Relieving the Capital Administration Burden

A WHITE PAPER FROM ALTER DOMUS

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Overview: The Capital Administration Burden

The alternative investment industry has grown beyond expectations in the last decade. More capital is being invested into this space than ever before and this trend shows no signs of slowing.

According to Preqin, the alternatives industry will manage more than USD $17 trillion by the end of 2025, as investors continue to search for strong uncorrelated investment returns in a low interest rate environment[1].

Growing investment demand has resulted in the launch of more funds and strategies, increasing the administrative load. In such quantities, data can stop being a blessing, and instead become an administrative, reputational, and regulatory burden. It's no wonder systems and people are being stretched to the breaking point. Ask the CFO of any General Partner (GP) to consider the number of funds being managed, multiplied by the number of Limited Partner (LP) investors and the number of portfolio companies, and they'll likely admit the amount of data involved is not just substantial, but in many respects terrifying.

Abstract

This white paper addresses the fact that the process of capital administration – namely waterfall calculations for LPs and carried interest allocations for GPs – has grown increasingly complex. Of course, these are general categorisations, and each LP and GP has their own set of unique challenges. But broadly speaking, we define the two stumbling blocks:

The volume of data has become overwhelming, leading to concerns over information security, transparency, accuracy, and speed. Therefore, how can LPs and GPs mitigate the risks of mishandled data and inaccurate reporting?

With increasingly complex fund structures in place, how can these firms incorporate a rules-based capital administration structure they know is reliable, repeatable, and capable of evolving to meet future demands?

We're here to talk

Capital administration is a complicated, nuanced area, and each GP and LP has its own set of distinctive challenges. We have taken a deliberately broad approach with this white paper, but we welcome the opportunity to expand further if you have any specific issues you would like to discuss with us.

[1] Preqin: The Future of Alternatives 2025

Managing Capital Complexity: The LP Perspective

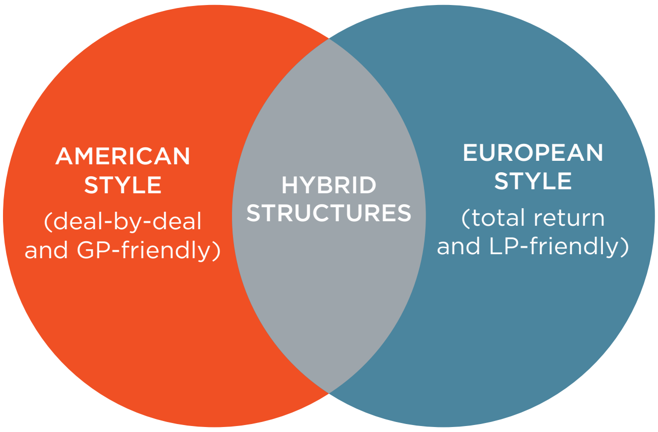
LP fund structures are increasingly complex and more exacting.

Distribution waterfalls define how the allocation of investment proceeds cascade down a series of capital recoupment tiers, followed by a preferred or priority return to the LPs, then a final sharing of residual profits between the LPs and the GP. Depending on the waterfall structure used – and the unique terms negotiated by each investor – distributions to LPs can vary significantly.

Historically, waterfalls for closed-ended funds have been defined as either **American style** (deal-by-deal and GP-friendly) or **European style** (total return and LP-friendly). More recently, the number of hybrid structures that seek to bridge the alignment gap between GPs and LPs (by including components of both American and European styles) and evergreen (open-ended) structures has increased dramatically.

Some recent expansions in LP waterfall complexity include:

- **Carry holdbacks:** The GP is eligible for carry but only a certain percentage of that carry (i.e. 75%) can be distributed. The non-distributed carry is held back until all LP principal and preferred return is returned.
- **Non-standard investor terms:** Including fees, preferred return or carry rates.
- **Preferred return:** Increasing non-standard LP-level terms as well as alternative measurement methodologies.
- **Interim clawbacks:** Clawback obligations are released prior to fund liquidation.
- **Sector or class-based waterfalls:** The fund is a deal-by-deal waterfall, but investments in certain sectors within the fund are allocated through a total return waterfall calculation (hybrid).
- **Carried interest rate ratchets:** The carried interest rate increases after a specific threshold is met.
- **Evergreen structures:** Open-ended funds providing enhanced liquidity and access to longer-term capital for investments.
- **Minimum return thresholds:** The GP can only take carry after a certain percentage (i.e. 70%) of capital is returned to its LPs.
- **Minimum value tests:** The value of the realised and unrealised investments must be greater than a certain percentage of contributed capital (i.e. 130%) before the GP can receive carry.



Alongside the increased complexity, LPs are demanding greater insight into the waterfall calculations used by GPs, and how capital is being administered. As a result of these daunting challenges, GPs have found it harder to manage the capital administration calculations through their traditional methods. Basic Excel models cannot support the greater level of complexity and are not dynamic enough to track and accurately report performance in complex waterfall situations.

GPs are under pressure to report accurately, transparently and in as timely a manner as they ever did. Yet their margin for error has shrunk, and the risk of a compliance breach, and financial and reputational risk, has magnified. Without rigorous reporting processes in place, an individual LP's capital performance, based on its own LPA terms, becomes incredibly difficult to measure.

The operational pain points for managing LP waterfalls

For CFOs and teams managing waterfall calculations, three operational pain points exist:

All three pain points have been exacerbated as waterfall structures have become more complex.

Volume of data

First, with more capital being invested in the alternatives space, and successful fund managers raising multiple funds, the volume of data managed by CFOs and their teams has never been higher. The fund manager who was managing two funds three years ago may now be managing five or seven, each with its own terms, investors and investment strategy.

To cope with this data volume burden, fund managers need an institutionalised process that tracks all the cashflows moving within the multiple fund complexes. Hiring additional employees to do this via Excel spreadsheets (if you can find the talent) does not solve the volume problem – it just leaves the fund manager exposed to multiple different models that can easily be modified with significant limitations.

Transparency requirements

Second, LPs require additional transparency to invest capital in new funds. These new reporting requirements may be written into the LPA or as a result of the fund manager following ILPA standards. To successfully meet these LP requests, fund managers must track data at the LP level. Should the finance team only track waterfall data at the fund level, it will prove extremely difficult to be 100% certain that it has responded to LP requests accurately.

Precision reporting

Finally, because of these issues, accurate reporting to LPs has never been more difficult. To ensure complete accuracy, a fund manager must manage its waterfalls on a “bottom-up” basis, deal-by-deal, LP-by-LP, and cashflow-by-cashflow. Only this level of granularity can ensure fund managers are reporting to and paying its LPs accurately.

Managing Capital Complexity: The GP Allocation Perspective

For GPs, once it has defined the appropriate carry to be paid then the next step is to allocate that carry to members – incentivising and compensating high-performing members. These carry plan structures are continuously evolving and becoming more complex.

Just as with the increased requirements and complexities associated with an expanding number of LPs, GPs must now cope with the burden of the increased size and scale of their operations, an increased number of funds, and a growing array of members who may be operating under different incentive structures.

Depending on its size, the number of funds under management, the number of investment professionals involved (including joiners and leavers), and the number of vintage years applicable, the level of complexity of a GP's carried interest calculations can soon become bewildering. Furthermore, a manager needs to layer the accounting requirements around committed capital and the potential use of credit facilities to support GP capital requirements.

While some GPs had previously been comfortable relying on employing their own 'Excel wizard' to develop and maintain spreadsheets that manage their carry and capital allocations to the GP members, many have grown to realise that this presents both an enormous 'key man' risk, as well as a significant technology disadvantage.

SOME RECENT EXAMPLES OF CARRY PLAN COMPLEXITY INCLUDE:

Static percentage carry plans are being replaced by bespoke arrangements where GP members are allocated incremental points on an individual basis (including by deal, industry, geography and vintage year) as well as a base carry percentage.

Where the base allocation of carry is adjusted to reflect the impact of cashflows from one investment being used to recoup losses from another (cross collateralisation). This can often impact how much carry a GP member truly has.

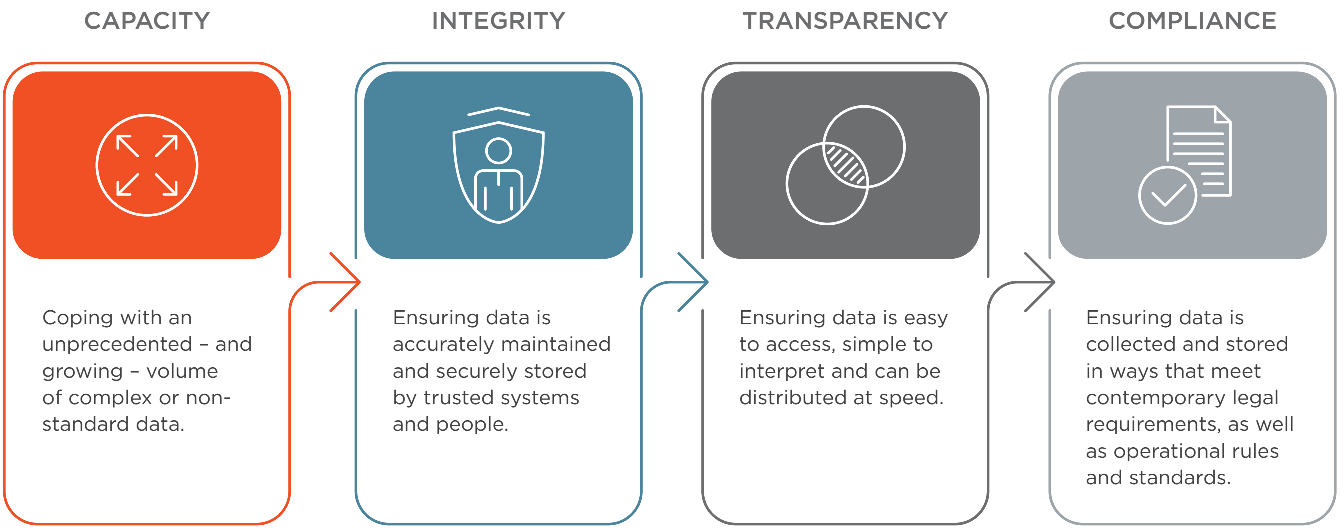
More fund managers now allow for (or require) GP members to provide an investment commitment to the fund. These member commitments also need to be administered and reported to the GPs. Some funds also enhance GP economics by providing credit lines to fund member commitments, creating management fee waiver plans, allowing for member co-investments and funding GP commitments on behalf of its members.

Easing the Burden: Capital Administration Systems and Operations

As the alternatives industry has accelerated in its scope and sophistication, it has become increasingly difficult – almost impossible – for human resources to keep pace.

Fortunately, there are both systems and operations solutions built to do exactly that. Both GPs and LPs share a similar set of stumbling blocks when it comes to capital administration:

CAPITAL ADMINISTRATION STUMBLING BLOCKS



Up to now, most GPs and LPs have been 'making do' with their internal capital administration processes, relying on Excel spreadsheets and Excel-trained employees, and keeping fingers crossed that nothing goes wrong. But the influx of investment capital, expanded number of funds being managed (and consequential reporting burden) and increased levels of competition within the marketplace makes this unsustainable.

Arguably, the 'legacy' way to solve administration issues was to simply bring in more employees to cope with the workload. This might have worked when GPs were managing one or two funds and reporting to a handful of LPs. But the sheer number of new funds under management – coupled with more sophisticated and bespoke terms – means coping with multiple variations on each partner agreement. The risk of human error, through inconsistent application and interpretation of these agreements, has increased dramatically.

Overcoming increased complexity and higher data volumes

As far back as 1983, the Capital Administration team at Alter Domus began developing a rules-based capital administration discipline, including systems and operations.

Our **CapAssure**® software is based on algorithms that interpret LPAs and convert them into a ‘spine’ of operational rules that form the basis of waterfall and/or carried interest calculations. Individual rules can be created and followed for each individual LP or investment partner, ensuring that every individual cashflow is accurate, regardless of the complexity of the agreement. Calculations that would have taken weeks to confirm as correct can now be completed in seconds.

What are the advantages of using rules-based software?

Creating a rules-based software platform ensures firms can confidently handle what was once an overwhelming volume of data. Instead of being forced to rely on that one person with Excel knowledge (along with the business and security risks that entails), the information is securely stored on a shared platform. All LPA agreements and legal obligations are encoded in the system (along with any relevant accounting and tax rules), providing a complete data and process audit trail, and making reporting obligations pain-free.

Case Study: Overcoming the Growing Pains of an Expanding Fund Range

At Alter Domus, our Capital Administration Solutions are being used by asset managers to deliver consistent, complex calculations for a fraction of the cost of developing in-house resources.

One of the most common problems successful fund managers face is the added complexity that comes with launching more sophisticated funds, as well as responding to the specific terms negotiated by an ever-expanding number of LPs. As an example of this, in 2018, we started providing administrative support to a client with approximately $1 billion of assets under management across two funds. Three years later, the client has scaled up operations considerably, and now manages six funds with more than $8 billion of capital.

Three-year period

	2018	2021
	$1 billion	$8 billion
FUNDS	2	6
LP	x 1	x 4.5
GPs	x 1	x 2.5

The complexity

While the number of funds has increased threefold, the number of LPs has increased 4.5 times over the same three-year period. To add to the administrative burden, to accommodate the increasingly sophisticated demands of its LP client base, the newer funds have been designed with more complicated fund structures (moving from total return to hybrid style waterfall calculations). Additionally, one fund also has a ‘super-carry rate’ where if the manager achieves the performance hurdle, the carry increases from 15% to 20%. Along with the added difficulty of maintaining the LP specific fund terms negotiated by each LP, the number of GPs involved in the fund complex has also increased by 2.5 times in the last three years. Unsurprisingly, there have also been several joiners and leavers during that period, with each requiring ongoing tracking and reallocation of their respective carry.

A streamlined, software solution

Such complications brought about by fast-growing funds under management can create huge back-office problems, while errors have the potential to cause significant damage to LP relationships. But the software services we delivered to the client when they ran just two funds were able to cope with the complexity as the firm scaled its operations and expanded its LP base. **CapAssure**® supports all types of funds and integrates with the client's own in-house accounting platforms to ensure an accurate and timely flow of information.

For this client, using our software services has delivered a number of valuable benefits:

NO MORE DATA OVERLOAD

The client can process and distribute large volumes of data across its entire fund range, at significantly faster speeds than achieved through its previous resource-intensive processes.

NO MORE APOLOGY LETTERS

The client has eliminated the risk of 'fat finger' errors that can occur when making complex calculations in Excel, and also benefits from being able to call on our internal due diligence team to prove carry accuracy.

ROBUST, BEST PRACTICE PROCESSES

The client has developed repeatable, institutionalised procedures to manage its capital administration requirements across multiple funds – ensuring a comprehensive data and process audit trail.

FROM 'DOING' TO 'REVIEWING'

The client's finance department's time has been freed up, allowing them to focus on their core skill set and add value to the company, while leaving the capital administration function in safe hands.

> "There is an ever-increasing demand for talent in the GP community. To attract and retain talent, managers must offer world-class GP carry and investment structures with leading accuracy and transparency."

CapAssure® Client

Conclusion

The alternative investment industry has reached a critical point. Investors are continuing to adopt alternatives as a part of their asset allocation investment strategy.

This new-found level of maturity for the asset class comes with its own set of challenges and consequences. With the increased levels of allocation into alternatives in the last few years, particularly from institutional investors, the demands on GPs in terms of investment data and capital administration resources have increased dramatically.

As their investment operations have expanded, and the demands from investors have become more sophisticated, firms simply cannot afford to rely on old methods. GPs must manage LPAs on an LP-by-LP basis to ensure accuracy and specificity. At the same time, CFOs need assurance that their funds' cashflows are accurately accounted for deal-by-deal, investor-by-investor, and GP-by-GP, to ensure distributions and allocations are correct and complete. There is simply no longer any margin for error.

This is why firms need to consider the benefits of bespoke technology capable of managing the risks and simplifying the capital administrative process. Such solutions are now available, affordable and can blend seamlessly with existing accounting software.

"Our capital administration services are agnostic to investment strategy and fund structure, and work across different accounting technology, giving asset managers an unparalleled level of customisation and automation."

GARY SHELTO
Managing Director, North America at Alter Domus

Customised Capital Administration Solutions

Our solutions have been purpose-built to simplify complex capital administration issues, while delivering a seamless reporting experience internally to auditors and to Limited Partners.

Our clients can choose from two distinct routes:

CapAssure® is a fully automated Software-as-a-Service (SaaS)-based platform that delivers timely, accurate and auditable allocations of LP and GP capital. It can be fully customised and integrates with a range of investment accounting platforms. This allows asset managers to enhance their existing operations with a secure, robust, and flexible technology platform, while minimising infrastructure overheads.

CapAdministrationSM is our service-based outsourcing solution that supplements in-house resources with specialist accounting, technology, and operations expertise. The service includes all the platform features of CapAssure combined with turnkey solutions for capital administration needs, reinforced with dependable and cost-effective operational support. It's a comprehensive service offering supported by SOC 1 Type 2 accreditation.

OPERATIONAL SUPPORT FOR:

- Distribution waterfalls
- Hypothetical liquidation waterfalls
- Clawback accruals
- Profit and loss allocations
- Capital account maintenance
- Capital forecasting
- Reporting, analytics, and transparency

Who should consider using capital administration services?

- Clients with significant assets under administration
- Clients with multiple investment products
- Clients with complex investment structures
- Clients with specific and complex LPAs and service requirements
- Clients with additional transparency requirements

About Alter Domus

At Alter Domus, we believe in building lasting partnerships through knowledge, trust, and collaboration. With a range of services that span the entire value chain of alternative investment structures, the world's leading asset managers, lenders and asset owners choose us as their partner for growth. We're committed to staying at the forefront of technology, regulation, and market trends, providing timely solutions to meet the ever-changing needs of our industry, and our clients.

We focus on the private equity, infrastructure, real estate, and debt capital markets sectors, offering a comprehensive range of fund administration, corporate services, depositary services, transfer pricing, domiciliation, and management company services. Our deep experience in the debt capital markets sector means we can provide specialist solutions such as capital administration, loan administration, agency services, trade settlement and CLO manager services.

Our distinctive vertically integrated model helps us build dedicated teams to deliver support and bespoke solutions across the entire value chain. Our clients can tap into a talent pool of 3,300 employees in 21 countries, across more than 35 offices, applying expertise and cutting-edge technology to put them ahead of the competition.

Visit **www.alterdomus.com/capital-admin** to find out more about our capital administration solutions or to book a **CapAssure**® demo.

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