Opportunities in the Growth of Private Equity

Recent regulatory changes and market headwinds have brought private equity players into the spotlight. This article focuses on some related opportunities for third-party service providers.

Executive Summary

The 2008 crisis shook up the global capital markets. Recovery responses have been varied but a common underlying theme has been that of regulation. The comparatively less regulated private equity capital markets have been no exception. Given the growing trend of more money being raised in private capital than via public capital (i.e., IPOs), regulators’ purview over private equity markets will only increase. As a result, the role of the private equity fund administrator too will grow and become more important.

As administrators look at ways to become more efficient, IT-BPS players have the opportunity to help them. This paper reviews the impact of regulation on the private equity industry and outlines the trends that are likely to emerge.

Private Equity

As the name indicates, private equity (PE) is a class of equity that is not publicly traded. It is among the many sources of capital available to a company. In 2011, approximately $160 billion¹ was raised in IPO capital globally. During the same period, PE players raised approximately $263 billion.² PE firms, described till recently as channels for alternative investments, today manage approximately $3 trillion³ in assets. This is roughly equivalent to the total valuation of all the companies listed on the FTSE. The industry is clearly becoming a “core” investment theme.

Recent Developments

Some recent events have shone the spotlight on the PE industry. As a result it has seen a host of regulatory changes. Mitt Romney (former CEO of Bain Capital, a leading PE firm), the Republican candidate for the 2012 U.S. presidential election, is not the only connection that PE firms have with Capitol Hill. Here are some others:

Dodd-Frank Act (U.S., Dodd-Frank Wall Street Reform and Consumer Protection Act, 2010)

This act aims to keep a closer watch on banks, protect consumers and create contingency plans in case big banks fail. The Volcker Rule (which is a key element of this act), which came into effect in July 2012, prohibits a banking entity from sponsoring or investing in PE funds or hedge funds and requires them to reduce their holdings in such funds to a maximum of 3% of their Tier 1 capital by July 2014. The act will review the situation in 2014 and allows up to three one-year extensions for this deadline and another five-year extension. Compliance with this guideline will therefore be mandatory at least by 2022.
Additionally, a private-fund reporting form — Form PF — has been introduced starting in 2012. It requires PE funds to start filing their statements quarterly or annually, depending on the size of the fund. It seeks to collect industry information and identify any inherent risks. The filings are complex and require several data points (Form PF is over 40 pages long).

**FATCA (U.S., Foreign Accounts Tax Compliance Act, 2010)**

This act requires foreign firms to disclose details of all U.S. investors to the U.S. tax authorities. Noncompliance will result in the imposition of a 30% withholding tax from 2013 onwards on some of the firms’ U.S.-related transactions. Additionally, it prohibits U.S. funds from making payments to non-U.S. entities that refuse to comply with the directive. The main intent here is to get firms to share details about investors with the U.S. tax authorities. It is expected to add significantly to PE firms’ administrative tasks.


Beginning in 2013, when the directive is expected to be institutionalized across all member states, it will stipulate various rules and regulations around marketing, acquisitions, distributions, capital requirements, remuneration policies, reporting, depository and other guidelines. A major change is the need for PE firms to register their private placement memorandum (PPM) with the local regulators and obtain their approval before they begin their EU marketing activities. Substantial costs and administrative efforts will be involved in implementing these changes.

**Private Goes Public**

A recent trend among PE players is to get their funds or firms listed on stock exchanges. It is catching the fancy of many fund managers (e.g., Blackstone, KKR, Carlyle, etc.). Once a PE firm is listed, there is an increase in its reporting, administration and compliance costs. Additionally, there is increased public scrutiny of firm expenses including accounting, reporting and fund administration expenses. The increase in costs combined with the additional public scrutiny will force PE firms, which until now could afford to maintain an in-house fund administration team, to look at engaging a third-party service provider to save on costs.

**Basel III Capital Requirements**

To adhere to Basel III requirements, banks will need to shore up their capital. By 2015, banks will need to have common equity equivalent to at least 4.5% (currently 2%) of their risk weighted assets (RWA). Additionally, they will need Tier I capital to be 6% of their RWA (at 4% currently). The total capital requirement remains the same, at 8%, till 2015. Subsequently, by 2019 banks will require additional Tier I equity under a new head of “capital conservation buffer” at 2.5% of RWA. This takes the total capital to at least 10.5% of RWA in 2019 from the 8% in 2015. Banks will need to raise additional capital or alternatively they may shrink their noncore RWA exposures. If PE is considered noncore for a bank, then divesting their PE business will be an option.

**Implications for the Industry**

We believe that the events and trends mentioned above may result in the following changes in the industry:

**Banks Can Consider Exiting Private Equity**

Due to the recent regulatory developments, shareholders and management may begin to question banks over their continued operations in PE. Over the next few years, banks may pare down their PE exposure and some might exit PE altogether. This will help them adhere to the new regulatory guidelines and also shore up their capital base. A recent decision by Credit Suisse to pare its PE business could herald a trend. In a recent interview, Citigroup’s former CEO, Sandy Weil, called for a breakup of banking conglomerates that run a broad range of services into more risk-averse and conservative banking entities. This is in line with the growing chorus from politicians, regulators, investors and other stakeholders.

**Increased Consolidation — Big Players Will Grow Bigger**

As a corollary, there will be increased consolidation in the PE industry, with banks possibly divesting their PE divisions to pure-play PE players such as Blackstone, KKR, Carlyle, Apollo, etc. or to hedge funds. Even with 4,500 active PE players in the market today, over 80% of new capital (measured in U.S. dollars) is still being raised by existing general partners. Therefore, we assume that the PE business will continue to be concentrated with the large players; only a few new players will enter the market for fund-raising.
There will be increased focus on fund administrators and on outsourcing of fund administration activities. FAs will be depended upon to guide their clients through the new regulations. Recent trends such as public listing of PE firms will result in additional scrutiny of cost-effectiveness. This will lead PE players to reexamine the need to maintain in-house fund accountants versus outsourcing them. Investor preference for independent fund administrators may also drive a change in the existing mind-set. This may lead PE firms to consider outsourcing their fund administration activities to third parties.

Role and Opportunities for IT-BPS Players

Due to the reasons outlined above, there will be an increasing trend of moving to a third-party fund administrator. Fund managers will keep an eye on costs and, as a result, FAs will need to provide this service to the PE funds cost-effectively and efficiently. This is where IT-BPS players can help. In general, these services can be further sub-sourced from the third-party fund administrator to the IT-BPS player. Most IT-BPS players operate from cost-effective destinations. As Figure 1 indicates, a majority of fund administrators have not yet explored India as a service destination.

Partnering with FAs or helping them set up low-cost centers can be done through staff augmentation or other models. IT-BPS players can be the “flexi” model while the FAs can be the “core” piece of this operating model.

IT-BPS players in general have very effective IT teams and the FAs can leverage these skills. IT can be a significant multiplier in making work processes efficient. An IT macro is more easily discussed and understood in an environment of an IT-BPS operations team than in the environment of accountants in an FA's team.

Alliances and collaboration will be important too. There are product companies that develop the accounting software but are not into fund services and then there are fund administrators/service companies that use these software products but are not into IT development of these products. An IT-BPS company can be the go-between that explores an alliance with a reputed product company (e.g., Sungard) while trying to sub-outsource the work of an FA. Where an FA does not have the inclination to change its accounting software, the IT-BPS company can be a vanilla sub-outsourcer. However, where it can recommend an IT product, it may choose from the alliance partner's suite of products.

While these measures might take time and may not always be successful, IT-BPS players can also evaluate inorganic growth options if they are convinced about the potential of this space. Suitably combining all or some of these measures and making a first move will be a smart play. Who'll be the players? Time will tell.

<table>
<thead>
<tr>
<th>Rank</th>
<th>Provider</th>
<th>Do They Have a PE Admin Back Office in India?</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Augentis</td>
<td>No</td>
</tr>
<tr>
<td>2</td>
<td>BNY Mellom</td>
<td>No</td>
</tr>
<tr>
<td>3</td>
<td>CACEIS Investor Services</td>
<td>No</td>
</tr>
<tr>
<td>4</td>
<td>Citco Fund Services</td>
<td>No</td>
</tr>
<tr>
<td>5</td>
<td>Citi Private Equity Services</td>
<td>No</td>
</tr>
<tr>
<td>6</td>
<td>Deutsche Bank</td>
<td>Yes</td>
</tr>
<tr>
<td>7</td>
<td>J.P. Morgan</td>
<td>Yes</td>
</tr>
<tr>
<td>8</td>
<td>SS&amp;C PEI (Private Equity Industry) Solutions</td>
<td>Yes (Tie up with GlobeOp)</td>
</tr>
<tr>
<td>9</td>
<td>State Street Alternative Investment Solutions</td>
<td>Yes (With vendors/in-house)</td>
</tr>
</tbody>
</table>

Source: (Top nine PE administration players ranked by 213 respondents, 2011 survey)
About Cognizant

Cognizant (NASDAQ: CTSH) is a leading provider of information technology, consulting, and business process outsourcing services, dedicated to helping the world's leading companies build stronger businesses. Headquartered in Teaneck, New Jersey (U.S.), Cognizant combines a passion for client satisfaction, technology innovation, deep industry and business process expertise, and a global, collaborative workforce that embodies the future of work. With over 50 delivery centers worldwide and approximately 145,200 employees as of June 30, 2012, Cognizant is a member of the NASDAQ-100, the S&P 500, the Forbes Global 2000, and the Fortune 500 and is ranked among the top performing and fastest growing companies in the world. Visit us online at www.cognizant.com or follow us on Twitter: Cognizant.

About the Author

Sharad Sharma is an Associate Director within Cognizant's BFS vertical. He has over 13 years of experience in financial services, spanning auditing, budgeting, planning and control, asset management servicing, hedge funds reporting, etc. Prior to joining Cognizant in 2007, he worked with Capgemini and HP. He handles fund accounting and administration for the illiquid investments of a leading asset manager. He has an M.B.A. from the Indian School of Business and is a qualified chartered accountant. He can be reached at Sharad.Sharma@cognizant.com.