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The Cost-Benefit Analysis of Outsourcing

Private equity just may be suffering from its own successes. In an article in the Spring 2016 Journal of Private Equity, researchers Reiner Braun and Ingo Stoff argue that as private equity develops into a "well-established asset class", fund returns have inevitably decreased and "investors have become more cost conscious". While return spreads have dropped, they note that "when controlling for falling gross returns causing lower performance-based fees, the cost of PE investing has increased". The researchers point to the increasing levels of dry powder as one of the drivers of expenses for private equity firms.

The Competitive Pressures

A report from Bain & Co. noted buyout dry powder grew to a record $534 billion. The highly competitive alternative investing environment is placing additional stress on fund managers. Not surprisingly, increasing competition for deals continues to put upward pressure on asset prices. Industry players are worried about rising valuations on assets and its ultimate impact on returns. Bain & Co. data indicated that buyout purchase price multiples jumped above 10 times EBITDA on average in the US and Europe, setting a new record.

Regulation & the Global Perspective

Increasing regulation and the complexities of a global market are adding to the cost pressures. Whether it's the Dodd-Frank Act, Alternative Investment Fund Manager's Directive (AIFMD) or Foreign Account Tax Compliance Act (FATCA), compliance is a costly operation for alternative investment funds. Regulation is only likely to increase, demanding additional resources devoted to compliance. And with the UK's exit from the EU near, private equity firms and hedge funds will continue to navigate unchartered waters ahead.

Understanding Human Capital

According to Timothy Selby, partner and head of the investment management practice at Alston Bird LLP, and chair of the New York Alternative Investment Roundtable, outsourcing corporate, fiduciary or administrative services to a third party provider can be an especially smart move for new alternative investment funds. "It provides a means for making it easier to get into the industry with a turn-key professional infrastructure," he says. Outsourcing offers a new fund a "team of caliber" in a cost-effective way, says Selby.

More established funds are better able to support staff in-house, Selby notes. But it's often talent that they lure away from investment banks. Even for the bigger private equity firms and hedge funds, it's expensive to locate and retain qualified people, as well as costly to train good talent. Offices across multiple jurisdictions can present a headache for a fund, demanding local experts in a number of locations.

The Investor Push

Today, alternative investment funds are facing additional pressures and costs associated with their investor demands. As investors look for ever-increasing levels of service and greater transparency, a growing number of GPs and LPs are turning to outsourcing for middle and back office functions. By outsourcing corporate, fiduciary or administrative services to a third party provider, alternative investment funds can provide a quality level of service to investors and effectively concentrate on what they should do best—making money.

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