Private Equity, Going Digital

Abstract

Investments in private equity are growing manifold as private equity firms are delivering better returns than other forms of investments such as equities, fixed income, and real estate. With a growing investor base, private equity firms are under pressure to modify the 2-20 fee structure. Moreover, limited partners are playing an active role in the investment process, which has led to firms moving toward digitization to effectively lower the fees, streamline the investment life cycle, and improve operational efficiencies. This paper explores the current industry drivers for digitization, technology adoption, and challenges before firms.

Private Equity Firms are Going Big on Digitalization

Private equity (PE) is the largest asset class in the investment management industry. Investments in various traditional funds, co-investments, and direct deals are on the rise and have increased exponentially in the past few years.

Some of the key factors that are driving private equity firms to adopt digital technologies include:

Demand for customized products: There is increased demand from limited partners (LPs) to provide a range of customized products across diversified private equity investments, like buyouts, growth funds, and other investment vehicles like credit, and real assets that align with their investment mandates and yield targets.

Need for transparency and lower fees: The need for greater transparency through the investment lifecycle both in terms of standardized fee reporting and lower management and performance fees is pushing private equity firms to digitize core functions.

Shift toward direct and co-investments: LPs are also moving toward directly investing and co-investing in the companies along with private equity firms. In many cases, co-investment and direct investments are yielding better returns, and LPs' preference for such avenues is resulting in lower fee income for PE firms. This in turn is putting pressure on firms to move towards digitization to provide better services at reduced fees.

Focus on portfolio management and operational efficiencies: The need to improve operational efficiency in an effort to free resources to focus on more value-adding activities like analysis and investor relations is a key driver of digitalization. PE firms are seeking to improve decision-making in their operations and portfolios driving investments in portfolio analytics and management tools. This will also lead to greater transparency and better insights to investors.

These factors have led to a shift in the private equity business model with firms leveraging new technologies like artificial intelligence and blockchain to improve operational efficiency and garner better insights for decision making.

How Digital Technologies Will Help

Given the importance of digitalization in the private equity space, here are some technologies that firms must explore:

Artificial intelligence and deep learning: AI and machine learning techniques can be leveraged for efficient due diligence, deal valuation, execution, customization, and informed decision-making. Another important use could be with regard to the initial evaluation of companies to invest in. Such an evaluation could include scrutiny of financial statements as well as earnings and performance reports to provide insights into the health of a company, potential value in investment, and expected future returns. Combining this with the available unstructured data (business, legal, or financial) helps inform decisions and model risk, return, and exit strategies, besides speeding up due diligence and execution of deals.

Data analytics: Adoption of advanced analytics strategies throughout the life cycle ranging from deal valuation reporting to portfolio management reporting on performance and other key indicators can result in time-sensitive decisions using reporting data models. Data lakes can be leveraged to collate all the firm's data and build an analytics platform on top of it to cater to automated investment research, due diligence of target companies, regulatory compliance and reporting, and so on.

Other functions that could benefit from analytics are fund structuring for tax optimization, tax advisory and compliance, governance and regulatory reviews, and so on. Data visualization tools like interactive dashboards help both the buyers and sellers by providing a single, unified view of data and facilitating personalized simulations. Automated alerts can also be set up for capital calls, redemptions, and stock and cash distributions.

Blockchain: Blockchain technology can be utilized for the maintenance of records. Record-keeping in private equity is typically manual and time-consuming. Using a blockchain system enables participants to collaborate over a distributed ledger to maintain legal and contractual agreements and record transaction related information. Besides enhancing process efficiency, cutting costs, and driving transparency, blockchain systems have the potential to alter the fee model and put pressure on firms following a traditional model. Some asset management firms have already adopted blockchain technology to improve efficiency, security, and transparency.[1]

Social platforms: Social and online platforms can be leveraged to create a network of fundraisers and investors allowing direct access to private equity investments, thus providing a better deal and lowering management fees. The platforms also provide reports on the buyout firm's performance, potential earnings, and so on based on predictive models and historical analytics. Private equity firms should look at opening up alternate channels of communication through social platforms to connect with investors and offer investment opportunities, thus increasing reach and lowering costs.

Multi-channel investor communications: Private equity firms regularly send customized reports to their investors on their investments. In addition, investors seek information about various aspects like leadership team, diversity and environment, social, and governance (ESG) factors, of the companies firms invest in, apart from fees, and expenses. Digital technologies can be leveraged to standardize all such communications. Professional networks like LinkedIn can be leveraged to research companies in which a firm invests. General Partners must consider using social media platforms to reach LPs and prospective customers to extend credibility.

Looking Ahead

Digital technology adoption in private equity firms, however, comes with its own roadblocks. Building investment and risk models pose challenges as the portfolio companies vary from each other in terms of size, business, and more. Deal valuation and execution consider several qualitative factors that cannot be incorporated into a digital model. Niche deals that do not reach the wider market hinder efficient customer relationship management and marketing. Private equity firms must look at partnering with FinTech startups and service providers to address these challenges and equip themselves with the requisite capabilities required for digital transformation.

Demands for increased returns and improved service is putting pressure on private equity firms to transform their business model. Cost effective operations, lower performance fees, and increased transparency are becoming crucial to their success. The way forward lies in leveraging digital technologies as part of an overarching strategy rather than opting for tactical investments to address operational challenges. Defining and implementing a digital strategy that focuses on investing in the right technologies based on a thorough evaluation of individual firms' internal operations and strategic goals will be key to realizing the return on investment and gaining a competitive edge.

References

1] Northern Trust, Press Release: Northern Trust and IBM Pioneer Use of Blockchain Technology to Help Transform Private Equity Administration (February 2017), accessed December 28, 2017, https://www.northerntrust.com/about-us/news/press-release?c=70b5ba1adc9928f9977162844c34f57a

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