Private Ties: Technology Rises in Private Equity

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Much of private equity rests on old relationships and privity of information, but with limited partnership investments becoming more common for a wider array of investors, and a secondaries market gaining steam, technology is blossoming in unlikely places. By Tim Bourgaize Murray

Following the financial services industry's collective flogging four years ago, the 2012 US elections saw a more specific target this time around: private equity—and presidential candidate Mitt Romney's firm, Bain Capital, in particular. Whether that criticism was deserved is a matter of judgment—surely not all venture capitalism is "vulture" capitalism, and the private markets offer a number of advantages public trading does not—but the takeaway was clear: Private equity is naturally secretive and, therefore, is not properly understood.

The irony of all this is its timing. Private equity, perhaps more than at any time in its three-decade history, is changing, and many say for the better. Deals are becoming more complex; limited partnerships (LPs)—e.g., institutional investors, sovereign wealth funds, even endowments—are growing more diverse; and because of macro and regional instability, the secondaries market, where firms sell existing stakes in portfolio companies, is expanding.

Those trends portend a greater affinity for information and communication between LPs and their general partners (GPs) like Carlyle Group and Kohlberg Kravis Roberts (KKR). Three recent projects suggest it means better technology.

'Adult Rules'

Erik Hirsch, chief investment officer at private equity manager and adviser Hamilton Lane, says traditional views of the space—internally, as well as externally—have to do with process as much as mystique.

"Historically, this has been an asset class so long-term in nature that there was no pressure to have efficient information-sharing like you would have in a public market where decisions are made in seconds—whereas it would be months and years in private equity. That's changing—not so far as day trading, obviously, but as standards change, we struggle to determine why we're different. The explanation has been that in private equity it's just 'different.' No benchmarks, or seamless data transition. It's just 'different.' The asset class is too big and too important for that excuse now."

Bala Cynwyd, Pa.-based Hamilton Lane, with $167 billion assets under management or supervision, recently inked a strategic partnership with iLevel, a portfolio management system provider originally spun off from Blackstone Goup.

The objective, Hirsch says, is to build the platform to "bridge" LPs and GPs, aggregating and disseminating portfolio company information, such as capital call notices, that iLevel already collects.

"Software packages now tend to skew either toward one or the other; there is no notion of participation and passing information in an efficient way. To connect the pipe between LPs and GPs—this will be a game changer," Hirsch says. "The limited partner world has typically seen reporting only at a fund level, where you're invested in 10 fund positions, and what is in your reporting system is top-line information: how much is committed, invested, distributed, and what is the multiple and internal rate of return. The system is not designed to look into the portfolio company level through the funds, but as private equity matures and becomes more important in LPs' overall portfolios, people will want access to more granular information more frequently, beyond just fundraising periods."

Hirsch says that maturation is also overdue. “There’s a reason why we’re 30 years into the asset class’s development, but still talking about this. For some number of parties, a lack of benchmarking and inefficient reporting is okay, either because it’s how they grew up, or it’s even benefited their franchise. If you’re the consistent third or fourth quartile performer, you’re fine with that because it makes it easier to manipulate the system to your advantage. This is where the asset class just needs to grow up, and play under adult rules,” he says.

Crawl, Walk, Run

Pioneering firms in the space, though, have long been attuned to technology’s advantages. Coller Capital, a global investor in private equity secondaries, established in 1990, provides a creative model of how firms can advance technology’s role in the business. The London-based firm primarily develops its own IT solutions, but two years ago realized an “augmentation” strategy was needed, says Coller CTO, Howard Lask.

“We are around 150 people and a niche player within private equity. When we set out to identify a systems solution for our operational areas we were unable to find off-the-shelf software to do what we needed. At that time, large software providers created systems mainly for primary buyout and venture funds in private equity. A lot of funds-of-funds and secondaries firms used industry-standard systems via workarounds, and lived with the inefficiencies caused from doing that,” he says.

“We took a different approach and built our own. However, with an internal IT team, certain issues arise: cost to recruit and train an IT development team in the UK; key-person dependency risk; and the ability to scale up quickly when new projects or additional requirements are generated by the business. So, using a very considered selection process, we set out to look for a partner to help us overcome these challenges.”

The answer was custom software provider DataArt. The strategy, the developer’s managing director Alexei Miller says, was deliberate: “Crawl, walk, run.”

Ben Shilliam, Coller’s program manager who oversees the partnership, says the staggered approach began with minor Microsoft Sharepoint support and updates, which would subject DataArt to a diverse set of the firm’s users. After proving itself there, DataArt worked on an initiative to replace Coller’s Microsoft Biztalk implementation with a customized data feed delivery system.

“Now we’re onto more bespoke projects and chunkier enhancements to existing applications,” says Shilliam. “They’ve just finished a large update to the system used to support our analysis and execution activities. We’re also using DataArt to mitigate key-person dependency risk in our main in-house application, which is a back-office investment monitoring and tax reporting solution.”

Coller’s relationship with DataArt promises operational savings as business volume ramps up, but Lask says the partnership is also about flexibility. “There isn’t a direct relationship between the deals we do and demands of technology, but an indirect relationship does exist,” he says. “Sometimes we’ll do a deal that’s a bit unique or out of the ordinary, something Coller is well-known for, and that can then generate a requirement where the existing functionality falls short in some way of delivering what’s needed. This creates the situation where we have to respond rapidly with system changes.”

Whether for Coller’s “direct” secondaries deals or its fund strategies, that means organizing data in a way that makes information actionable, DataArt’s Miller says. “Coller has a very systematic approach in how technology should support their evolving business. An idea comes to their mind, and immediately the question is how soon afterward we can put that idea on sure operational footing,” Miller says.

Choice, Not Liquidity

Innovating business models is also having an effect in private equity intermediation—particularly, the role fund placement agents play in delivering information as well as a deal-making apparatus, itself. Here, too, technology is making a mark—if more carefully.

Paris-based Triago, one of the first placement agents in the space, says a record amount of private equity commitments are set to expire in the next year-and-a-half, meaning capital will return to the market. "LPs will have more room for new commitments, and by 2013, that's likely to drive annual fundraising back up to a two- to three-year annual range of $300 billion to $400 billion, in line with 10-year fundraising averages, though less than half the peak annual sums collected during the 2005 to 2008 credit bubble," says Nicolas de Nazelle, a managing partner at Triago.

De Nazelle says that with private equity funds taking longer to realize investments, and thus make distributions to their LPs, investors are likely to seek strategies that shorten investment duration and that pay out quickly, which secondaries and secondary directs are designed for. How firms avail themselves of wider choices, without making the process tricky or costly, is the question.

"There may be opportunities for electronic platforms, provided they permit the use of other discovery channels such as specialist intermediaries and personal LP and GP networks. To succeed, such platforms will also have to hardwire into their operations the possibility for more sophisticated offline discussions and negotiations, given the bespoke nature of each secondary deal," he says.

A number of such platforms have popped up the past few years, including Secondcap, Nyppex, and Palico. But theories about just what private equity firms expect are still being tested. Blending new and old appears key.

For example, Palico, created this May and hosting a swath of emerging markets LPs like the Government of Singapore Investment Corporation, Malaysia's government employee pension fund KWAP, and frontier market specialist Leopard Capital in addition to Western players, says globalizing private equity through an anonymous auction process, rather than shackling deal execution in its entirety, is the way forward.

"No one invests in private equity expecting liquidity—although it's nice when the terms are right—but everyone always wants to know what their investment choices are across regions, specialities and structures," says Antoine Drean, founder of Palico, noting that bidders will often only attract seller interest when the discount on net asset value is in the single digits, or 15 to 20 percent at the outer edges.

Drean says that the space's past won't totally fall away, because it can't.

"An online private equity platform can do much to streamline things for discovery and engagement, but it cannot automate the entire investment process. Private equity fund management is all about taking an activist approach to investment and having a proprietary edge, which makes the human element much more important than it is in securities markets," he says.

"If we had tried to automate the whole process from A to Z, we believe Palico would have had very little buy-in, " Drean says, adding that GPs will often withhold their private placement memoranda (PPM) until bidders are identified and face-to-face meetings are initiated, as an example of the platform's optional safeguards.

Peer Pressure

While all of private equity's different players—advisers, funds, and intermediaries—continue to measure and mete a proper role for technology, the pursuit for all of them remains essentially the same: how to take advantage of an opening by thinking long-term.

Coller's Lask says the DataArt model is not only novel, but also durable. "We have several years worth of roadmap already in place, and within our space, I like to think that we are at the 'bleeding edge,' not only in the technology we're building, but the way in which we're delivering information technology, as well," Lask says.

Likewise, Hirsch at Hamilton Lane says once iLevel's initial LP module is achieved, other tools like portfolio planning and cash-flow forecasting models become possible for the offering. Adoption, though never instantaneous, is now simply a matter of time because sophistication around data and reporting is no longer a choice so much as a necessity.

"There will be a peer pressure effect," Hirsch says. "If you're a GP, LPs will come asking, 'Blackstone and Carlyle, Providence and TPG are doing this, so why aren't you doing this?' LPs are not looking to expand their number of partners. If anything, they are holding or even reducing, and the criteria as to who stays and who is cut will evolve. The quality of the firm's infrastructure and data management are not more important than returns, certainly, but if you're in a world where firm X and firm Y both have a 25 percent rate of return, but one reinvests LPs' fees in their systems and demonstrates as much, that becomes an easy choice."