The institutionalization of private equity

With the growth of private equity and the wall of money flowing in, managers are struggling with the 'institutionalization' of the asset class. *Malcolm Pobjoy,* Vistra's group commercial director for North America, sets out what GPs need to do to deal with new investor demands

Q When you talk about the 'institutionalization' of private equity, what do you mean?

MP: With so much money being allocated to private equity, managers have to deal with transformation in governance and oversight being driven by investor demand. Vistra is helping private equity firms come to terms with this new institutionalized environment. We work with clients by helping them build the infrastructure and back-office capabilities they need to meet demands, while always taking into consideration the changing regulatory backdrop.

The institutional investors coming into private equity are really a major driving force for change. They remain focused on the ability of a GP to find opportunities to execute deals and deliver consistent returns – that has not changed – but our research tells us LPs are now looking for a lot more information around fund governance and oversight. In particular, they are focused on transparency, independence, costs and fees, diligence and globalization.

Q What do investors expect of managers in terms of transparency and independence?

MP: We see investors demanding a lot more information and data about their investments and fund performance, and the level of financial analysis expected has grown significantly. There is a lot of interest in new platforms that facilitate the ease of communication and information-sharing among GPs, LPs and administrators.

Pobjoy : LPs are getting more sophisticated

"There is growing demand for transparency around decision-making, and for the more widespread use of LP advisory committees"

There is also growing demand for transparency around decision-making, and for the more widespread use of LP Advisory Committees, which enable investors to engage and get closer to that process.

As for independence, investors are looking to allocate to GPs that have independent advisors and administrators, and these investors are supporting the growth in the outsourcing of administration. We see private equity is a couple of years behind hedge funds in this regard, where virtually every hedge manager now has outsourced administration.

Q What about LP demands around costs and fees, diligence and globalization?

MP: The growth of co-investments is partially driven by LP demand for lower-cost options that allow them to gain access to deals. Investors are also focused on what is being charged to the funds, and again, that drives them to favor the GPs that use administrators rather than investing heavily in growing their own back-office function.

When it comes to diligence, LPs are looking to delve down into the robustness of the operations of both the manager and the portfolio companies. Cybersecurity is a big concern here, and investors are looking at scalability and the depth of expertise that managers have to make sure funds are being properly looked after, that regulations are being complied with across the entirety of their businesses, and that all their providers have the requisite expertise.

That leads to concerns around globalization: investors are backing private equity managers investing globally because they want diversification. That often means doing deals in multiple locations, but LPs are seeking reassurance that there is sufficient on-the-ground expertise to deal with all the necessary administration compliance and structuring. Furthermore, they want GPs to be structuring their funds in the right domiciles, where there is a lot of interest in new jurisdictions like Luxembourg and Cayman, as well as cost-efficient solutions involving Guernsey and Jersey, for example.

Q How important is the back office in LP and GP relationships?

MP: Private equity allocations are still heavily weighted towards the top-tier players, and we continue to see the private equity industry growing, despite the large amount of un-deployed capital. And yet we do see competition to win mandates from institutional investors becoming more aggressive, and to win that competition, GPs need the right combination of performance, infrastructure and partners, so as to give those investors the right level of comfort that their investment is being well looked after.

We are helping GPs develop that infrastructure, transparency and high level of customer service that will drive better LP relationships. New investors continue to come into the market, whether they are endowments, state funds or others, and they are more cautious. There is more capital to be chased, but there are more people chasing it, and the people allocating it are getting far more sophisticated.

Q What should GPs be doing around vendor management and oversight?

MP: Historically, when private equity managers were operating on a global basis, they might have multiple vendors in different countries, and different vendors working with different funds. Now investors are pushing back on that and demanding vendor oversight and consolidation programmes, asking managers to demonstrate how they are able to effectively monitor multiple vendors for compliance, for good HR practices, and for more general corporate behavior.

As a result, GPs are reducing the number of providers that they work with, and showing a preference for those that can deliver multiple service offerings in multiple jurisdictions. In doing so, GPs are able to work with fewer partners, perform vendor oversight more efficiently and drive down the costs of that control.

This is very much a feature of traditional asset management, and is another example of the institutionalization of private equity.

Q How can managers achieve operational efficiencies?

MP: As private equity firms grow, it makes sense to constantly review and upgrade their operating models. Many have small in-house accounting teams that have grown up with the business, but as the scale of operations expand, firms can be exposed to single-person risk and an operating model that is not easily scalable.

For firms to pursue the larger institutional investors, it is necessary to have more robust operating models, and having single-person dependency becomes an issue – investors are looking for confidence that the operating model is strong enough to cope with growth.

Q What do you consider to be regulatory and accounting best practice?

MP: All of these investor demands are increasing at a time when regulatory and accounting compliance challenges are a constant backdrop. The Alternative Investment Fund Managers Directive is now well-established in Europe, while in the US, even if regulation is rolled back, it is the volume of regulatory change that presents the challenge.

> "When it comes to diligence, LPs are looking for managers to delve down into the robustness of the operations of their portfolio companies when they are allocating money"

At Vistra, we believe there will continue to be a strong current of regulatory change impacting the private equity industry globally. We know our clients and prospects view making sure they are up to date and their systems are fully compliant as a real challenge that is driving them to outsource these functions to a variable cost model.

In the case of accounting, we see an increasing collaboration across the private equity industry to agree on best practice, in terms of issues like what gets charged to the fund versus the manager, how performance returns are calculated and more. As the industry matures and institutional investors demand more comparative techniques, the market will collaborate and drive towards best practice, rather than continuing to remain fragmented. ■