

Time to Consider a New Infrastructure Model?

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Thinking about raising a first-time private equity fund or raising your next private equity fund? With a strong market for fundraising forecasted for 2008, you are not alone. Spurred on by announcements of increased institutional allocations, new market entrants, a vibrant (albeit volatile) financing market and a renewed focus on relative returns, many partners at leading private equity firms see windows of opportunity. Most hope that market optimism will sustain the rising tide in private equity.

While you focus on investor appetite, the challenging mechanics of your raise and craft your complex offering memorandum, you might also take stock of your firm. You might consider why many of the leading private equity firms are now reviewing (and re-creating) their infrastructure model as they raise new capital. While hardly as exciting as closing a new round of financing or recruiting a new strategic partner, understanding the infrastructure evolution story and its implications might be just as important to your firm's long-term success.

Under the "traditional" model of the private equity firm, once capital was successfully raised from investors, the firm's partners then had to build a firm infrastructure. A CFO or Controller was recruited, in many cases with a finance staff. A technologist (or a series of technology personnel) was hired and system development commenced. Other human resources, investor relations or non-investment staff members were hired. In essence, a small business, with a large investment pool, was painstakingly created.

You bravely built infrastructure while focusing on your principal activity, investing. You recruited and hired a range of experienced personnel and built your own architecture. Often a partner was designated as the "administrative partner" with the responsibility to execute the strategy. Like any good investor, he/she learned the business, provided resources, managed the skill sets of the staff and reported results to the partnership.

When executed successfully, the benefits of the "traditional" firm infrastructure model included a strong accountability for results. When executed unsuccessfully, the drawbacks included turnover, run-away expense and a lack of alignment of interests.

The "traditional" model worked well for many firms during a period of successful investment results and limited firm complexity. In many ways, the model worked until the 2000 market downturn. Infrastructure costs remained modest when measured against investment success. A high level of investor tolerance regarding transparency, expenses and best practice governance acted as a "safe harbor."

Facing the 2000 downturn and its financial consequences for private equity firms, many partnerships began to closely examine the "traditional" firm infrastructure model. Some firms did this at a leisurely pace, while others found it necessary to do on a highly expedited basis. In doing so, they began to question some of the most basic underlying assumptions of the Do-It-Yourself (DIY) model. A "new" hybrid firm infrastructure model for the industry began to take shape.

For many of the private equity and venture capital firms embarked on a stated mission to build a strong, enduring brand name in alternatives and attain success as an institutional asset manager, building a world-class internal infrastructure was no longer the same game after 2000. Some of the cachet of "DIY" had disappeared. With complexity, transparency, specialization, corporate governance, risk management, litigation risk and delivery cost increasing at all firms and investment returns slowing, infrastructure "home cooking" was

just not as tasty an alternative. In some cases the internal expertise was just not available, the development time too long or the cost of education too great. With the consequences of investment failure up sharply, firms were also faced with the need to shift more resources into areas like investment staff upgrading and apprenticeship. Venture partners with industry expertise were needed. Administrative partners were now needed to be working directly with the portfolio companies, not with the internal staff or technology.

During the same time the recognition that many of the infrastructure needs of the private equity firm could be successfully outsourced or managed externally took hold. Outsourcing or off-shoring investments were made, managed and harvested profitably by many venture capital firms. Partners became familiar with core competency, best practices, benchmarking and best-in-class. Private equity infrastructure outsourcing success stories in the areas of human resources, technology, investor relations, accounting and administration emerged, their costs became more transparent, and

investors became familiar with specialized professional service providers. Established firms began to look at evolving their "traditional" internal infrastructure model, albeit carefully.

For firms now thinking of raising a new private equity fund or their next private equity fund, understanding the continuing evolution of the "traditional" firm infrastructure model, its implications and particularly, what alternatives your firm might consider is increasingly important. It's not just "back office." Given the stakes (and cost), you need to take a hard look at just what is (and what is not) under the hood at your firm and what you will expect to need in the future. What infrastructure resources, professionals and managerial time you and your partners decide to provide (or bear) – over the typical ten to twelve year fund term, good performance or bad – should be a key consideration for you right now. Do you adopt or continue with the "traditional" infrastructure model? Knowing reliable partnering alternatives now exist and are in many cases the preferred choice for new

funds, do you move to a hybrid co-sourcing or outsourced model? The decisions made will reflect favorably or unfavorably over time with your investors, impact your returns and finally, shape your partnership.

While hardly easy, you might ask yourself the following pointed question before you meet with your prospective investors. Before you staff up, commit (or re-commit) the partnership to the "traditional" infrastructure model and set the performance bar as high as possible. Ask the single question not on a blanket basis, but in relationship to the various infrastructure components and roles within your firm. Ask simply if you absolutely need to "build it" or if you can "buy it." If the answer is a "no" or even "possibly," maybe it's time to consider a new model.