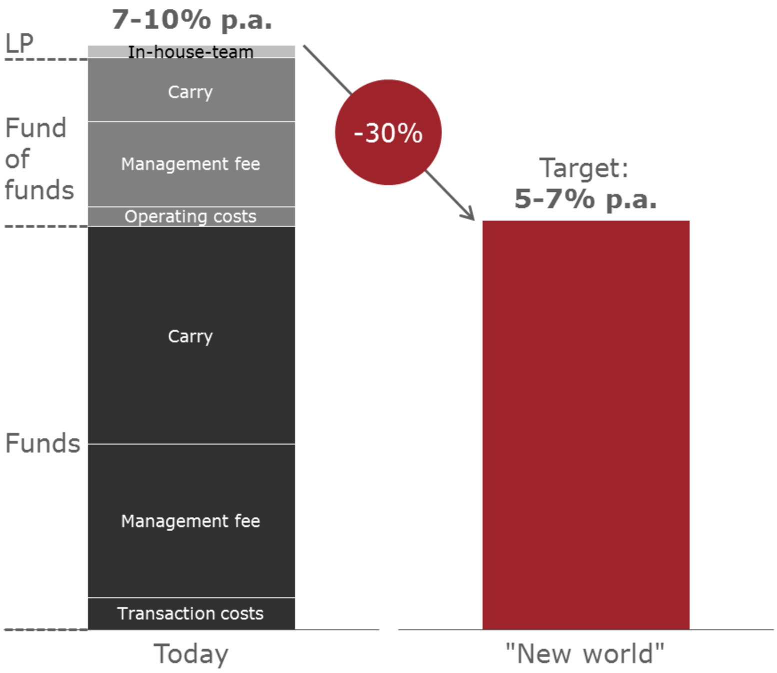
[6] Source: AssetMetrix analysis, based on our own experience and surveys among our customers
[7] Source: AM Deal and Performance Database
[8] Source: AssetMetrix analysis based on the AM Deal and Performance database

Illustration 5: Total expense ratio



If average deal multiples were to fall in future to 2.0x (a scenario that is not unrealistic in light of the current capital market environment), it is likely that – based on the current fee and cost structures for institutional investors – returns above 8% could no longer be generated. In order to keep the "economics" of investing by the end-investor at the current level, the total expense ratio needs to be within the range of 5 to 7% p.a.

If fund managers and fund-of-fund managers take the step to optimize and digitalize their internal work flows and pass on the savings made, this target range does not appear to be unrealistic. Moreover, all parties concerned benefit from greater transparency, improved compliance, consistent quality and a significantly better insight of their private capital investments.

Summary

The digital transformation has also reached the private capital sector. Automated data capture, centralized data storage, customized reports and integrated work flows enable private capital investors to improve operational efficiency, while at the same time reducing costs. Equipped with their digital platforms, asset servicers are opening up opportunities for private capital investors to optimize their business models going forward and embrace digital change practically "overnight" through the selective outsourcing of tasks. The laborious process of changing internal processes and systems will no longer be necessary. By taking this step, LPs and GPs can be somewhat more relaxed about declining returns and increasingly demanding reporting requirements. Are you ready for the change?

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About AssetMetrix

AssetMetrix is Europe’s leading provider of high-end analytics and tailored asset servicing for private capital investors. The innovative service concept developed by AssetMetrix enables LPs und GPs to make better investment decisions and reduce the burden on in-house resources. As a dedicated service provider with more than 20 years of experience in the field of institutional investing, we are independent and without conflicting interests. AssetMetrix does not act as investor, investment consultant or placement agent. AssetMetrix currently manages portfolios with a total volume in excess of EUR 4 billion, covering more than 400 funds.

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