



**PRIVATE EQUITY
INTERNATIONAL**

INSIDE THE FUND MANAGEMENT FIRM

How to build and deliver operational excellence

Edited by
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	<i>Iain Bannatyne, Partner and Global Head of Private Equity Funds Audit, KPMG</i>	
	<i>Jonathan Martin, Professional Standards Committee, Invest Europe, and partner, KPMG</i>	
	<i>Deirdre Davies, Partner & Chief Operating Officer, Glendower Capital</i>	
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About the editor

Karen Sands is a partner and the finance director of Hermes GPE with overall responsibility for the financial oversight of corporate and fund finance, the financial control environment, systems and operations. Karen joined Hermes Private Equity in 2004. She previously worked in finance at Matrix Property Management and began her career at Equity Asset Management. Karen is a member of the Chartered Institute of Management Accountants and a Chartered Member of the Chartered Institute for Securities and Investment. She is a member of the Hermes GPE Management Committee and the Pensions Governance Group. In 2016 Karen was appointed as a member of the Invest Europe Working Group on Accounting Standards, Valuation and Reporting.

About Hermes GPE

Hermes GPE is a leading specialist investor in global private markets with a track record that spans over 25 years and manages £8 billion of capital for leading global pension funds and institutional investors. Hermes GPE acts as an investment manager and advisor, specialising in developing bespoke and diversified portfolios for clients that provide access to global private markets via investments in buyouts, growth equity, infrastructure and renewables. The platform comprises two distinct businesses, one investing in private equity and the other in infrastructure. On behalf of its clients, investments are made both via funds and by direct/co-investments, with the aim of offering clients the best and most relevant investment opportunities that match their risk/return criteria. Hermes GPE has a strong commitment to responsible investment to improve investment performance and is a signatory to the UN's Principles of Responsible Investment (PRI). Both the private equity and infrastructure businesses achieved A*/A gradings in the firm's PRI 2017 Assessment Report.

Foreword

By Jonathan Martin, Invest Europe and KPMG

Private equity has been seeding, growing, developing and maturing businesses for over 40 years. The sector is all about delivering excellence in the management of other companies, but what about the performance and management of the private equity firm itself?

In many ways, private equity is a cottage industry. It has grown from spinouts of large institutions and inspirational entrepreneurs set up on a small, some might say at times threadbare, footprint. A private equity firm manages dozens of businesses and multi-million- and billion-dollar funds, but often with less employees than the marketing department of a retail portfolio company or the research and development (R&D) function of a manufacturing portfolio company.

In the 1990s, when regulation was light, if even relevant, where public scrutiny was non-existent, and where political and stakeholder oversight was sparse, it was possible for private fund management companies to thrive. Since the global financial crisis, however, there has been an exponential increase in regulation and scrutiny of the industry. The landscape in which private equity operates has changed drastically due to, among others, the Alternative Investment Fund Managers Directive (AIFMD), Invest Europe Reporting Guidelines, IPEV Valuation Guidelines, the Institutional Limited Partners Association (ILPA) and, in the UK, the Walker Guidelines for significant portfolio companies. Add to this the advent of the EU's MiFID II and Solvency II, and you have an increase in reporting and governance that would put pressure on even the largest of organisations.

Operational excellence is a term not often heard or discussed at industry conferences and seminars, yet it is critical to the effective management of every business, including the private equity house and its ever more complex structures. Often the core tenets that are deployed to such levels of success in portfolio companies are rarely, if ever, deployed within private equity firms themselves. A classic example perhaps of not practising what they preach!

Even more surprising is the lack of guidance and thought leadership from the industry in this area. There are countless guides covering specific areas of operational excellence - regulatory management, cyber risks and valuation, to name a few examples - but rarely together in one manual or location. This book looks to set that record straight and to turn the tide. The weight of change in the private equity sector, of regulation from governments and supranational bodies, the pressure from investors looking for ever greater returns and competitive angles, along with the increasing demands of the complex businesses and business models that private equity invests in

Inside the fund management firm

will continue to increase. There has never been a better time to help manage the pressures these changes create for the private equity house, and to ensure that the industry, and not only the portfolio companies it manages, continue to survive and thrive.

If private equity is to continue to drive greater returns to ensure continued investment in the sector against an ever more increasing level of competition from other asset classes, then developing and excelling internally is a must.

Critical to the deployment of outstanding operations is commitment and buy-in from all. That means embedding the operational excellence culture throughout the organisation: from the senior partner/CEO down to the junior members of the investment team and junior staff working in the back office. Driving the right culture ensures that everyone sees operational excellence as part of their responsibility to continue to observe, suggest and improve the business, to focus not just on the businesses that are invested in but in their own business as well. This does not mean adding complexity and bureaucracy where it is not needed, but it does mean creating a framework that ensures there are the right checks and balances in place. A framework where if one member of the team is absent there are others that can pick up the role, and where everyone understands the requirements of the different parts of the business, even if they themselves do not operate in that area. In simple terms, this means driving a culture that values the back office and the work that is done at the very core of the private equity house.

This does not mean creating roles or functions where they are not needed, nor requiring there to be multiple people trained to do any one role. As with all businesses, there should be a pragmatic approach to delivering operational excellence in private equity firms, not a one-size-fits-all model. It is about creating appropriate checks and balances, and ensuring that as the businesses invested in change and the funds managed diversify, whether by geography or type, the private equity firm changes and adapts appropriately too. To drive greater returns, to deliver more robust businesses and to help continue to grow the economies in which we operate, private equity firms also must learn to change and excel internally.

This book offers guidance on all the key risks and challenges currently facing the sector from legislation, talent development and risk management through to cyber security and data-related regulation. It covers the current issues facing the industry, how the market has changed and is changing, and provides thoughts and practical guidance on how to adapt to change. It is not a replacement for entrepreneurialism, for spotting and investing in the winners of the future, but it will help facilitate that approach and further those aims.

Jonathan Martin has been a member of Invest Europe's Professional Standards Committee since 2011 and chairs the Reporting and Valuation Committee. In this role he is responsible for leading the development of professional standards to the European private equity community and chaired the redrafting of Invest Europe's Investor Reporting Guidelines for the 2015 and 2018 versions. He is also a member of KPMG's private equity audit leadership team where he leads the audit of private equity funds and their management companies, and also heads the private equity regulatory group.

Introduction

Welcome to this brand-new book opening the door to the private fund management company. Private equity has for a long time been exactly that - private. As such, there has been to date very little guidance or published research in one accessible volume to act as a reference guide when trying to answer the critical questions around what operational excellence - a theme now front and centre of the value-add discussion across all alternative asset classes - looks like in practice.

What happens when you take on a new appointment at a private equity firm (the general partner or 'GP') in a function that is underperforming or you join a start-up and are looking to establish from scratch pretty much every business function other than investment? When the GP is about to launch its third or fourth fund, how can scalability be ensured while maintaining operational efficiency and effectiveness in a collaborative environment between different functions? What governance and committees are required within a GP? How can support systems be future proofed? How do you get all functions within the GP working together to meet the greater goal?

**Defining
operational
excellence?**

Operational excellence is in my view the output of delivering internal and external stakeholder objectives by efficient, effective and fit-for-purpose systems, processes and people - a culture set from the top. It has been described by one contributor to this book as the "oil that makes the private equity system work" and more is required as the engine gets bigger with increased transparency, regulation, political pressure and diversification, not to mention competition.

**Why it's
important now?**

The financial crisis of 2007-2008 gave rise to increased regulation and the demand for greater transparency from GPs. Consequently, this led to a change in reporting to LPs and the development of organisations such as ILPA. These themes are often key agenda items at CFO and COO conferences. However, there is one topic that is often bypassed - that is the internal one of the GP. Operational excellence is an important and significant triangulation in meeting GP, limited partner (LP) and regulatory pressures. Operational excellence is always implicit within private equity but rarely explicitly discussed. This book attempts to redress this.

We are fortunate to have a group of highly talented professionals - fund managers, service providers, operations and compliance experts, and lawyers - sharing their insight and experiences with you on all these issues.

In **chapter 1**, Sam Kay of Travers Smith takes a look at how regulatory and compliance requirements are impacting the infrastructure of private funds. ESG and sustainability

are now firmly part of the operational excellence equation so in **chapter 2** PRI's Natasha Buckley sets out key steps for integrating these issues into firm and investment processes, and how best to articulate these practices during fundraising and anticipate LP expectations.

Blue Wolf Capital Partners' Dana Halasz recounts her own firm's operational growth in **chapter 3**, highlighting the challenges and risks encountered along the way and how the team successfully worked through them. In **chapter 4**, Charlie Hunt of search firm PER passes on his expert knowledge of how to run an efficient search and recruitment process for top operations staff, and critically advice on retaining them once hired. In **chapter 5**, Cindy Ma and Milko Pavlov of Houlihan Lokey argue that a well-executed valuation framework plays an integral role in minimising risk and explains how to design and execute one.

Data protection and cybersecurity are big issues for private funds. In **chapter 6**, Toby Duthie and Jimmy Ko of Forensic Risk Alliance highlight some of the key international data protection laws that firms must navigate, and they look at the implications of the forthcoming EU General Data Protection Regulation (GDPR). In **chapter 7**, The Riverside Company's chief information officer Eric Feldman explores strategies for protecting private fund management companies against cyber attacks, including practical guidance on building cyber awareness throughout the organisation. Jason Scharfman of Corgentum Consulting presents best practice considerations for GPs when assessing their operational risks in **chapter 8**.

With compliance pressures ramping up every passing year and technology and big data requiring a new set of skills, it is not surprising that some firms prefer to outsource some business functions to third-party service providers, so in **chapter 9** Alan Dundon of Alter Domus sets out his thoughts on how to do this intelligently. Dundon addresses how to select the right outsourcing model, find the right partner, and work with and supervise them.

LPs expect their GP to demonstrate high-quality operations; it is no longer a nice to have. In **chapter 10**, Goodwin's Ed Hall looks at the factors that are facilitating this and discusses what their expectations are both pre- and post-investment, while in **chapter 11**, LP Analyst's Katita Palamar and Bill Farrell list the processes, information and documents LPs analyse for evidence of operational best practice.

Finally, back in January, we brought top-level practitioners round a table to provide their thoughts on how to build and deliver operational excellence, and their own experiences of the challenges involved. You can read this insightful discussion in **chapter 12**.

All that remains is for me to thank everyone involved in this book: to the publishers, PEI, for giving me the channel to get this critical topic to market; to PEI's managing editor, Helen Lewer, for helping to shape the content and offer editorial support throughout; and of course, to the authors. It is a big undertaking writing a 10-page chapter while doing day jobs. I'm grateful to you all for giving your time.

Introduction

And to the reader; I hope you find the content compelling, insightful and, importantly, usable in your own organisations.

Karen Sands

March 2018