



MEMBERS' CONFERENCE BOSTON

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Operational Due Diligence: Tips for LPs

Christopher Slavin, Partner and Head of
Private Markets Operational Due Diligence,
Albourne Partners

Learning Objectives and Focus of the Workshop

- Describe the value proposition of third party administration vs. self administration, identify service providers with an appropriate level of PE experience and discuss trends seen in the utilization of third-party administrators
- Identify whether or not a GP has the administrative and technical ability to implement the provisions of the waterfall per the LPA, based on a better understanding of the complexities of the partnership accounting and waterfall calculations
- Explain the level of work auditors are doing on carried interest distributions, discuss non-generally accepted reporting standards and scope out the concept of “LPA audits”
- Discuss techniques for investor to incorporate fair valuation reviews into their due diligence and provide observations over valuation agent usage
- Describe common remuneration practices for operating partners, identify best practices on the treatment of fees associated with captive operating partners and LP reporting and disclosure considerations

Private Equity ODD Risk Overview

Risk Identification

Private Market strategies have unique operational risks and issues of conflict. While these issues have only started to garner industry-wide attention recently, Albourne has been helping educate investors on these risks for years. While many Private Market funds have certain inherent operational risks to consider, including a lack of independence in the administration of books and records and fair valuation determination, many of the key operating risks are idiosyncratic to specific strategies:

Strategy	ODD Risk Focus
Buy Out	The financial press has recently been informing both investors and the general public on many of the unique operational risks inherent with many buy out managers / funds: including, issues in charging expenses, the structure of additional fee arrangements and conflicts of interest introduced through diversified business lines
Turnaround	Many turnaround managers have either captive or affiliated consulting businesses. The salaries and expenses of these employees can either be expensed to the management company or the fund. In the latter scenario, investors must understand i) the arms length nature of the arrangements and ii) the level of reporting and management provisions around the conflicts presented in these arrangements
Direct Lending	Investing in originated loans introduces unique tax consequences for LPs, especially for those that are tax exempt. The traditional tax planning structures to address these risks have recently fallen under scrutiny by the tax authorities, so investors need to understand how managers are meeting the requirements of a new environment
Venture Capital	While venture investing is inherently more risky than other private market strategies, it also introduces more operational risks. Venture managers often have small teams, limiting the ability to apply appropriate segregation of duties in tasks such as cash management, deal funding and fair valuation, the confluence of which can produce opportunities for fraud
Real Estate and Real Assets	With physical assets, management needs to demonstrate its controls over cash and the oversight and influence it has on the operations of asset level servicing counterparty. While with real estate lending, unique operational risks are introduced through the activities of loan servicers, who can sometimes be affiliates – introducing unique conflicts

Private Equity Fund Administration

Value Proposition – Third Party

- Independent determination of carried interest and management fees, but not valuation
 - Carried interest and management fees are two primary sources of income to the GP. While the payment of carried interest can naturally enhance the alignment of interest between LPs & GP, there may be an incentive for the GP to apply the calculation in a way that increases its take. An administrator provides an independent determination on the economic terms of the waterfall and its “grey areas” (e.g. the timing of the preferred return)
 - Management fee calculations are more complicated than they seem. An administrator who independently calculates the management fee, must do so by verifying the total “transaction fees” earned by the fund and are eligible for offset. In doing so, LPs can gain assurance over the **completeness** of offsets and the accuracy of management fees payable
- Oversight of the expenses being charged to the fund
 - The administrator can be responsible for ensuring that fees charged to the fund are in accordance with the governing documents. The more prescriptive the LPA, the better enabled the administrator should be in testing the appropriateness of expenses being charged
 - As a by-product of the SEC’s focus on PE, LPA disclosures over fund expenses have become more and more detailed
 - Trend of passing more expenses onto the fund, in the form of information technology, compliance and internal administration expenses

Private Equity Fund Administration

Value Proposition – 3rd Party

■ Advanced Technology

- An administrator should be utilizing appropriate partnership accounting technology. This helps create a better control environment than many GPs, who can often be understaffed and performing the majority of accounting and reporting in Excel. A partnership accounting system can:
 - Automate accounting processes, including waterfall and management fee calculations
 - Apply pre-populated templates for recurring accounting events
 - Manage reporting data to create quarterly packages, annual reports and ad hoc requests
 - Produce financial and capital account statements
- Top administrators tend to have the control environment around their maintenance of fund records and LP capital accounts reviewed and attested to annually (e.g. SOC I reporting). LPs should review the SOC I reports of the administrators to their accounts, focusing on the results from the test of controls

■ Data Security

- LP banking and other sensitive data maintained by an administrator will often be more secure than if maintained by the GP. Top administrators will maintain LP data in systems behind advanced cybersecurity measures. Investor statements tend to be distributed through online and secure platforms

Private Equity Fund Administration

Value Proposition – Third Party

- Processing of capital call / distribution
 - With the use of advanced technology, allocations will be calculated in a controlled environment and less apt to error
 - With fewer dedicated staff and less use of technology, GP processes can lead to mistakes in wire details, mailing information, email details etc.
 - Administrators should have the technical ability to process call and distribution notices in accordance with ILPA standards

- Oversight of cash accounts, assets and fund flows
 - As the private equity and real estate industries become more regulated, there is an increasing need for managers to consider the use of Custodian / Depositary Services. Different levels of services are required in different jurisdictions:
 - U.S. – administrators can act as Qualified Custodians to clients under the Dodd-Frank Wall Street Reform and Consumer Protection Act. Assets can be maintained in safe-keeping on behalf of clients, and Custody Statements produced in accordance with the regulations
 - EU / AIFMD – EU AIFMs managing EU AIFs with aggregate AUM over €500m (£430m) in unleveraged funds, or €100 in leveraged funds, need to appoint a depositary. Depositary responsible for cashflow monitoring, overview of cash flows, cash and capital reconciliations

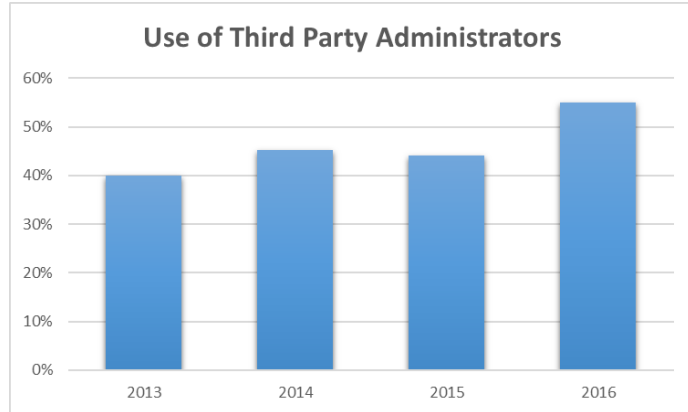
Private Equity Fund Administration

Value Proposition – Self-Administration

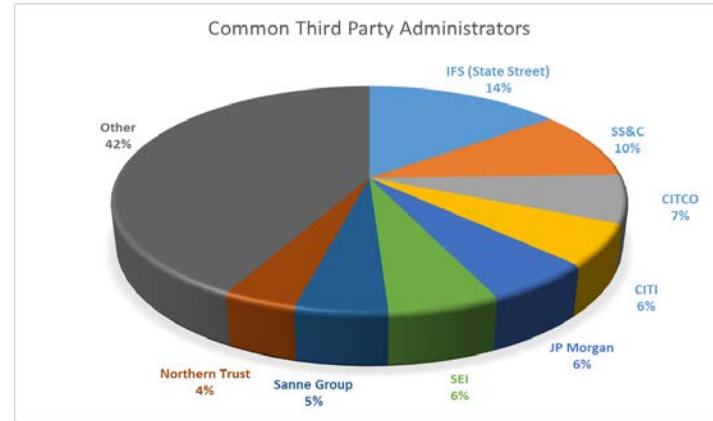
- Better service level for LPs, due to a stronger level of knowledge over the investments and fund operations
- Continuity of service level due to lower levels of turnover
- Bespoke reporting capabilities
- Faster response rate to LP inquiries and requests
- Lower cost
- GPs tend to retain the higher risk and more complex administrative tasks anyways (e.g. waterfall calculations, deal structuring)

Trends in PE Fund Administration

- The use of PE administrators increased in the years following the global financial crisis as investor demand for greater fund transparency and regulatory obligations increased the complexity of reporting requirements for fund managers
- Historical inverse relationship between size / complexity and the use of third party administrators showing signs of reversing. Certain large and complex managers, who typically would self-administer, have adopted third party administrators
- Consolidation continues to be a theme within the fund administration industry. Examples of large acquisitions in 2016 include MUFG Investor Services' acquisition of Capital Analytics, Neuberger Berman's fund services arm, and SS&C's acquisition of Wells Fargo Global Fund Services. Still, market share is widely disbursed



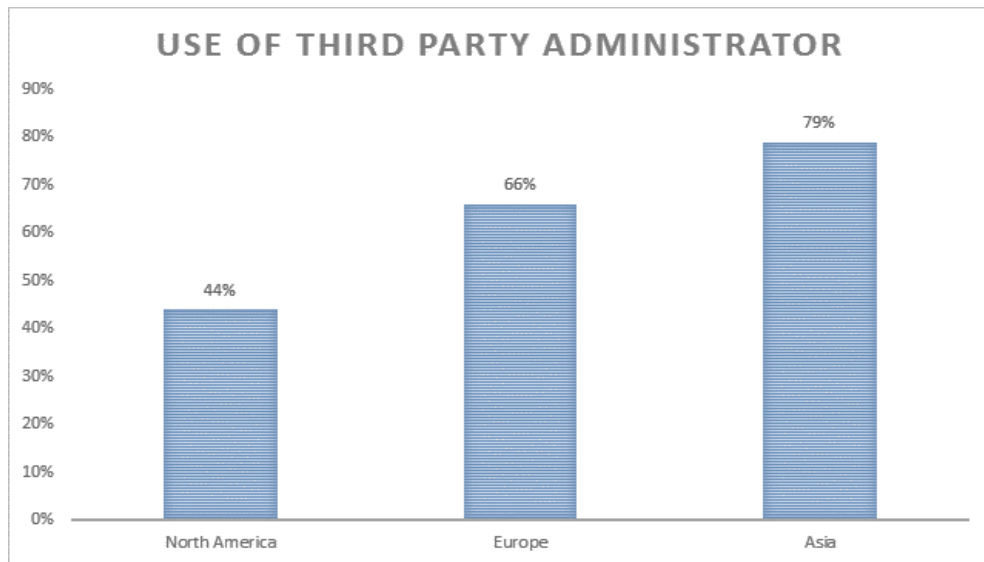
Data based on Albourne's review of 208 Private market Funds; including, PE, RA and RE strategies



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Trends in PE Fund Administration

- Distinct trends in the use of third party administrators based on the geographical location of the GP:



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Waterfall Calculations & Partnership Accounting

- Carried interest, the proportion of a fund's profits received by the fund manager, is determined by running the profits of a fund through a “distribution waterfall,” which refers to the priority of distributions returned to the LPs and the GP
- The calculation of carried interest is complex and investors often do not track the amount of carried interest accrued and paid
- Issues to be aware of when assessing the carried interest waterfall:
 - Is the preferred return calculated and accrued on all capital contributions made by the LP or only on those attributable to investments?
 - Does the “clock” on the preferred return start at the time of contribution, or at the time of funding an investment?
 - In the event that bridge financing is being used in lieu of calling capital, what implications does this have on the LPs preferred return, and consequently the carried interest being paid to the GP?
 - Does the waterfall include a return of expenses, and if so is it a full return up-front or an allocation of expenses on a deal-by-deal basis?
 - Treatment of “written-off” vs. “written-down” investments

Waterfall Types

■ Deal-by-Deal Waterfall

- LP receives all capital contributions (including fees and expenses) associated with the investment being sold and the preferred return (generally on realized and written off investments) before the GP can participate in carried interest
- GP friendly distribution which creates the risk of clawback, which is invariably after tax. This risk is somewhat addressed by escrow requirements and modifications to the traditional approach (e.g. overdistribution to LPs until a certain NAV threshold is reached)

■ “Enhanced” Deal-by-Deal Waterfall terms

- Treatment of written-off and written-down Investments – inclusion of write-downs, not just write-off
- Return of Expenses – full return of expenses before profit distributions, rather than allocation of expenses
- Catch-Up – delay of carried interest payments through a 50% / 80% catch-up
- Portfolio Value Test – in order for the GP to receive carried interest, the NAV of the Fund (on a fair value basis) needs to exceed the unrealized capital base by 25%
- Overdistribution Model – accelerated distribution approach where LPs receive 50% of the carried interest distribution up to their minimum return requirement
- Interim Clawback – at certain periods of the fund life (e.g. y6, y8, end of life), theoretical liquidation

Waterfall Types

■ Whole Fund “European” Waterfall

- GP does not receive any carried interest until all capital contributions, for both realized and unrealized investment, plus the full preferred return on aggregate capital contributions are returned to LPs
- Full return of expenses before GP carry, whereas deal-by-deal generally allocated as such
- LP friendly distribution model that minimizes the risk of clawback

Whole Fund Distribution Waterfall Illustration

Assumptions:

Five Investments made during investment period (total cost \$90m)

Sale of first investment (cost \$20m) in year 3 and sale of second investment (cost \$20m) year 4

Cummulative Fees and expenses as of year 3: \$5m and year 4: \$10m

Preferred Return as at year 4: \$4m

	Year 1		Year 2		Year 3		Year 4	
Sales Proceeds	-		-		\$50m		\$65m	
Cummulative capital contributions	-		-		\$95m		\$100m	
	LP	GP	LP	GP	LP	GP	LP	GP
Step 1 Return of Cost	-	-	-	-	\$50m	-	\$50m	-
Step 2 Preferred Return to LPs	-	-	-	-	-	-	\$4m	0
Step 3 Catch Up to GP	-	-	-	-	-	-	-	\$1m
Subtotal: Net Gains Distributed							\$10m	
Step 4 80/20 Residual							\$8m	\$2m
Total Distribution							\$112m	\$3m

Key Considerations in ODD Review

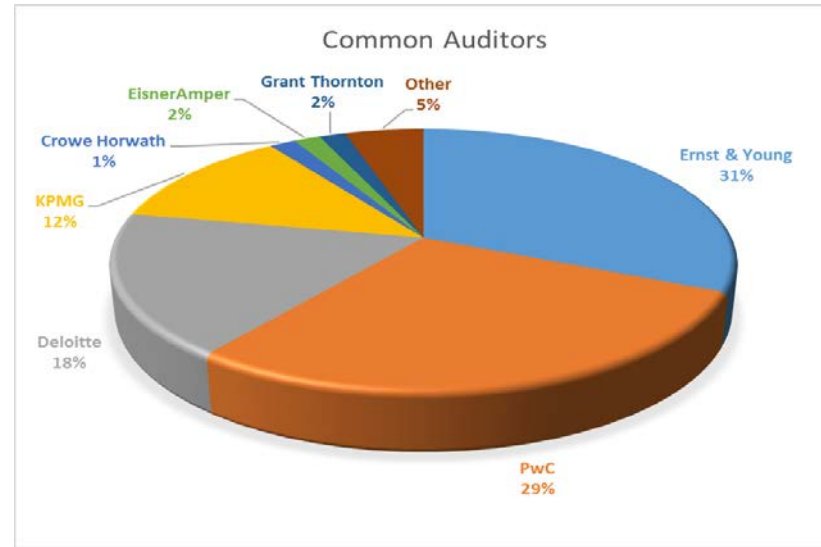
- Is the waterfall being calculated in Excel or within a partnership allocation system?
- Does the GP have the administrative and technical ability to implement the provisions of the waterfall?
- Is the waterfall, as defined in the LPA, clear on: the treatment of fees and expenses; the treatment of current income vs. invested capital; the calculation of the preferred return?
- Dividend Recap treated as return of capital or current income?
- Are distributions “in kind” limited to marketable securities?

Private Equity Audits

- Auditors play an important role in helping to ensure trust between the LPs and the GPs managing their investments, by providing an independent third party review of fund accounts, ensuring that assets are fairly valued and that disclosures are appropriate and complete

Typical Scope of PE Fund Audit

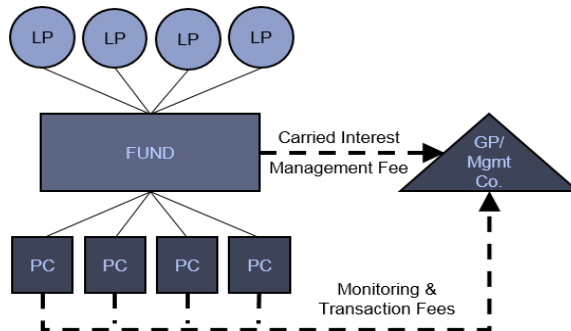
- Materiality typically set at 3-10% of NAV (closer to 1-3% of NAV on open ended funds); high, to allow for subjectivity in pricing difference
- “Risk based audits” allow for significant variability in audit procedures
- Focus of testing tends to be on inter-company and related party expenses; less testing on third party expenses
- Reliance on “Manager Representations” for certain aspects of the audit; notably, transaction fee offsets and compliance with the LPA
- Third party existence testing limited; reliance on original transaction documents and confirmation from controlled entities
- Designed to report on the financial position of the fund “as a whole”



Data based on Albourne's review of 208 Private market Funds; including, PE, RA and RE strategies

Key Considerations in ODD Review (Audit)

- What is the level of work being performed by the auditor on the carried interest and profit allocations?
 - The primary focus of testing during the audit is over the allocation of carried interest to the GP, but profit allocations and distributions to LPs are tested on a “sample basis”
 - Preference should be for Capital Account audit opinions, necessarily lowering the testing threshold of the audit and thereby providing more comfort over the accuracy of an LPs capital account
 - In deal-by-deal structures, best practice would dictate auditor testing, as agreed to through an agreed upon procedure engagement (“AUP”), over all carried interest and distribution calculations before money leaves the door
- What is the level of work being performed on the management fees?
 - As discussed earlier, the completeness and correct allocation of offsets is the key issue when assessing the correctness of management fees
 - If the auditor of the fund is not also auditing the management company, what work is being done on the revenue side of the transaction?



Key Considerations in ODD Review (Audit)

- Non-generally accepted accounting standards are sometimes difficult to identify, but invariably yield insufficient disclosures. Otherwise known as “LPA accounting standards”, the accounting techniques and level of disclosure is defined by the formation documents of the fund. The audit opinion will be based on these limited requirements.
- Preference should be for generally-accepted accounting and reporting standards (e.g. US GAAP, IFRS), as LPs can take comfort from the completeness of disclosures and the appropriate treatment of expenses, revenues etc.
- LPA accounting standards are still relatively common in Europe; however, the argument for applying them, namely the consolidated treatment of portfolio companies, is no longer valid.
- Observations seen in LPA accounting audited statements:
 - Insufficient disclosure of related party transactions
 - Lack of disclosure over valuation techniques
 - Financing at both the fund and deal level undisclosed, while backed by LP commitments

Regulatory and LPA Compliance Audits

- SEC reviews of GPs has intensified; however, disclosure over the nature and findings from interactions is not uniform
- An LPA Compliance Audit would promote greater transparency, addressing some of the concerns raised earlier, and help LPs gain comfort that the fund is being managed in accordance with the LPA
- LPs can promote certain measures to address these issues:
 1. Enhanced Disclosures Related to Fund Manager Regulatory Compliance: LPs should be attuned to regulatory and reporting obligations of their GPs, as well as the particular areas of sensitivities of the local regulators (FCA vs. SEC). GPs should be obliged to proactively inform LPs of meaningful interactions with regulators, including a full review of the scope and exit findings from regulatory audits (ideally by review of findings and response letters)
 2. Expanded Fund Audit Scope and Provision of More Detailed Audit Findings to LPACs: Financial audits are not designed to ensure compliance with the funds governing documents (e.g. consideration is not given to whether or not an expense is allowable), rather they are designed to ensure appropriate accounting standards are followed and assets, liabilities, revenues and expenses are verified. Better communication between the Auditor and LPs could be achieved through the LPAC acting in the capacity of “Audit Committee”, to borrow a public company concept
 3. Authorize LPACs to Engage Third Party LPA Compliance Review: Given the limitations of financial audits, third parties could be employed to conduct reviews of fund compliance to provide an impartial opinion on current fund policies and disclosures and to validate expense allocations and waterfall calculations

Fair Valuation - Risks

- Arguments are made that interim valuations are inconsequential, given that management fee is based on committed capital and carried interest on realized; however:
 - Valuations have gotten more attention because virtually all US-based private equity firms are registered with the SEC, and valuations are one of the agency's main areas of focus
 - Interim valuations are important for fund marketing and provide a picture of the health of a portfolio. Question: Have 2010 and 2012 Energy funds really beaten their public equity benchmarks?
 - The fact that there isn't one accepted valuation method always calls valuations into question
 - "Enhanced" deal-by-deal terms can include NAV triggers for the release of escrowed carried interest to GP
 - How do LPs get comfortable over the valuation ascribed to the remaining assets in "zombie funds"?

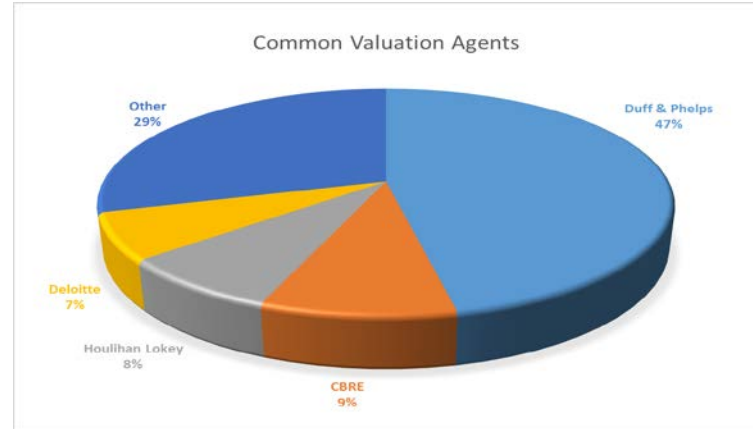
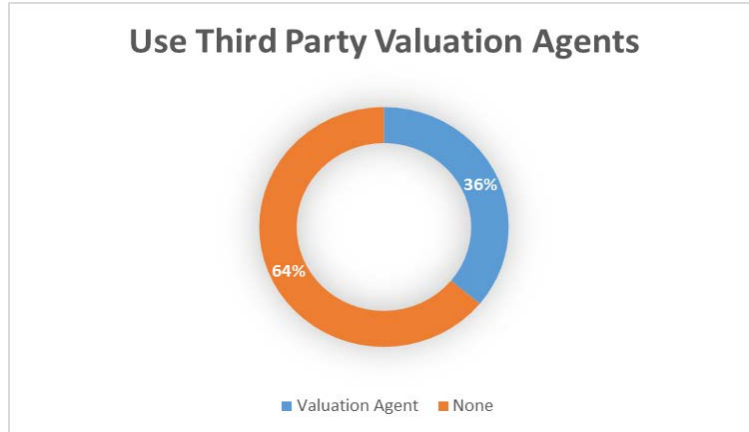
Fair Valuation Process & Review

FMV is a key determinant of performance in Private Equity

- The International Private Equity and Venture Capital Valuation (“IPEV”) guidelines set out best practice where private equity investment are reported at fair valuation to help investors make sound allocation and economic choices
- When reviewing a GP’s valuation processes, consider the following:
 - Is there appropriate independence in the valuation process?
 - What is the predominant valuation technique used (Market vs. Income)?
 - Opportunities for cherry-picking comps or adding back inappropriate items to EBITDA.
 - Changes in valuation methodology from period to period.
 - The results from backtesting recent exits.

Valuation Independence

- Valuation Agents are third parties that provide an independent assessment of the fair values ascribed by the Investment Manager. The service level provided is variable (negative vs. positive assurance) and their use is sporadic, but growing
- Valuation Agents can add a layer of independence and control to a GP's valuation process; however, at a cost
- The utilization of valuation agents may have greater value to LPs i) when clawback calculations are run and ii) late in a fund's life when a GP may be "holding onto" assets



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ILPA MEMBERS' CONFERENCE

Operating Partners

- “Operating Partners” are often dedicated to the GP, engaged and paid by portfolio companies for their efforts in consultation and the generation of value through operational improvements
 - Can be captive, often employed by a controlled affiliate, or technically independent
 - Generally, remuneration paid to Operating Partners is specifically carved out of the management fee offset provision
- LPs should consider the following when investing in funds managed by GPs with captive Operating Partners
 - What is the level of disclosure with regard to fees paid?
 - Is remuneration determined based on an arms length equivalent?
 - Generally, remuneration paid to Operating Partners is specifically carved out of the management fee offset provision.

Questions?



THANK YOU

Christopher Slavin

Partner and Head of Private Markets Operational Due
Diligence, Albourne Partners
e C.Slavin@albourne.com