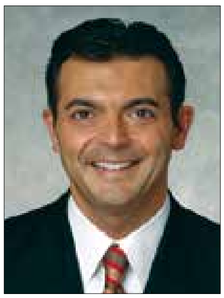
The move to more outsourcing

As the volume and complexity of private equity and real estate fund administration work increases more fund managers are moving certain functions out of house, says BNY Mellon's Frank La Salla and Alan Flanagan

Private equity and real estate fund administration is becoming more complicated and time-consuming. Not only that, the volume of work fund managers must complete is also on the rise. The ever-increasing intricacy of real estate transactions and heightened regulatory and tax pressures have all played a part in the increased back-office burden. Not helping fund managers is that, for the majority, the size of the firm's staff has not kept pace with this increasing workload.

Accordingly, fund managers are searching for efficiencies around back-office administration to free their time for other functions like deals, valuation and direct interaction with investors. Administrators, who tend to invest more resources in the latest accounting software, are often better suited to automate these functions, where possible.

With a new head of private equity and real estate fund services in place, and a big boost from the addition of Deutsche Bank's real estate fund administration in February, BNY Mellon's Alternative Investment Services group's Alan Flanagan, global head of private equity and real estate fund services, and Frank La Salla, chief executive of BNY Mellon's Alternative Investment Services business, explained to *PERE* why more fund managers are exploring outsourcing certain back-office functions.



La Salla: Investors demand more outsourcing

PERE: *Has the private equity and real estate industry been slow to outsource fund administration functions compared to other asset classes?*

Flanagan: There are vastly different levels of outsourcing in our service sectors. While the assets under management in the hedge fund market and in the private equity and real estate market are roughly the same, about $2.5 trillion, the level of service outsourcing is dramatically different. In the hedge fund sector, about 90 percent of fund administration is already outsourced. It is a big business, and a very important one to us, as well as the other major service firms. But in private equity and real estate, only 20 percent to 30 percent of the fund administration is outsourced. That means that 70 percent to 80 percent of the value has yet to come to market.

One reason for the delay in private equity and real estate managers outsourcing, is that these are sophisticated asset classes. Managers have had the question if service firms have the ability to handle these complex transactions, filings, and communications. That's not the case anymore. Take the Deutsche Bank transaction. BNY Mellon and Deutsche Asset & Wealth Management (AWM) announced an agreement where Deutsche will outsource its real estate and infrastructure fund accounting and parts of its reporting functions to BNY Mellon covering more than $45 billion in assets under administration.

La Salla: Private equity funds are obviously much more complex than are long – only 40 'Act funds. They have to deal with things like complex corporate structures and distribution waterfalls. Managers got their start doing everything in-house, and just tended to keep things that way.

Increased complexity of regulatory requirements and the cost of technology and the expertise needed to run it, along with the demands of investors for separation, all combine to drive fund managers to look for outside help. I would imagine that most of them look at what they would need to do to keep everything in-house and come to a realization that 'to better compete in this space, we need to select a partner who has already made the investments.'

PERE: *Which functions are most commonly outsourced?*

Flanagan: That really does vary. Some fund managers are ready to outsource everything. They even tell us, 'we want you to correspond with our investors.' That frees them to focus on asset management. Other funds want to keep their personal relationship with their investors. For them, that interface is key. Investor queries are the opportunity for interactions and feedback. For others, it is a nightmare that bogs them down.

PERE: *How has the increased regulatory pressure impacted a real estate fund manager's back-office? Why is this driving more managers to outsource certain functions?*

La Salla: Fund managers have significant reporting requirements, and yet they are still under the same pricing pressures as the rest of the financial services industry. These pricing pressures are forcing them to seriously consider outsourcing. Another factor is investor demand. That is what is driving separation. Investor demand takes precedence over economics much of the time. At least it drives managers to find a way to make it work.

PERE: *Why do investors care about a fund manager's back-office now, when in the past it was not really a concern?*

La Salla: The simplest thing investors care about is clear checks and balances. In this post-Madoff world, investors want to mitigate their risk. They want to see a separation of back-office functions to try to prevent the kind of things that Bernie Madoff did. Now no separation is foolproof, but it is a meaningful and effective risk mitigation. There is significant regulatory oversight, and there are objective measures of performance.

PERE: *What questions are investors asking their fund managers about their back-office functions? What do the investors want to hear?*

La Salla: Investors want to know what fund managers control. They want to know what is managed inside and what is managed outside. They want to know who is managing what, and how they – the investors – are being protected. What they want to hear is that there is separation, that there are checks and balances that they can see and evaluate for themselves.

PERE: *Are there any regulatory requirements that might act as an impediment to outsourcing?*

La Salla: There hasn't been an instance where regulatory requirements have impeded a manager to outsource any function to a provider. Chief executives or chief financial officers have to sign-off on documents and disclosures all of the time, as well as conduct independent checks. However, we haven't come across a situation where a fund manager cannot outsource a function to a service provider because of any regulatory requirement. Even statements, because there are audits and independent checks, the C-suite has confidence signing off on these documents.

PERE: *How does the size of a fund manager affect whether or not they are likely to outsource their fund administration?*

La Salla: The size of the fund in either of those terms is not as important as a few other factors. One is the type of fund. If it is one that needs to strike a net asset value daily, and is also a small fund, the economics for outsourcing might not work because the cost of processing is higher, relative to the value of the fund. In those cases, the managers may want to decide to keep things in-house.

At the other end of the spectrum, for a very large fund, that only has to strike a NAV quarterly, the economics are cheaper. But then complexity can be a factor. The more complex the fund, the more they may want to outsource.

Flanagan: RE behind the outsourcing curve

PERE: *What roles do advances in technology play in a real estate fund manager's desire to outsource its fund administration?*

La Salla: This is another case of where the demands of the investor is driving everything else. Investors are looking for a digital experience. This includes private equity, real estate and virtually all other asset classes. Investors want self-service. They want access to the reports and analyses that they need and they want to get them in the format they want, and when they want it. That is why we have committed to delivering our new portal, NEXEN^{SM}. portal. NEXEN provides access to everything a manager and investor needs from one application. We expect to roll NEXEN out to our clients by the end of 2015 or early in 2016.

Flanagan: We believe our investments in global technology platforms, coupled with our global operating model allow large global asset managers to benefit from a consistent approach to administration and reporting. □

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Chief executive, global structured products/ alternative investment services
Recently appointed to this newly created post, La Salla is responsible for overseeing and developing BNY Mellon's global product suite of funds, including exchange traded funds, unit investment trusts (ETFs and UITS), and alternative investment services. La Salla is a member of BNY Mellon's Operating Committee.

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Flanagan is responsible for overseeing global business and driving growth at the new unit within AIS. Flanagan serves on a number of executive committees at BNY Mellon, including its European operating committee, Asset Servicing global business risk committee, and is a director of BNY Mellon Trust Company.

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