

Investor reporting

by Justin Partington

Giving a good report – how investor reporting has moved up the agenda

In the last 12 to 24 months the power in the GP-LP relationship has swung in favour of the LPs. As a result, investor reporting has become steadily more high profile.

Investor reporting is now no longer seen as the preserve of the large fund managers and neither is it regarded as a tedious and annual exercise. Investors want up-to-date information tailored to their requirements; they want it on a regular and timely basis and most want to be able to access it online.

In a recent research study by Ernst & Young¹ into the outlook for global private equity, it was noted that private equity fund managers are now “focusing on improving back-office operations to meet both regulatory requirements and investor demands for clearer, more consistent, more complete financial reporting.”

Ipes assists more than 75 private equity fund manager clients on the frontline when it comes to reporting. This article is intended to provide an overview of some of the key trends in this area, and the practical implications this is having for fund managers.

Due to the ongoing negotiation and upcoming votes on the AIFMD between the Council and Parliament drafts, the additional disclosure requirements required by the AIFMD are not contemplated in this article.

The need to know

Post downturn, transparency and control command a premium. Investors need to know how the funds which they have committed their capital to are performing and more than that; they are looking for comfort that fund managers have robust procedures in place to monitor and report this information accurately and on time.

In a recent survey conducted by KPMG², 78 % of Institutional Investors in alternative investments indicated that Transparency was a major challenge facing the industry over the next three years, vs. 44 % Investment Performance and 33 % Downward Fee Pressure as major challenges in the years ahead.

As such the ability to provide good information to investors becomes a source of competitive advantage. Ernst & Young believe “a flight to quality can be expected, as investors seek to limit ‘surprises’ and make choices based on performance and the quality of a firm’s financial information and risk management practices”.

This sentiment is underpinned by the best practice guidelines provided by the EVCA and BVCA which cover fund reporting, portfolio reporting and capital accounts. While the guidelines were issued in 2000 and

2003 respectively, adoption was slower than expected. However, further to the 2007 Walker Report, a Guidelines Monitoring Group now regularly reviews and reports on adoption of the industry guidelines and portfolio company reporting for qualifying portfolio companies.

Key portfolio company reporting requirements are:

- The audited report and accounts should be readily accessible, including via the company’s website, no more than six months after fiscal year end.
- Reporting should identify the private equity ownership and composition of the Board.
- Financial review covering risk management objectives and policies in light of the financial risk and uncertainties facing the company.
- Business review conforming with Section 417 of the Companies Act 2006 including Enhanced requirements that ordinarily apply to quoted companies.

The above requirements place reporting requirements on large, UK focused portfolio companies similar to that of listed entities.

The ILPA private equity principles further support this trend through outlining detailed disclosure requirements for valuation and financial information on portfolio companies on a quarterly basis. As at 14 June 2010 more than 100 Institutional Investors had endorsed them. Refer to the guest article from Richard Watkins of Kirkland & Ellis in this Update for more detail on the ILPA guidelines.

Information to support investment decision is key

Investors are interested in the details that matter to their decision making activity - with a specific focus on fund performance, capital accounts and portfolio reporting. They are looking to fund managers to provide information which they can use to understand how investments are performing, and aid planning.

This has been particularly important during and following the downturn where fund managers and investors alike had limited visibility regarding the value of investments.

Good reporting helps to restore confidence, even if it is just because the worst case scenario is known, and is something both the EVCA and BVCA guidelines seek to achieve. As the BVCA describes it in their Reporting Guidelines document, their aim is to “promote best practice and to improve the quality and consistency of reporting to investors, thereby enabling investors to make better economic decisions”.

Notably another trend in this regard is for investors, particularly Institutional Investors and pension funds in the U.S., to have their capital accounts audited following the year end audit. In a number of cases,



this requirement is being written into investor side letters. It highlights a wider concern around objectivity and control. Increasingly this is driving demand for administration services because the involvement of a professional third party gives investors greater confidence in the rigour of the corporate governance procedures applied to a fund.

Online and on-demand

In today's environment where we are all used to accessing the information we want in real time - bank balance, where a package is, the World Cup results – it is no surprise that the timelines for investor reporting have become steadily shorter.

It is also more relevant as there has been greater variance in recent years with regards to the performance and valuation of Private Equity portfolios.

Where once half-yearly or annual accounts were standard, quarterly reporting is now the norm and disclosing detailed valuation and financial information on portfolio companies on a quarterly basis is one of the ILPA principles.

Specific reporting deadlines

We are seeing a trend for specific timeframes for both quarterly and audited reports to be included within LPAs, however increasingly there is an expectation set within side letters for this timeline to be shorter still. For quarterly reports, 45 days appears to be emerging as the standard, however the range we have seen is anywhere between 30 and 60 days.

In terms of audited accounts, 90 days appears to be standard, however in some cases we are seeing specific requirements for the provision of management accounts or K1s at a set point within the period. This is a broad trend spanning the asset class, rather than being specific to a certain fund type.

Recent developments in technology mean that providing up to date information is now more achievable than ever.

On the data processing side cumbersome Excel spreadsheets, known affectionately as the Microsoft fund accounting system, are increasingly seen as inadequate, as sophisticated private equity software and data warehouses can bring together large volumes of information from diverse data sources. In addition to handling increasingly complex allocations and calculations, these systems link in with payment modules, CRM systems and web portals and continue to work along the value chain into the middle office space of Portfolio Company reporting and traffic lights.

The move away from printed reports towards electronic files held in online portals is driving a real-time and self service approach. It has also increased the security of data, as access rights can be specified and modern document management systems can track who has viewed, saved and copied information.

One size does not fit all

Whilst the BVCA and EVCA have set the standard in terms of reporting, another trend is a focus on tailored reporting. This correlates with the tilting of power in the GP/LP relationship to LPs as characterised by the growth of investor specific terms and side letters.

In some cases the larger Institutional Investors, particularly in the US and Germany, want to specify a format that feeds into their own reports easily, and this is defined in side letters. In other cases, reports need to be tailored to reflect parallel offshore / onshore structures and sometimes it is as simple as some reports still being delivered in hardcopy.

Investors in funds are increasingly diverse geographically and frequently we are seeing side letter provisions relating to specific accounting standards. For example in a number of cases our clients' investors have made requests for accounts to be translated in US GAAP.

What is clear is that whilst a minimum reporting standard is now defined, going beyond this will be the norm. Investors tend to invest across multiple funds and this broader exposure results in benchmarking of reports by Institutional Investors and Fund of Fund GPs that further leads to the transfer of best practice approaches.

On a practical level what are the implications for fund managers:

The key takeaways as we see it are as follows:

- Quality reporting is something investors now require, and benchmarking is conducted by Institutional Investors.
- Spreadsheets alone are not effective – Investors want secure online access to real time information.
- Industry guidelines set a base but funds need to tailor reports to Investors.
- Reporting can be a source of competitive advantage and a key differentiator.

Our experience is such that this is all achievable with the right systems and support. It can be beneficial for fund managers through driving improved investor relations and better control and visibility of key data.

For further information

Ipes would be pleased to conduct an informal review of your investor report against industry best practices – for more information, please contact Justin Partington.



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Justin Partington joined Ipes in March 2010.

As Commercial Director, Justin is responsible for delivering the group marketing strategy to expand Ipes' profile in key markets, diversify its product range, and grow the revenue base.

Justin joined Ipes from a London based Fund Administrator, where he headed the Private Equity department. Prior to that, Justin was a Director at UBS Fund Services in Toronto. Before UBS, Justin was the Financial Controller for the Cayman back office of Swiss Life Private Equity Partners.

- 1 Ernst & Young – 2010 Global Private Equity Watch, New Horizons Emerge (April 2010)
- 2 KPMG report – Transformation The Future of Alternative Investments (2010)



ILPA - one year on

by Richard Watkins

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In September last year, the Institutional Limited Partners Association (ILPA) published its "Private Equity Principles", an investor's guide to best practice in private equity. The ILPA Principles are intended to ensure that the interests of fund managers are correctly aligned with investors' interests, to enhance fund governance and to provide greater transparency. They comprise a number of high level principles coupled with a more detailed explanation of how those principles might be reflected in fund terms. Over 100 institutional investors have now formally endorsed the ILPA Principles. ILPA is a global organisation "dedicated to the interests of Institutional Limited Partners in private equity" but one which has historically had a low profile, at least on this side of the Atlantic. By way of background, ILPA has existed as the trade association for institutional private equity investors since the early 1990s. It has grown over the years, like the wider industry itself, and now boasts more than 200 members globally, including public and corporate pension plans, endowments, foundations, family offices and insurance companies, and its membership represents more than U.S. \$1 trillion in private equity assets under management.

The private equity world certainly paid attention when the ILPA Principles were issued, not least because of the size of capital behind ILPA, but also because, given the paucity of market data as to terms of funds being raised in the 'new environment', they provided a potentially valuable insight into investors' views on various issues. Almost a year later, the key questions are what impact have the ILPA Principles had on fund terms, and will this continue into the future? Very little data exists on which to base any view as to current trends in private equity fund terms - funds announcing final closings over the past six to twelve months have invariably been in the market (formally or otherwise) for a considerable period prior to publication of the ILPA Principles. However, we do have first-hand evidence as to how different groups of prospective investors have used the ILPA Principles since their launch.

Education aid or negotiation tool?

Whilst it is clear that the ILPA Principles represent something of a laundry list of issues on which LPs think some GPs have pushed the boundaries over recent years, the principles are often quite general in their approach. Representatives of ILPA maintain that the ILPA Principles reflect best practices and are intended to stimulate broad discussion, within both LP and GP communities, as to appropriate approaches on a range of issues - not to dictate a universally applicable model. Nevertheless, in the current fund raising environment, GPs are finding themselves benchmarked against the ILPA Principles by prospective investors. It is an easy due diligence question for a prospective investor to pose, and GPs need to consider whether to be reactive or to proactively demonstrate and promote their compliance.

Themes covered by the ILPA principles

The ILPA Principles seek to address alignment of interest, governance standards and transparency. These broad principles are generally unobjectionable. However, when you drill down into some of the detail, a significant number of current fund agreements are not fully "ILPA-compliant".

Alignment of interests

Generally, European funds have an easier time complying with the carried interest model proposed by ILPA. Their carry is generally subordinated to all drawn capital plus hurdle (a whole fund model)

rather than being calculated on a 'deal-by-deal' basis, which is singled out for improvement recommendations in the ILPA Principles. The management and transaction fee sections cause more tensions around the negotiating table. Clearly this is an area of focus for many LPs, whether vociferous ILPA proponents or otherwise, and GPs are having to concede ground to attract capital. Whilst management fees are not immune from pressure, there is little evidence of a fundamental shift to an 'operating cost' model. Transaction fees, however, have been a bugbear of a number of LPs for some time and there is considerably more pressure to increase management fee offsets.

Governance

In terms of governance, certain of the ILPA Principles have been pressed strongly by LPs wishing to re-balance the statements of fiduciary and other duties owed by the GP in a private equity fund as well as introducing generally broader suspension, termination and GP removal rights as part of achieving balanced governance. The stronger and more prescriptive role of the Advisory Board is also getting some traction in the market - most commonly coupled with more frequent and increased disclosure and consultation. There is also a larger role for the fund's independent auditor.

Transparency

Although the industry has historically been transparent with its investors, obligations on the GP in this regard are being fully codified. In particular, the ILPA Principles require detailed disclosure of fees, carried interest payments and clawback, and the calculation methods used - although most fund quarterly reports already satisfy these requirements.

Negotiating strength

There is naturally a sense that in the current market, with the scarcity of investor capital and a gradually increasing supply of GPs raising funds, the pendulum of negotiating strength has swung from GPs to LPs. Certain LPs are exploiting this to its fullest and are using the ILPA Principles (or a sub-set) as a 'must have' list of requirements. Other investors are either using the ILPA Principles in whole or part as a diligence checklist or as a basis for negotiation with GPs. Accordingly, it is not possible to say with conviction whether any recent movement in fund terms has been brought about by the ILPA Principles themselves or is just generally reflective of a shift in negotiating power in favour of LPs. The lack of current data in the market due to the small number of funds launched and closed since the announcement of the ILPA Principles means that any accurate assessment will only be possible in hindsight over the coming months and years.



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Richard primarily advises in relation

to private equity fund structuring, carried interest, co-investment and other private equity incentive schemes and also advises on private equity transactions including secondaries, spin-outs and mergers of private equity houses.



New capital adequacy rules

by Sharon Alvarez

The Guernsey Financial Services Commission (the "GFSC") issued The Licensees (Capital Adequacy) Rules, 2010 (the "Rules") on 13 April 2010 which became effective on 16 April 2010. Transitional provisions however gave until 30 June 2010 for existing Licensees to comply with the Rules.

The Rules set out the regulatory requirement in respect of the minimum 'capital' permitted for entities licensed under the Protection of Investors (Bailiwick of Guernsey) Law, 1987, as amended (the "POI law") by way of both a Financial Resources Requirement and a Liquidity Requirement, each of which must be maintained at all times.

The essence of the new legislation is to focus the Licensee and its board of directors on the maintenance of a capital base and liquidity commensurate with the nature and scale of its operations and the inherent risks associated with the business.

Who does it effect?

The Rules are mandatory for all Licensees authorised under the POI Law. In practical terms for fund administrators operating in Guernsey, the Rules will require both the fund administrator itself to comply with the Rules together with all of the licensed General Partners under its administration.

In Summary, what does it mean for Licensed General Partners?

The Rules state that licensed GPs with no physical presence (staff and premises) in the Bailiwick of Guernsey, must maintain at all times:-

1. Financial Resources Requirement – the higher of:
 - a) £10,000 (or currency equivalent); or
 - b) net assets and professional indemnity insurance cover which in the opinion of its directors is sufficient to meet its commitments and to withstand the risks which its business is subject to and
2. Liquidity Requirement - the higher of:
 - a) £10,000; or
 - b) 10% of annual audited expenditure (based on the last audited financial statements and broadly excludes directors' remuneration and fees payable where based on fees receivable).

The licensee board must demonstrate that they have considered and determined that the level of capital adequacy is appropriate considering the nature, complexity and risk profile of their business. Going forward it will be mandatory for Licensees to monitor compliance with the Rules at all times and for their board to carry out periodic reviews.

What must be considered?

When reviewing the level of capital adequacy required, the board of a Licensee must consider: (i) whether a level above the minimum set out in the Rules is necessary, and (ii) the calculation set out in Rule 5 (which includes consideration of Position Risk and Counterparty Risk). If the board determine that a higher level of capital adequacy is required, the Rule 5 calculation will need to be used as a basis for any increase in relation to the Financial Resource Requirement.

Breach of the rules

It is worth noting that every Licensee has an obligation to inform the GFSC immediately of any breach of either the Financial Resources Requirement or the Liquidity Requirement, or if it anticipates being in breach of either requirement within one month.

Furthermore, notification to the GFSC of any breach or anticipated breach must importantly include the steps being taken to remedy the breach.

It is likely that auditors to the Licensees for accounting periods ending on 30 June 2010 or later will include reference to the Rules in their audit report and will require to see evidence that the Rules have been considered and that controls and procedures are in place to monitor compliance accordingly.

Further legal and regulatory changes and additions are expected in Guernsey in the following months and include updates to the current Guernsey Company Law, a new Code of Corporate Governance, an updated Partnership Law and amendments to the POI Law.



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Sharon is a Director of Ipes having joined the Company in June 2005.

She also acts as a Director on a number of general partner boards with a broad client base from the UK and Europe. In addition to her client responsibilities Sharon is responsible for technical and corporate governance matters with a focus on compliance with new regulation and legislation.

Ipes News

Prestigious award win for Ipes

Ipes has been named Investment Funds Advisory Firm of the Year in the Channel Islands at the Corporate Intl Global Awards 2010. The awards recognise excellence in the world's leading advisers and financiers in countries and continents globally. Category winners were selected from a short list of up to six firms by a panel of industry experts. In addition to this award the Company has also received two other industry awards in the last six months, Specialist Professional Services Firm of the Year at the Private Equity Awards 2010 and Administrator of the Year at the EVCJ Awards 2009.

Ipes' Executive Board grows

Justin Partington has been appointed to Ipes' Executive Board. As Commercial Director, Justin will spearhead the continued development and growth of Ipes' business across the group, with a specific focus on the UK and Europe following the firm's recent move into Luxembourg. Justin has over 11 years experience in the funds industry, spanning the alternative investment asset class. He joins Ipes from a London-based fund administrator, where he was Head of Private Equity. Previously Justin was Division Head of UBS Fund Services in Cayman and Toronto.

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Ipes is regulated in the provision of fund administration services, for more details please see our website.

