KEYNOTE INTERVIEW

Automation for capital administration is gaining traction

The industry is embracing automation as capital continues to flow into the alternative investment sector, argue Alter Domus's Gary Shelto and Dean Schaffer

As private equity grows, so does the complexity of managing an increasing number of funds – including real estate vehicles. In June 2021, Alter Domus acquired Investors Economic Assurance, a leading provider of capital administration solutions specializing in waterfall and carried interest. Joining Alter Domus from IEA, Gary Shelto, managing director, North America, and Dean Schaffer, also managing director, North America, discuss the challenges that come with more complex capital allocations and how technology is helping to support the industry.

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Q There's a trend for LPs who invest in private equity – including real estate – to demand more data. Has this push for greater levels of transparency accelerated during the pandemic?

Gary Shelto: We believe this trend began before the pandemic, and it has certainly continued during the pandemic. I wouldn't say it's just limited to investors; transparency requirements are continuing to increase across both the manager and investor communities. On the manager side, there is definitely an increase to look for transparency, reporting and information in this environment.

Dean Schaffer: Over the last three or four years, as additional capital has been coming into the alternative investment community, investors have been requiring increasing levels of transparency. And in the last two years there's been more capital coming into the alternative investment world than ever before, so that trend has continued – as investors have been writing these checks, they have also required additional transparency.

This additional capital has created pain points for managers, because they have more funds and complex structures than ever before, more data than ever before and more transparency requirements than ever before. We are seeing more and more people looking to technology to be able to solve these issues.

GS: The acceleration of the volume of capital coming into the market is not only putting a stress on transparency capabilities, we are also seeing more and more sophisticated terms being negotiated between investors and managers. It is almost a double-edged challenge here: more complex relationships, non-standard relationships and, on top of that, an increase in transparency requirements. It is a challenging environment, we believe, for managers to address those dimensions.

Q How have managers adapted to these demands? Are they using bespoke technology, embracing automation, or do they continue to use Excel as the main tool for fund administration?

GS: Managers are certainly starting to embrace technology as it's introduced to the market. Furthermore, it is occurring at a much more accelerated rate than before.

DS: There is appetite among managers to utilize technology more than ever before. And we believe that technology trend will continue to increase.

There are plenty of people that are still relying on Excel, but we are starting to see the CFO community become much more open to outsourcing expertise. They want to find people who are experts in certain areas and then have those people do that work.

In our case, we are experts in the waterfall calculation and the carry side of a business – we help our clients in this area leverage our CapAssure technology platform. And so, increasing numbers of CFOs are becoming more open to technology than ever before.

Again, that doesn't mean a 100 percent adoption rate. But, every year, more and more funds are becoming a lot more comfortable in implementing technology to support their back office.

Q As you said, many managers are still using Excel today. Why is automation still getting pushback?

GS: Over the last 20 years we have seen that the Excel model offers a very flexible environment. However, we have also seen the numerous limitations of Excel and the fact that CFOs are now continuing to appreciate those limitations. The two primary vulnerabilities of Excel are control and consistency. These vulnerabilities get increasingly tested as data volumes increase.

But, as the industry matures, we are seeing managers who recognize the limitations of Excel. They are looking for a production-strength, controlled environment that can support a fund for 15 to 20 years, following rules articulated in a partnership agreement.

"Additional capital has created pain points for managers, because they have more funds and complex structures than ever before"

DEAN SCHAFFER

It is not only the complexity of the models, but the risk associated with managing carry plans both at the investor and the manager level. Doing it correctly for 15 or 20 years in an Excel environment is extremely daunting. It doesn't matter if my Excel model is perfect today or tomorrow; it's an Excel model that could get changed. The benefit of a truly rules-based technology platform is that it can follow those rules in an extremely reliable manner, not only for the granularity and transparency, but for consistency.

DS: There is still an education element going on in the marketplace, where CFOs are being educated on the technology and automation capabilities that are out there. Not everyone knows that you can automate your waterfalls and carry plan yet. A lot more people know that today than they did five years ago and a lot more people will know that tomorrow than last year.

So, I don't think there is a pushback. There is just more education that needs to happen.

Q Carried interest waterfalls can be automated through technology. Which trends are you seeing in this space?

GS: We are seeing the continuation of more and more sophistication in the terms being negotiated between investors and managers. On top of that, we are seeing the number of investors going into funds increasing. So, there is an explosion in the challenges to the community for managing these plans.

DS: Historically, there could have been a traditional European style or a traditional US deal-by-deal style waterfall fund, where every investor has the same terms and there is no nuance within the waterfall. What we are seeing more and more is people creating hybrid structure funds where there are different tests or different nuances in

Q What are the main advances in the development of new technology for fund administration?

DS: Technology as a whole is expanding in the space. Early on, there were one or two fund accounting platforms available for the alternative investment space. Now, there are half a dozen choices available. So, we are seeing additional platforms coming to market.

We are also seeing an expansion of the areas that we are focusing on. While there has always been a core fund accounting technology solution environment out there, we are seeing an expansion of things like CapAssure that does capital administration. So, there are additional choices to investors and managers as well as additional areas of scope addressed by technology.

GS: Alter Domus's ambition is to provide tech-driven, innovative and value-added solutions to its clients. The acquisition of IEA was fully aligned with this desire—thanks in large part to our leading technology platform, CapAssure, and reliable service-based outsourcing solution, CapAdministration. It's clear that the days when a fund administrator could just throw bodies to support clients are long gone. Today, technology is the key to delivering the best and most meaningful solutions to clients.

the waterfall – which makes it complicated to manage.

We are also seeing an increase in the number of open-ended or evergreen funds in the marketplace. This fund structure is even more complicated to manage and requires increased capabilities, skills and an understanding of capital administration to manage.

And, as Gary said, we are seeing structurally more unique terms within the LPA. But then even within that, we are seeing investors negotiating special terms. So, if you have 100 investors in your funds, 70 may have the same terms, but 30 of them may have unique structures, may have negotiated a different management fee or a different carry. And so, each of those dynamics has to be taken into account when managing the waterfall.

Q Can today's software really accommodate the many nuances and complexities of managers' waterfall models?

GS: One of the biggest challenges we saw when we built our platform was the ability to be nimble enough and flexible enough to address not only the dynamics of the industry today, but the dynamics of the industry tomorrow. That is why this is a unique space, I believe, in the technology world.

This is not the old technology world where you build a software package that supports a defined and consistent process, and then you just do that millions of times. This is a different model – and that is why people are using our model: because it is a technology platform that is flexible enough to support different fund structures. The challenge in the technology space is not only the control, but it is just as much – if not more – the flexibility, the ability to adapt to new trends in the industry.

DS: With more capital coming into the market, there has been a continuing complication of structures today. And because of the way CapAssure has been built, we are able to support all of those types of structures. Part of this is because we built our technology on a bottom-up basis. So, we are truly tracking on a cashflow by cashflow, deal by deal, investor by investor and manager by manager basis.

In the past we have seen technology platforms that were developed for different purposes and attempts made to deploy them to support alternative investments. But we think those have not necessarily been the most effective approaches – taking existing technology and trying to apply it to this industry. We believe this industry demands and deserves specifically developed technology to support its specific and unique requirements. ■