Transitioning to PE-style fund structures requires shift in mindset

Interview with Scott Burns

Scott Burns, Senior Vice President at Horseshoe Group

Commitments to Private Equity ('PE') are breaking records, as investors seek better returns. At a time when the global hedge funds industry has seen record recent net outflows, some of hedge funds managers, who are riding this new wave, are choosing to launch hybrid PE-style funds, to tap into investor demand.

However, the ones who go down this path should be mindful of numerous operational traits, when morphing from an open-ended to a closed-ended fund structure.

Scott Burns, Senior Vice President of Horseshoe Group, a leading fund administrator specialised in alternative Investments comments: "We provide fund administration solutions to both PE and Hedge Fund managers. Working closely with our clients enables us to have a good perspective on current market trend and the challenges faced by hedge fund managers as they reposition into PE and hybrid products, to take advantage of a more permanent funding model.

"Investors continue to increase their allocation to PE, at the expense of hedge funds and such investment behaviour is driving hedge fund managers to revisit their current business model and switch from monthly performance reporting and pricing, to a domain of longer term valuation practice. It is also worth noting that PE Investors demand and expect greater transparency around reporting and they are less focused on monthly valuation/pricing."

Therefore, hedge fund managers transitioning to PE style fund structures require a shift in mindset and an acknowledgement that establishing best practices, from documentation management to investor reporting and valuation policies, are crucial at the outset.

"Investors in PE funds demand more detailed reporting than investors in hedge fund structures. The PE industry has been moving toward the Institutional Limited Partners Association (ILPA) standard of reporting over the last few years and we are seeing more players embracing this reporting standard," says Burns.

This enhanced reporting regime, requires dedicated PE systems and rigorous procedures and for this reason, Horseshoe Group has made significant investments in system and qualified personnel, to deliver first-class reporting to its clients.

In addition to a more robust and transparent reporting world, one of the most significant difference between the PE and hedge fund structure is the mechanics of the performance fee. Unlike a hedge fund performance fee, the PE waterfall carry structure creates a back-ended fee flow that often requires several years before payments are received by the manager.

This fee flow timing will impact the cash flow management approach, as well as reporting procedures.

"Another operational area that hedge fund managers might not be familiar with relates to capital calls and distributions. Subscription money stays in open-ended funds until the investor redeems whereas with a PE fund, the manager often does periodic, quarterly capital calls.

"This means they are regularly managing cash flow for investments and expenses and when they get to the harvesting side of the investment cycle they have to pivot to capital distributions. This process often involves complex waterfall calculations that often require a completely different model than performance fees calculated by hedge fund managers."

Burns thinks this might create some friction as hedge fund managers' transition into PE funds. Launching a fund first and then attempting to put the right operational infrastructure in place, when things start to get complicated, will likely lead to irregularities and a poor investor experience.

Commitment to best industry practices in reporting, valuation, investor communication and technology is the only way forward in Burns' view.

"Horseshoe can step in and assist any manager looking to launch their first PE fund(s). From consultation, fund structuring, valuation documentation best practice, financial reporting and carry waterfall model creation," concludes Burns. ■