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Tracking Transparency

Survey Results of Investment Deal Teams

By Daniel Piehler

> *Investing in private equity is not like investing in mutual funds, in which investors have no contact with the manager, and in which, with no vesting system, they can leave overnight. That is why the relationship is at the heart of private equity.*
>
> ***Dominique Peninon***
>
> ***Chairman & Managing Partner, Access Capital Partners Group SA***

Introduction

In the wake of the global financial crisis, the private equity industry has been slow to recover to its former levels of success. Limited partners have become more conservative with their investment dollars as memories of financial catastrophe still resonate in the unstable economy. To ensure that nothing of this severity happens again, government regulations along with investor expectations have forced new levels of financial reporting and transparency upon fund managers and portfolio companies. While the demand for consistent, timely reporting continues to grow throughout this industry, a faction of professionals who deem change unnecessary still exists. This group believes that increased analysis and transparency does not always translate into better fund performance, which they maintain, trumps reporting strategy.

Nevertheless, with the rapid development of financial software products and an almost limitless landscape of devices that support them, the potential and capabilities of these solutions are difficult to dispute. As financial software providers have continued to demonstrate the sophistication of these products, adopting a holistic reporting solution has quickly become a growing industry trend.

The Problem

It may seem obvious that increased transparency will lead to better analysis and eventually, better investing but not all fund managers have agreed with such theory. For as many general partners that are proponents of reporting changes, there are still those that do not see it as a top-tier issue. In fact, an overwhelming majority of GP's feel that the current level of information expected by their LP's is adequate. Does this mean that more financial data is not completely necessary? To some, so long as portfolio company performance and cash flow continually improve, reporting becomes a secondhand issue.

> *While even some of the most successful GPs are, in my opinion, too guarded with their information, their actual financial performance is much more important to us than the quality of their financial reports.*
>
> ***Clinton Harris,***
> ***Managing Partner***
> ***Grove Street Advisors***

This begs the question: Can better real-time reporting enable financial partners and their portfolio managers to deliver better financial results? If not, what are the benefits to increased financial transparency and comprehensive reporting? While the age-old saying of, "If it ain't broke, don't fix it" is still occasionally used, it is hard to discern that having more information that is routinely collected, analyzed and organized is ever a bad thing.

Analysts

For years the process of aggregating, organizing and evaluating financial data has been a cumbersome task for financial analysts. While it once was the case that these professionals were expected to process data from start to finish, technological solutions have helped mitigate this process tremendously. Rather than spending hours or even days with the error-prone task of manually creating and modifying financial models, analysts can now leverage the analytic outputs from these tools and present them to their fund managers using both standard and custom reporting templates.

In addition to receiving comprehensive reports, fund managers and portfolio companies can also benefit from analysts using these tools because it helps ensure the security of their information. The average turnover rate for a financial analyst has historically been two years, so the possibility of data trickling its way onto multiple computers and portable storage devices has been a known issue. This difficulty, along with the endless exchange of spreadsheets and paper documents has made it difficult to guarantee the confidentiality of information. Fortunately, most of these problems have been alleviated with the development of user-specific credentials and digital data rooms embedded within SaaS products.

Solution providers have also taken careful steps to ease the analysts' concerns of relearning and integrating a new solution into an existing system. This has become an important component in many value propositions since the time and hassle of converting an entire firm's data can become an overwhelming task. Some of the steps used to ease this process have included professional services, on-site training, web-demos and data uploading. By offering services such as these, providers are making it difficult to ignore not only the functionality of their products, but also the practicality of implementing them.

Limited Partners

Since the humbling events of 2008, many of the capital allocations designated to the private equity industry have deteriorated. Rather than pumping additional cash into new funds, many LP's are closely monitoring existing investments and waiting to see if economic conditions become more favorable. Along with these conservative behaviors, there has been a sparked interest among GP's to take greater control of their investments and utilize more rigorous analytics. Incorporating sophisticated metrics such as forecasting and risk analyses have helped investors to recognize problems early on, allowing them to find solutions proactively rather than reactively.

Adding to the increased demand for information, investor organizations such as the Institutional Limited Partners Association (ILPA) have encouraged greater interaction between investors along with helping them organize and advertise what they believe to be best-practices. Through a combination of conventions, publications and educational opportunities, ILPA has dramatically increased the exposure of investor concerns in hopes that they can spark more open GP-LP relationships. While it will remain difficult to integrate their ambitious industry-wide standards, LP's and organizations such as ILPA are doing their best to encourage changes in financial transparency.

General Partners

As the intermediary between portfolio companies and the individuals and institutions investing in them, the expectation of GP's to deliver both comprehensive data and financial performance can be daunting.

With that said, this group has received a large portion of the scrutiny revolving around recent financial transparency discussions. While a large segment of GP's believe that the information they provide is already sufficient, those opinions will always be left in the hands of their investors. So long as LP's are allocating capital into the alternative asset market, they will also influence the level of information required.

Adopting a holistic reporting solution that streamlines the aggregation, analysis, reporting and archiving of financial data should not be limited to just those aiming to please their investors. By implementing these changes, general partners can put themselves in position to get more from their investments. As with almost anything else, knowledge is power and in the case of GP's, possessing knowledge about portfolio company performance could be the difference between making a deal and losing one.

Survey

In an effort to gauge the feelings of multiple levels of personnel, spanning across numerous investment categories, a brief survey was conducted that was tailored to fit each of the aforementioned positions within the alternative asset industry. With the data collected from these questionnaires, the goal was to understand the different perspectives of these professionals and how they pertain to financial reporting.

To obtain contact information that would produce an adequate sample-size we utilized multiple online databases along with our own internal contacts. After accounting for 99 emails that either bounced or were not received, the surveys eventually reached the inboxes of 10,530 people. The overall response rate of our mailing list was 3.64% with the LP's being the most responsive of the three groups. In effort to obtain the largest survey population possible, the questions were limited to either a multiple choice or matrix-ranking format. After providing recipients five days to complete the surveys, the data was aggregated and quantified using Microsoft Excel. After analyzing the data and using appropriate sampling techniques, it was determined that most results approached a confidence level of 95% with a margin of error equal to ±5%.

Results

Analyst

The survey data showed that the majority of analysts felt that transparency and change were in fact necessary in the alternative asset market and that financial software implementation could help alleviate these problems. That said, over 2/3 of analyst respondents felt that financial software was an important component in the evolution of financial analysis and reporting.

Figure 1.0

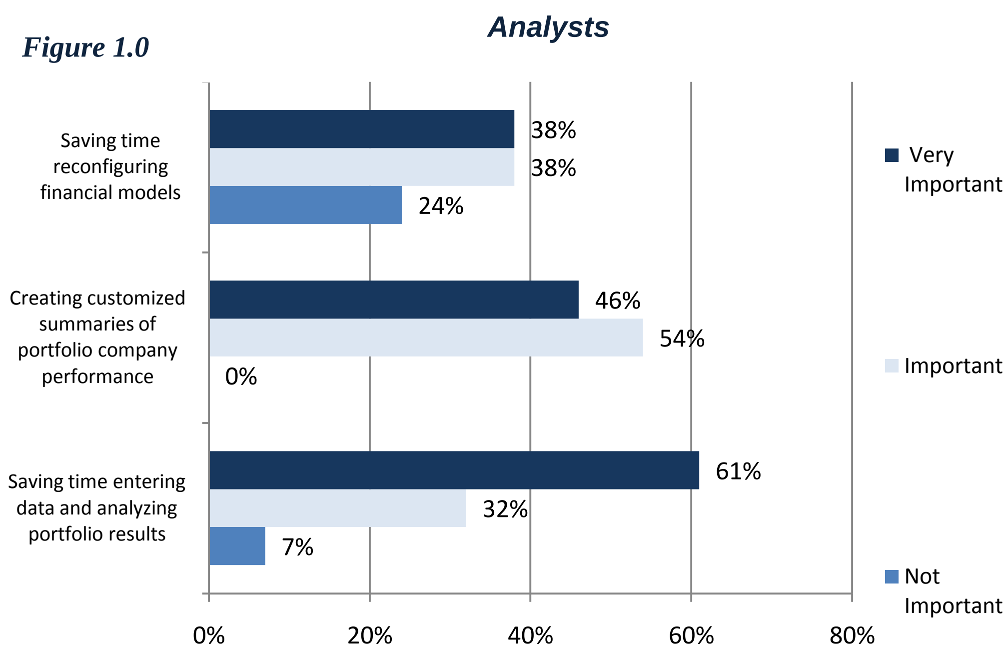


Figure 1.0 shows the analyst responses from the survey's matrix-ranking question. By examining these results we are able to see that aggregately, analysts would greatly benefit from using a financial analytics program. Whether being used for creating customized reports, saving time entering and analyzing data or alleviating the burden of reformatting financial models, the advantages of these types of products for this group of professionals seems to be quite high.

The survey also revealed that 77% of analysts believed that the level of information expected by their GP's and LP's was just right, 0% felt that they were asking for too much and 23% actually felt that they were not asking for enough. Why is it that nearly ¼ of the sample believed that they were not being asked for enough information?

Considering that analysts spend the most time with the data, it is fascinating that such a substantial number of them answered this way. Could it be that analysts are finding data points or trends that their colleagues are not asking for? Considering the progression of sophisticated data processing tools, it is possible that partners are missing out on information because they have not altered their reporting strategies to keep pace with new technology.

Basic economics says that there needs to be a way to connect buyers with sellers, or in this case, partners with data. Therefore it probably isn't that fund managers and investors do not want to utilize new tools and metrics, but rather, they aren't sure which to try and where to find them. This ideology can be used to refute the common argument of, "If it ain't broke, don't fix it". Rather than looking for something to *fix*, it may prove more valuable for investors and fund managers to look into how they can *enhance* their existing investments.

General Partner/Limited Partner

The results from the GP and LP surveys were the most anticipated component of this study. As mentioned earlier, much of the criticism regarding financial-reporting and transparency has been placed upon general partners, thus collecting insightful data from them and LP's was crucial. The questions that were included in each of the two surveys were kept similar in order to properly evaluate any similarities or differences between the two groups.

The GP survey revealed that 76% of fund managers disagreed with the notion that there was a lack of financial transparency between them and their LP's, however, the limited partners viewed this much differently. Interestingly, 50% of the surveyed LP's felt that there *was* a lack of transparency between them and their fund managers. So while over ¾ of GP's believe that they are supplying their investors with adequate data, only half of their investors are satisfied with what they have been receiving. To support this perception even further, an outside survey completed in 2008 by the advisory firm Acanthus, found that while 85% of GP's thought they were providing sufficient information, only 39% of the LP's approved.

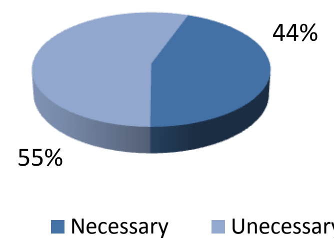
Additionally, when asked about the current level of detail expected by their investors, 12% of GP's said they expect too little, 7% said they expect too much and 81% said current LP expectations were just right. Conversely, the limited partners were split 50/50 between their fund managers supplying them either too little or just the right amount of information.

Figure 1.1 provides a visual representation of a question included in all three surveys. It illustrates that while more than half of LP's answered that transparency and change is necessary, an almost equal percentage of GP's responded ambiguously.

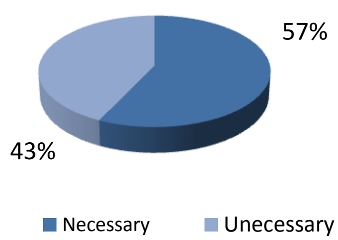
Transparency, change and new regulation in the alternate asset industry are:

Figure 1.1

GP



LP



Along with this misalignment, while 100% of LP's said that they are more likely to invest with fund managers that provide timely, in-depth reporting, more than half of GP's claimed that this would not give them any competitive advantage over their peers.

> ***100%***
>
> *Percentage of LP's who are more likely to invest with GP's that provide in-depth reporting*
>
> ***52%***
>
> *Percentage of GP's who believe reporting does not give them an advantage in fundraising*

As the survey data supports, there are two conflicting theories regarding what constitutes "best-practice" financial reporting. While many of the statistics point to the idea that holistic reporting and analytics programs are the way of the future, numerous data-points say otherwise. Recognizing the complexity and depth built within the alternative asset market, maybe it's best that there is no definition to "best-practice". Maybe the meaning of this term should be determined at the individual level since assigning an industry-wide solution has been so puzzling thus far. So long as solution providers continue to develop tools that accommodate different reporting requirements, it is very possible that the disagreements regarding this issue will diminish.

Conclusion

Even if new reporting standards, practices and products do not directly translate into increased capital gains, the qualitative advantages are perhaps equally profound. Simply having the ability to archive, search and compare financial data over multiple years is a substantial benefit in and of itself. Combine this functionality with CRM, analytic and marketing tools and the entire investing structure can instantly become more efficient.

While it has been argued that some LP's do not want monthly or quarterly reports for all the companies in their portfolio, shouldn't fund managers be tracking this information in preparation of an audit, merger or acquisition? Just because the data is available does not mean that is has to be distributed among the entire deal team every month. By incorporating a holistic reporting solution that includes data aggregation, storage, analytics and commentary, fund managers and analysts can react proactively rather than reactively if an issue were to occur.

Furthermore, by implementing a system that automates data collection and organization, it allows analysts more time to evaluate data rather than organize it.

The industry has already seen a steady increase in the number of financial software providers and rightfully so. With a wide variety of investment categories and even more firms that demand specific functionalities, the market has been up for grabs. Combine this environment with new government regulations, higher investor expectations and the diminishing costs of software-engineering and it appears to be market nirvana.

What will set certain providers apart from others will be those who can best adapt their product to a wide range of investment classes. This combined with ease of use, analytic capability and mobile interface will differentiate those with the most market-share.

Is there a lack of financial information being exchanged among investment deal teams, and if so, is it an issue? As it has been stated numerous times throughout this article, it is difficult to assign a definitive answer to a question comprised of so many unique perspectives, relationships and expectations. So long as the level of information between partners and their investors remains sufficient, this question may not require an answer.

While in some ways an industry-wide reporting standard may sound promising, it seems to remain implausible. The alternative asset industry is built amid numerous dimensions of asset classes, criteria and regulations, so to a certain extent individualism remains desirable. So long as GP's and LP's can find congruity within their partnerships, standardization may not be necessary. However, it is important to recognize that the implementations of best-practices, whether they are increased transparency, governance or alignment of interests, are vital in the continuing recovery and success of the alternative asset market.

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