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Published by: Private Equity Wire, 8 St James's Square, London SW1Y 4JU, UK
www.privateequitywire.co.uk

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Case for outsourcing bolstered by industry shifts

By A. Paris

The case for private equity outsourcing has been bolstered in the past year as general partners (GPs) are having to handle larger volumes of data and compliance teams are stretched to their limit. Industry participants have attested to the growing burden that private equity operations are facing and the potential fragmentation to which they may be vulnerable.

"Technology and data-gathering pain points that are a source of irritation for principal investors in normal times have become a source of critical risk. A patchwork of systems, complicated processes, and fragmented data often require teams to run a gauntlet to complete routine analyses, with many resorting to manual workarounds," note partners at Boston Consulting Group in a report outlining the optimal post-crisis operating model.

This state of affairs has been thrown into further relief by the Covid-19 crisis. John H. Eley, chief executive officer at GoldenSource reflects on the increase in outsourcing witnessed after the dotcom bubble and the 2008 financial crisis. He writes: "These historical events and their impact on asset services outsourcing form a precedent for another spike in outsourcing due to the current economic crisis."

A survey by Northern Trust revealed almost half of the 300 asset managers included in the study were considering outsourcing their data management within the next two years. A third were also mulling delegation of their middle-office functions.

In the view of Michael Tracy, director, Lionpoint, the two – data and middle-office – are linked. He says data-heavy tasks in the middle office are prime candidates for being outsourced. Tracy notes: "External support for asset management, portfolio analytics and valuations, is a nascent kind of outsourcing framework that is growing significantly. This includes data collection for portfolio companies. In these situations, the outsourced provider collects all the financial data and operational KPIs from the portfolio companies and aggregates it within a system – be it their own or that of the PE firm itself."

PwC's 2020 Private Equity report finds that 84% planned to invest in digitalisation and 81% of this group specifically aimed to focus on data analytics. In addition, 95% of these have used analytics to source deals.

Given analytics are expected to play a significant role in PE firms going forward, investment professionals need time

> *As the space evolves, investors will need to maintain the flexibility to adjust their ESG strategy and, in turn, the ESG data they use while maintaining seamless connectivity to all data sources supporting the investment process.*
>
> Mackenzie Hargrave, Factset

to focus on their analysis and insight. Data alone does not provide value-add, it is the investment acumen which will lead to sound investment decisions. In view of this, it can make sense for the data-gathering exercise to be delegated to a third party.

The sustainability challenge

Another industry trend which further supports the argument for outsourcing is the rise of sustainability and ESG investing. S&P Global's 2021 Global Private Equity Outlook, finds 40% of PE/venture capital firms report they are planning to work on improving ESG standards within their current portfolio companies. The number of firms not considering ESG in the decision-making and post-investment process decreased from 25% last year to 19% this year, whereas the number of firms just starting to introduce ESG in their strategy increased from 18% to 24%.

"The results show a clear shift indicating that many firms that had not tackled ESG last year will be working on it this year. ESG was already gaining in momentum but the pandemic amplified and accelerated the need for improved social welfare and governance," write Ewa Skornas and Elisabeth Bautista Suarez at S&P Global.

This additional focus on ESG factors means more data to process. In addition, increasing regulation, like the Sustainable Finance Disclosure Regulation (SFDR) in Europe, means firms are facing a growing reporting burden. These are administrative tasks with which outsourced providers can support.

However, when selecting data providers, alternative asset managers need to make several considerations. Mackenzie Hargrave, VP, content and technology, Factset says: "As more firms consider how to incorporate ESG into their workflows, they are faced with the challenge of determining which sources of ESG information best align with their investment approach.... While the lack of consistency of data on the market can seem overwhelming, it is essential to understand the differences between vendors and establish a flexible framework for evaluating them."

She goes on to remind players that "ESG data is only one component of the investment process – it is never used in isolation and always needs to be linked to financial reports, broker estimates, pricing, and more. As the space evolves, investors will need to maintain the flexibility to adjust their ESG strategy and, in turn, the ESG data they use while maintaining seamless connectivity to all data sources supporting the investment process."

Far from the front

According to a number of industry reports, private equity could see the outsourcing of front-office functions, like portfolio management or even the act of trading itself. These functions "could now start to go to the asset servicers. This allows lean asset management firms to focus on investment decisions and using technology to research and analyse securities and the markets," continues Eley at GoldenSource.

However, according to BCG, firms have not made enough efforts to streamline their organisation in preparation for this move. The consulting firm outlines: "Many principal investors have embraced lean teams but have not adopted new ways of working or made the right organisational changes to harvest their new-found flexibility... many routine processes feature multiple handoffs that require manual intervention. Such handoffs are exacerbated by fragmented technology and software solutions that hinder coordination and interoperability – such as the typical trade-booking cycle, which requires users to log on to several different systems to input data."

Although service providers have created scalable capabilities to help the front office with marketing strategy and support services, other industry experts also think GPs still have a way to go for this to come to fruition.

Andy Welch, director, ACA Group, comments: "Considering the make-up of private market teams, the industry is never going to get away from needing someone in-house as a registered compliance officer and anti-money laundering officer. These are two very important functions that I can't see being outsourced."

Welch does not think the industry will get to a point where the regulated PE business is only made up of capital raising and investment decisions functions: "There are too many other necessary roles internally. In addition, some of these roles need to be a sounding board or hold the other two areas of the business accountable."

Outsourcing in the hedge fund space and in liquid markets has made the transition into the front office where a large portion of portfolio analytics and trading can be outsourced. Due to the legal and slower nature of private transactions, this could be hard to replicate.

"One of the success factors of the private markets is the diligence and targeted nature of the investment team, followed by that team's ability to analyse and promote growth in those businesses. This takes an enormous human effort, which I can't see being replicated by technology in any way." ■

Data requirements drive middle office outsourcing

Interview with Michael Tracy

This past year has proven that general partners (GPs) can retain control and oversight over the various functions within their firm, even while working with outsourced partners. The shift to virtual working demonstrated that the ability to interact and collaborate across an organisation is in no way hampered by being in remote locations. In addition, the focus on data is driving the need for external support in middle office functions.

The PE operating model has historically been largely driven by in-house functions. Michael Tracy, director, Lionpoint Group, comments: "It's not a surprise that the sector has been a laggard in terms of technology and outsourcing. PE professionals previously wanted to have full control over everything in the space. This was a hurdle the industry needed to overcome."

In part, the catalyst for the growing role of outsourcing has been the exponential growth of the PE industry itself. Vehicles are also becoming more complex in their investment operations which results in needing to access specialist expertise.

Tracy elaborates: "To fundraise for a new strategy or to access a new source of capital, GPs would need to hire professionals to administer those functions in the middle and back offices of their firm.

"In choosing to work with an outsourced partner instead, they access professionals who have been successful at operating an efficient framework and have invested in technology to scale their clients' business models."

The manager will also retain a position of oversight. This is critical for that relationship to be successful. Tracy says: "Through a robust monitoring framework the managers can ensure the complex nuances of the different legal entities and structures of their investment operations are being administered correctly and the functions being performed effectively."

The outsourcing journey

When an outsourcing relationship begins, it is often the back and middle office functions which are delegated in the first instance.

"As that relationship deepens, these models start to evolve and become more mature. That is when other functions start to come into play, under the same umbrella. For example, in the front office, you have investor relations and certain client relationship management functions which can be outsourced. Anything data related or any of the more analytical functions can be taken off the managers' plate," notes Tracy.

He caveats this by explaining that large portions of the front office are not usually outsourced: "This part of the business is often the 'secret sauce' of a firm, it's what differentiates them and provides their clients with value-add. So, in this space it's only market analysis and data functions which would be handed to another provider."

Data-heavy tasks in the middle office on the other hand are prime candidates for being outsourced. Tracy notes: "External support for asset management, portfolio analytics and valuations, is a nascent kind of outsourcing framework that is growing significantly. This includes data collection for portfolio companies. In these situations, the outsourced provider collects all the financial data and operational KPIs from the portfolio companies and aggregates it within a system – be it their own or that of the PE firm itself."

This role is critical given that the disruption stemming from the Covid-19 pandemic has resulted in a lot more data which needs to be consumed. Tracy highlights: "This is a result of the nature of the environment we're in and also the advancements made in technology throughout the world.

Jonathan Balkin, co-founder and executive director at Lionpoint, says: "When



outsourcing, firms still need to bring back their data in-house to support their oversight, fund models, track record, cash flow forecast, exit scenario modelling, carry plan administration and ad hoc reporting and other critical needs to run your business. Historically, this has been a significant compromise with outsourcing where you need that data to run your business. With cloud-based technologies and better integration options, clients can more easily ingest data from their administrator to have control and across of their data in an automated way with limited technology overhead."

"In this context therefore, the ability to collect more data is ultimately going to drive investment insight," says Tracy. "We've seen the need for PE managers to have a much more widespread, holistic view on what information to collect from their portfolio companies. The firms need to have the ability to do this both from a resource and a technology perspective. In view of this, expert outsourcing firms which are able to do that successfully, are becoming more popular."

The technology angle has a significant role in the drive to improve outsourcing rates among PE firms. Tracy comments: "PE firms often buy-in robust pieces of technology. However, they need to evolve with them and upgrade them. They also need to make sure they have the right IT support to guarantee the systems are up to date and adding value. This is a significant investment which firms can avoid by leveraging the technology platforms used by their outsourced partners."

Headline advantages

Logically, there is a cost dimension to the case for outsourcing. When choosing to outsource, GPs not only save on hiring in-house professionals, but they also can pass on some of the cost to their investors.

Tracy elaborates: "Due to the way the legal documents are structured, an outsourcing agreement provides a certain element of independence in relation to the functions it governs, which investors are keen on. This also means the outsourcer fees are passed down to the fund level, which is a huge draw and benefit to the GPs."

Further, Tracy adds: "If a manager can use their lead outsourced provider for 70 to 75 percent of the work, their job in relation to those functions is more of an oversight capacity. In addition, if they are able to utilise the providers' technology in an automated capacity they can have a more lightweight framework and can reduce many of the expenses PE firms have historically had to take on."

Another headline advantage of outsourcing is that it frees up time for PE professionals to focus on their core expertise. "The PE firm is therefore able to refocus on the investment vehicles, on deploying capital and on finding and highlighting the differentiating factors in their ability to source deals. In addition to making investment decisions and fund-raising, PE managers will be able to focus on marketing and business development – they can work to grow and scale their business internally," Tracy advises. ■



Michael Tracy
Director, Private Markets Advisory, GP, Lionpoint

Michael Tracy's background includes extensive experience leading global operating model transformations for top private equity, hedge funds and credit firms. As Director for Private Markets Advisory, leading the GP practice, he specialises in designing and implementing target operating models, including technology implementation, process workflow and operational efficiencies for large investment managers across credit, private equity and private market strategies.



Relieving pressure in overburdened compliance teams

Interview with Andrew Welch

Regulation and compliance teams within private equity (PE) firms are overloaded with their day-to-day tasks. Relieving some of this pressure will allow them to work on strategic, risk-based matters which will see them being more effective to the business overall.

Outsourcing can help alleviate some of this stress. Andy Welch, managing director, ACA Group (ACA), outlines: "There is significant regulatory and legislative pressure to increase the effectiveness of their compliance programs, manage with fewer internal resources, ensure high-quality results, reduce turnaround times, and lower costs. There are many routine tasks which compliance teams carry out that eat up considerable time. We're seeing many compliance professionals feeling under uncomfortable strain just to get their day-to-day work done."

These senior team members would be far more effective and impactful to the broader business if they could focus on the more strategic, structurally valuable aspects of regulation, compliance and operations.

In view of this situation, ACA has identified a growing demand for managed services. Welch says: "We are seeing material demand for solutions around resource-heavy, administrative, repetitive tasks at a functional level. This includes providing email and call surveillance, monitoring of electronic communications, identifying conflicts of interest, transaction reporting support and assistance with KYC and AML (anti-money laundering) processes. This allows the senior compliance teams to focus on important risk-based matters." In fact, the firm has expanded its managed services team to accommodate these requirements.

This outsourcing exercise can also help a PE firm become more competitive. Rather than the compliance teams struggling to get through a mundane list of tasks or fight fires, they have more time and energy to be proactive and have more to give the business on a strategic dimension.

From a regulatory and operational perspective, PE firms are also battling with headcount. Welch comments: "It's difficult to get hold of the right staff just because there's quite a lot of demand in the market for regulatory and operational professionals. Further, even fairly junior individuals are coming at a premium from a salary perspective which makes hiring costs fairly expensive."

According to Welch, an area that outsourcing firms can expect to see considerable traction is the AML/KYC space: "This is becoming a significant burden for PE firms, but it still needs to be done. There are higher and more onerous standards introduced by the fifth anti-money laundering

directive and there is a cognisance that people want to do it right."

ACA recently launched an AML KYC/CIP solution that combines ACA's regulatory technology (RegTech) and managed services to provide its clients with a full-service, cost-effective offering for meeting their requirements under various KYC and CIP regulations in the US, Europe, and Cayman Islands. In addition, ACA's clients can use the solution for conducting AML oversight of their clients, prospects, vendors, and portfolio companies.

Partner selection and cyber concerns

Before selecting an outsourced provider, PE firms need to carry out an exercise in introspection. Welch suggests: "The firms need to really understand what they want from that outsourcing exercise. Is it simply a cost saving exercise or are they looking to build efficiencies? Ultimately, the GP board needs to be reassured that this is going to be a consistent, well-delivered, long-term solution."

Fundamentally, when choosing a partner, GPs need to understand the stability of the business they are going to be working with. "They should ask about things like staff turnover, absenteeism and resilience of the technology powering that business. When considering this last point, they need to tackle it almost as though they're building key performance indicators for that solution. They need to ask about how often its reviewed, what the senior oversight framework is and what happens if something goes wrong," notes Welch.

Cybersecurity is also now a critical requirement as attackers in the sphere are becoming more sophisticated. Welch homes in on what is called payment fraud: "This is when a cybercriminal organisation infiltrates a firm's technology perimeter to watch its payment flows. The criminals then mimic that process to divert funds. The concern here is often by the time the victim notices the money has moved, its too late to recover it."

ACA has a large cybersecurity division, which focuses cyber, privacy and risk. Its solutions include payment fraud, cybersecurity and technology risk programs, data privacy compliance services, vendor and M&A diligence services, portfolio company oversight, network testing, and advisory services for companies of all sizes. The firm works with clients to understand the links between the LPs, GPs and portfolio companies. By drilling down into the payment process, ACA can make sure the firm's whole perimeter is secure.

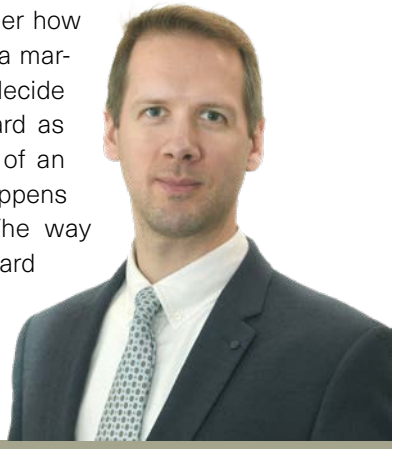
Welch recognises a different approach across jurisdictions: "In the US, there is cyber legislation, which means firms are legally bound to take stock of their position in this regard. This is not the case in the UK however where most of the effort in the cybersecurity space has been through industry bodies and guidance; it's been driven by fear of being attacked rather than a pure regulatory obligation to undertake a cybersecurity exercise."

This means some areas of the market might only pay attention to this once it's too late. In Welch's view technology infrastructure in the PE space is still not secure enough from a cyber perspective.

Technology, sustainability, and growth

As awareness and regulation around sustainability grows, outsourced partners can also be of support to PE firms in the ESG space. "It will be interesting to see the applied use of technology and outsourcing in the ESG arena. These can provide analytics on measuring the ESG impact of firms and their investments, and how this relates to performance. Going forward I think we will see firms really utilising technology solutions to demonstrate the impacts a firm is having on an ESG dimension; though we're not quite there yet," Welch observes.

He adds that GPs need to consider how to approach the ESG element from a marketing perspective. They need to decide whether they put themselves forward as a returns-based business or more of an impact and ESG-based firm that happens to be commercially successful. The way they position themselves in this regard will most likely determine how they adhere to the ESG rules. ■



Andrew Welch
Managing Director, ACA Group

Andrew Welch is a Managing Director at ACA Group, at leading governance, risk and compliance advisory firm. In this role, he advises alternative private market companies, fund managers and other investment firms on their ongoing FCA compliance obligations and complex regulatory projects.

Prior to ACA, Andrew was Director of Alternative Fund Services at SS&C GlobeOp. Before that, he was Associate Director and head of Financial Services Authority ("FSA") authorisations at a leading London compliance consultancy.



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