Deloitte.

Ten considerations for early-stage private equity managers

Finance and operational priorities for new and growing PE firms

The alternative investments industry is soaring, with assets under management expected to reach $20 trillion by 2025.[1] The rapid growth in private equity (PE) continues to attract and reward a steady stream of new PE fund managers.

Taking advantage of opportunities in this lucrative market typically requires leaders of new or early-stage PE funds or firms to delve into areas that may be unfamiliar to them—specifically finance and operations (F&O) functions. If they are like most new PE fund/firm founders, they may have spent a considerable time at a large PE firm with a proportionately sized operations team. As "investors first" deal professionals, chances are they were not focused on behind-the-scenes F&O processes, such as accounting, fund administration, and compliance managed by dedicated operations staff.

Taking inventory of finance and operational requirements

From our experience advising new and early-stage PE funds and firms, we've found that leaders often underestimate the time and effort required to initiate the F&O processes of their new business. They may also be less familiar with finance and compliance leading practices. Underinvestment in these critical functions can create significant risk to the success of the firm.

Ten finance and operations leading practices for early-stage firms

We've assembled a list of 10 finance and operations requirements that early-stage PE firm leaders should consider early in their journeys. These F&O leading practices are by no means an all-inclusive road map or checklist of everything firms would need to consider. Fast-moving, impactful changes—such as diversity, equity, and inclusion; sustainability; digital assets; and talent considerations, for example—are PE hot topics that could each generate a thought piece on its own. However, the following areas are the 10 we think should be top of mind during the ramp-up phase for early-stage PE firms.

1. Fund and partnership accounting
2. Reporting
3. Tax structuring, compliance, and advisory services
4. Independent financial statement audit and audit readiness
5. Valuation and pricing
6. Treasury management
7. Regulatory risk and compliance function
8. Budgeting and forecasting
9. Management company finance considerations
10. Enterprise technology and security digital infrastructure

1 Prequin Ltd., *Preqin special report: Service providers in alternative assets*, Q4 2021.

1 Fund and partnership accounting

At the same time firms are consulting with their legal counsel and bankers, they may also want to engage accounting advisory services to consult on how they want to set up their fund and partnership accounting, covering critical elements such as general ledger, partner allocations, gain/loss allocations, valuations pricing, and fund controlling.

Leading practice: An early decision should be made on whether to outsource fund administration or hire a controller to conduct fund and partnership accounting in-house. Although there are cost considerations, it's important to invest in hiring a chief financial officer (CFO) or controller who not only oversees the fund administration relationship but may also act as the quarterback for some internal and stakeholder requests. CFO activities are far-reaching and may include meeting with investors to discuss track records; answering payroll questions for firm employees; and serving as a liaison for requests from auditors, tax compliance firms, and regulators.

2 Reporting

Reporting, which dovetails closely with accounting, covers some of the essential management activities for PE firms and may be a make-or-break process for an early-stage business. Reports for limited partners and clients, as well as for financial, tax, and regulatory purposes, (including SEC compliance), are just some of the reporting requirements for PE firms.

Leading practice: Early investment in technology to support reporting obligations may be expensive, so it may be best for firms to choose service providers with technology options that can be leveraged. They should keep in mind that as a firm grows, it may eventually need to invest in in-house reporting solutions. Firms should consider avoiding an overreliance on spreadsheet software from the start and developing a more modern reporting solution for the long term.

3 Tax structuring, compliance, and advisory services

Tax operations for PE firms are likely to grow in complexity over time. But even at the outset, they likely involve managing complicated tax allocations to partners and tiering results through complex organizational structures.

Leading practice: When interviewing tax advisers, PE firms need to concentrate on organizations with extensive experience with PE funds. Equally important, the organization hired should have a well-tested technology solution that allows services to scale as the firm grows. A tax adviser should also discuss how to leverage a wide range of subject-matter specialists to keep pace with an ever-changing tax environment.

4 Independent financial statement audit and audit readiness

Choosing an independent auditor is one of the most important first steps. An audit provider should have the PE experience and reputation required to provide audit and attestation services to meet annual or interim reporting requirements in compliance with US GAAP and IFRS protocols and providing audit readiness gap assessments focused on the company's current accounting knowledge, staffing, and reporting frameworks.

Leading practice: PE firms should choose an auditor that has experience working with investment firms through their entire life cycles. Their insight and networks may be critical as firms build out their operations.

5 Valuation and pricing

Another important early-stage step is setting up a robust valuation process, which requires the ability to value Level III privately held investments.

Leading practice: It's important to make an adequate investment in the process and for that process to be well documented. Valuation often quickly becomes a focus of investors, regulators, and auditors. A PE firm should consult with trusted advisers and consider whether it's necessary to engage a valuation firm early in its life cycle.

A good valuation process relies on considering all available information and establishing a valuation committee with a combination of investment, finance, and compliance professionals. One of the most critical aspects of valuation is the need for executive management to set the right tone from the start. PE firms should also consider investing in technology that increases transparency, automates documentation, and enables stress testing, among other capabilities.

6 Treasury management

Treasury management requires specific knowledge to help make sure cash management, wire management, and foreign exchange transactions are smooth and efficient, expenses are held to a minimum, and nothing gets lost in translation.

Leading practice: With millions (potentially billions) of dollars in treasury transactions, PE firms should develop banking relationships with reputable financial institutions, leveraging the advice of bankers that have experience in the industry. It's particularly important to develop policies on cash management and cybersecurity and to ensure there is firmwide awareness of these policies and that there are safeguards against phishing scams and other cybercrimes.

7 Regulatory risk and compliance function

When it comes to regulatory risk and compliance, new fund managers are faced with another critical decision early on—hire a compliance officer or outsource it.

Leading practice: In addition to meeting with outsourced compliance providers, PE firms should seek the advice of their attorneys on their day-one compliance needs and develop a plan to build a compliance team. In some newer firms, the compliance officer role is combined with the CFO role; while this may work for a brief period, it is not a leading practice. Functions certainly need to have a strong working relationship; however, it's recommended to separate finance from compliance.

8 Budgeting and forecasting

A new firm will want to make sure it's accurately managing cash flow so that it has sufficient liquidity and doesn't run out of cash. This requires industrial-strength budgeting and forecasting capabilities.

Leading practice: Early in the firm's life cycle, cash inflows and outflows should be monitored carefully, just as most startup or early-stage businesses would. The firm should look for opportunities to defer cash outlays and reward employees and service providers that make an early investment in the relationship. As the firm grows, the opportunities for growth for employees and service providers likely also will increase.

9 Management company finance considerations

Payroll, general ledger, and General Partner (GP) accounting are some of the capabilities a PE firm needs to manage the finances of its management company.

Leading practice: Firms should not understate the need to generate timely, reliable, and accurate financial information to run their management companies. Essential functions like payroll processing and cash management are needed to retain employees and keep the lights on. However, the ability to produce management company records will likely help the firm obtain debt financing and enter into meaningful business relationships, such as leases and long-term contracts, with vendors. A simple accounting platform may be deployed from the start to handle management company recordkeeping.

10 Enterprise technology and security digital infrastructure

In today's highly complex data environment, making sure that stakeholders have the transparent data they need requires an agile digital enterprise platform. This platform should provide access to primary data to meet PE firm needs now and, in the future, needs from frequent updates on portfolio performance (named as top priority for LPs over the next decade) to cybersecurity, ESG, and operational service-level agreements.

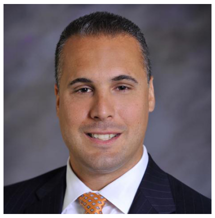
Leading practice: A "single source of truth," defined as all relevant departments within an organization having real-time access to the same accurate data, is critical for making strategic business decisions based on quality insights. Building a proper technology infrastructure with that in mind will likely be one of a PE firm's most important investments. The owners can think of it as a future expenditure that likely will yield increasing benefits as the organization grows. In the meantime, they should focus on the quality of the information they receive and work to ensure that the data they use to make decisions is well controlled and calibrated to other information within the organization.

How Deloitte can help

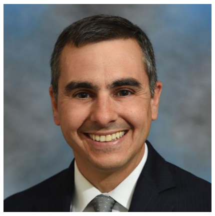
Deloitte has been advising emerging private equity fund management firms since this sector was first established.

Deloitte's Private Equity Practice has audit, M&A, and tax relationships with the majority of publicly traded private equity firms and has worked with many of these firms since their inception through IPO. We leverage this experience when working with our client firms in the industry.

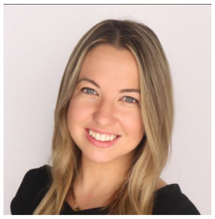
Deloitte Private Equity Team



Jason Menghi
Audit & Assurance Partner, National Audit Private Equity Leader
Deloitte & Touche LLP
jmenghi@deloitte.com



Frank Fumai
Audit & Assurance Partner and Vice Chairman, Private Equity Practice
Deloitte & Touche LLP
ffumai@deloitte.com



Katie Spinello Apuzzo
Senior Manager, Client Relationship Executive, Private Equity Practice
Deloitte Services LP
kapuzzo@deloitte.com

Private Equity Services