How private equity is tackling operational complexity

General partners are improving their efficiency and scalability through digital and analytical tools.

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We recently surveyed 24 general partners (GPs) about their internal operations.[1] The research produced several surprises, none bigger than this: for private equity (PE) firms, economies of scale start to kick in at roughly $8 billion to $10 billion in assets under management (AUM)—and that is also about where they stop. For example, smaller firms tend to employ 22 to 30 people per $1 billion in AUM, while firms with $5 billion to $10 billion employ just nine. But firms with more than $50 billion under management employ almost as many (eight per $1 billion in AUM). In some functions, the expected efficiencies are not only absent but even reversed: we found evidence of diseconomies of scale across finance, operations, human resources, and compliance. In PE, the largest firms are in many ways less efficient than their smaller peers.

This complexity is a growing pain for the industry. The first buyout firms were founded in the 1960s, and an industry was born as many more followed in the ’80s and ’90s. The PE industry, now more than 30 years old, is maturing in many ways. Historically, GPs tended to tackle operational problems by adding people; relatively high profit margins meant GPs did not have to focus on efficiency or costs. Today, the problems are more complex; yesterday’s bespoke solutions have begun to create their own challenges, and inefficiency not only adds considerably to costs but also inhibits scalability.

As our colleagues have discussed (see page x), PE firms and other private market managers are now turning to digital tools to improve many parts of their business. In this article, we will look at how one of those parts—the back and middle office—has grown increasingly complex, as well as the ways in which digital and analytical capabilities can improve operational efficiency.

Layer upon layer

The PE firm of the 1990s was a fairly simple operation, with just a few products and a small number of clients. Today’s PE firm offers an unprecedented variety of products to a wide range of clients. On every dimension—products, asset classes, legal entities, jurisdictions—PE firms are doing more and interacting with clients through a range of touch points, such as investor relations staff, fund administrators, and digital portals. To take just one example, in the 1990s few GPs offered more than a couple of distinct products. Today, the larger firms manufacture dozens of types of exposures, across many different asset classes around the world, for an ever more diverse client base.

The result is extraordinary complexity. Our survey found several examples, starting with the number of legal entities firms create to house their products, assets, and operations (Exhibit 1). Compared with smaller firms, the largest ones create many more entities—thousands of them for the larger multi-asset-class GPs. That complexity has a cost, as each entity must be accounted for, put in compliance with regulations, reported on to investors, and so on.

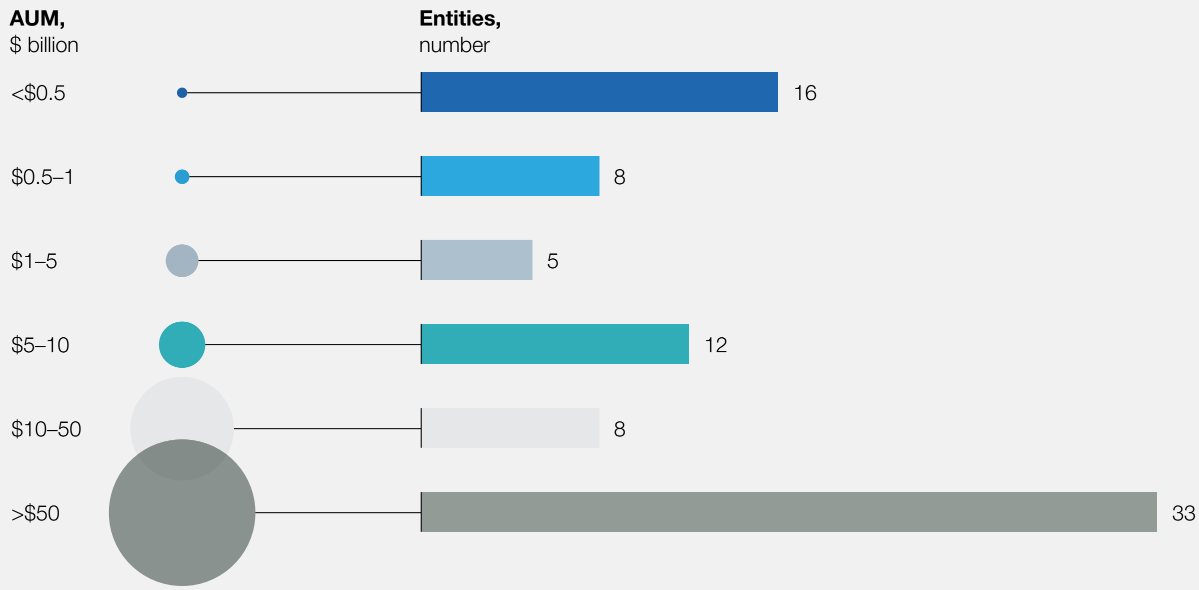
One of the biggest sources of added complexity is the growing number of ways firms interact with clients. Commingled funds used to be virtually the only method. Then, separately managed accounts appeared (Exhibit 2). Today, firms regularly create all manner of new relationships: not just blind pools and separate accounts but also sidecars, co-investments, and other structures with institutional clients—sometimes lumped together under the rubric of strategic partnerships. At the same time, firms are also experimenting with diverse vehicles aimed at the retail market. To be sure, this has created opportunities for more investors to access private markets with greater precision, but it has also massively increased complexity in the system, as each new arrangement is incrementally reflected in firm systems and processes.

In these and numerous other ways, complexity has been growing rapidly in PE. Behind the scenes, however, the modern PE firm still uses an outmoded approach to keep up: adding people. This has proved to be an expensive and inefficient solution, in many

Exhibit 1

Complexity expands markedly in firms with more than $50 billion in assets under management (AUM).

Legal entities per billion of AUM,[1]



[1] Calculated using total number of legal entities in each AUM grouping, divided by total AUM for funds within each AUM grouping.

Source: McKinsey survey of general partners, 2018

cases. Our survey showed that in several functions, including IT, finance, and fundraising, larger firms must hire proportionally more people than smaller firms do (Exhibit 3). Even where efficiencies show up (investment professionals, for example), they are much smaller than might be expected from a linear extrapolation.

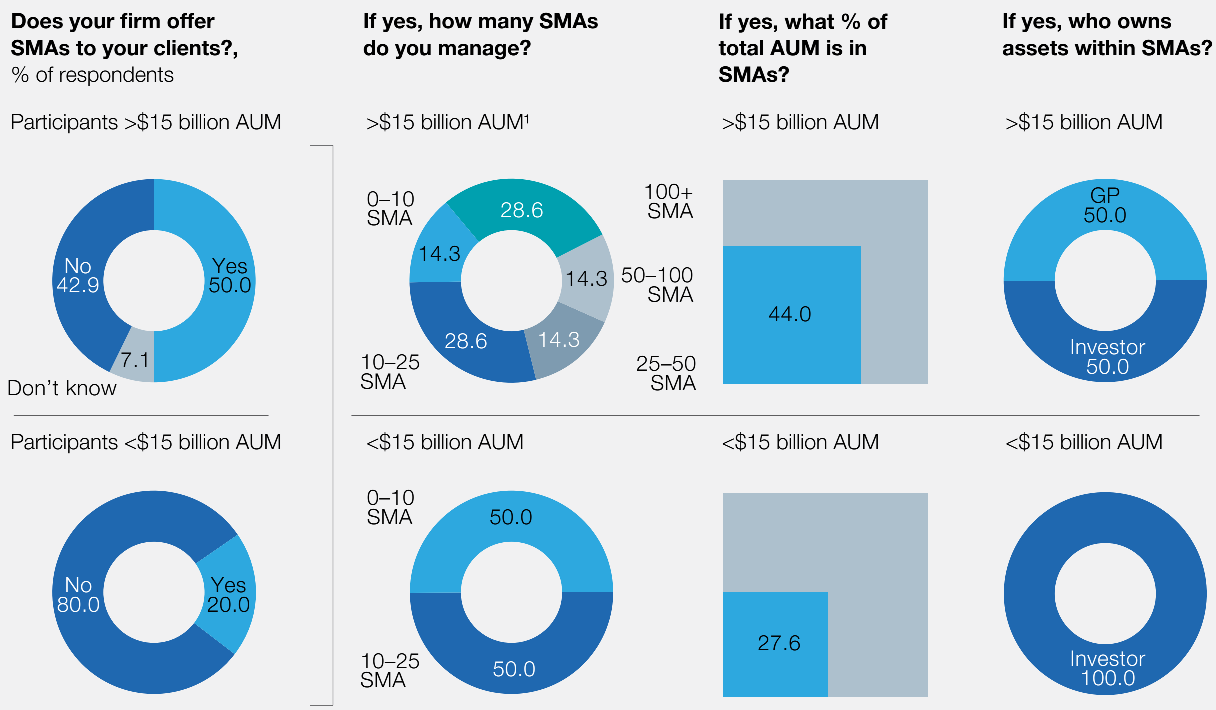
This complexity (and the ability to control it) doesn't matter only for controlling costs. As the industry matures, GPs are increasingly judged against traditional asset managers and other large financial institutions—organizations with a decades-long head start in streamlining and scaling operations. As these firms begin to shoulder their way into alternative assets, GPs will need to become more competitive on these dimensions.

A digital path forward

Digital is remaking ways of doing business. McKinsey research finds that, on average, companies around the world have digitized nearly 40 percent of their work.[2] That research did not include the private investing industry, but in our experience GPs have thus far stayed mostly on the digital sidelines, even as they have ensured that their portfolio companies are digitally competitive.

Digital offers GPs an escape from their productivity trap. Across back- and middle-office functions, a digital transformation holds the promise of creating expected economies of scale, so GPs can grow more profitably. More firms are willing to acknowledge that goal today than during what for many GPs was the stick-to-your-knitting times of the past.

Exhibit 2 **A big factor in rising complexity of assets under management (AUM) is the separately managed account (SMA).**



[1] Figures may not sum to 100%, because of rounding.

Source: McKinsey survey of general partners, 2018

A digital transformation certainly harnesses the power of cutting-edge digital tools but encompasses so much more, including client-experience and design-thinking principles. Firms that successfully digitize their operations apply five core levers, in combination.

Client-journey redesign

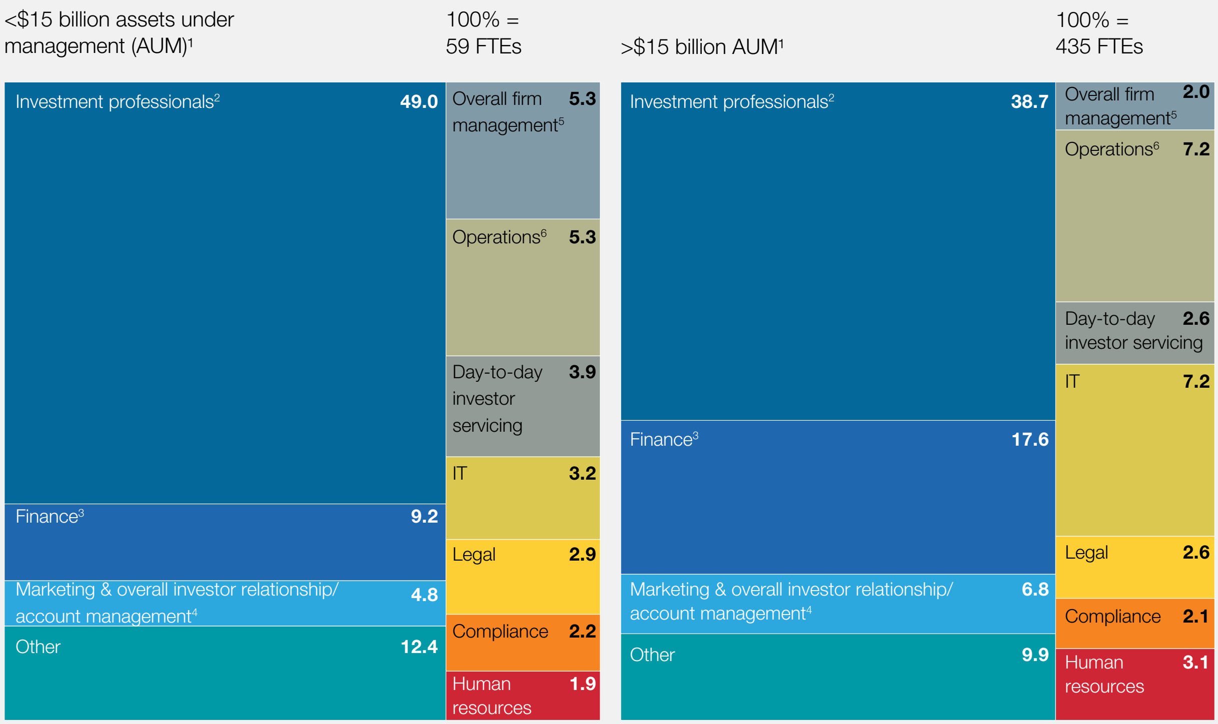
Firms are looking at their functions through a new lens, the client journey: a progression of touch points (personal, digital, paper, events, and so on) that together constitute the limited partner's (LP's) experience of its GP. Seeing the world as clients do and reshaping interactions into sequences of activities that cut across traditional functions can help firms organize and mobilize their employees around their clients' needs. Some firms, for example, have improved the client experience and their internal productivity by redesigning the way they deliver investment and market insights to LPs.

Intelligent process automation

Firms find significant efficiencies by investing in robotics to perform common, repetitive, and low-value tasks—for instance, using advanced optical character recognition to scan the reporting packages of portfolio companies and bots to upload them to a portfolio-management system. Smart work-flow tools are used to streamline and systematize complex activities, such as the money in/money out process, which requires numerous lookups, validations, and approvals across segregated functional roles in the treasury and accounting functions. This kind of intelligent process automation frees valued employees from burdensome work so they can focus

Exhibit 3 **As firms grow, some functions scale worse than others.**

How many professionals does your firm employ in each of the following areas?, % of all full-time-equivalent (FTE) employees



[1] Figures may not sum to 100%, because of rounding. 2For example CIO, portfolio managers, analysts, and traders. 3Including accounting, treasury, and tax. 4Excluding day-to-day investor servicing. 5For example CEO, president, managing partner. 6Including data management.

Source: McKinsey survey of general partners, 2018

on value-adding activities. That helps firms to retain top talent and to perform well overall.

Business process outsourcing

Outsourcing to third parties allows firms to focus on their core value-adding work while enabling scale and supplementing in-house capabilities. While this is old hat for public-market managers, many PE firms find that business process outsourcing can help break the linear relationship between costs and scale, although ease and efficiency often dip initially as functions are outsourced. This change has been enabled by the transparency into providers that digital and work-flow tools make possible and by the growing capabilities of companies that provide PE services. Many PE firms are examining strategic partnerships with fund administrators, for example. Fundamental to this evolution is the dawning recognition among many GPs that even if they are quite singular, some of their business processes are becoming commoditized.

Advanced analytics

A new breed of advanced analytics (AA) is providing the intelligence to improve the speed and quality of decision making across middle- and back-office functions—a development that will grow in prominence over the coming years. Although AA in PE is in the early stages, it has gained considerable traction in sales-force management. GPs are beginning to build data reservoirs of client characteristics, and they use AA to design more personalized distribution and service models centered on an understanding of their clients' needs. Another area with much promise is the generation of insights for client reporting through the application of artificial-intelligence techniques such as natural-language processing.

To succeed, AA must be coupled with strong data management, governance, and architecture—which, by and large, are new to private markets. Managers will also need both proprietary and third-party data to deliver benefits at scale. Firms that do this well focus on a few applications (typically, three to five) and ensure that these deliver an ROI before moving on to others.

Digital sprints

Leading GPs that transform their operations are not tweaking steps here and there but instead examining processes end to end and reimagining what they could look like with a new digital tool kit. Likely targets for digitization include tax reporting for thousands of entities, and bank-account reconciliations.

Firms are executing these digital transformations not as traditional "waterfall" projects, many of which fail to deliver their full promised impact. Instead, they rely on short digital sprints: 12- to 16-week cycles when cross-functional business and technology teams use agile principles to tackle a tightly scoped set of problems and to give users working functionality. Through an iterative sequence of such digital sprints, leading PE firms find that they can deliver higher returns on their IT investments, and at lower risk—a trade worth making.

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Digital effectiveness is a rare competitive advantage for GPs today. We expect that before long, it will be a competitive necessity. Initiating a digital transformation is therefore increasingly a top-of-house priority for many GPs—critical to maintaining their distinctiveness and improving their ability to serve clients. ■

[1] The survey was conducted in January through March 2018. Ten GPs had assets under management (AUM) of $10 billion or less; 14 had more. The mean AUM was $32 billion.

[2] Jacques Bughin, Laura LaBerge, and Anette Melbye, "The case for digital reinvention," *McKinsey Quarterly,* February 2017, McKinsey.com.

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