A RENEWED LOOK AT CASH MANAGEMENT & CONTROLS FOR PRIVATE EQUITY FUND MANAGERS:

EMBOLDENED BY A 'NEW NORMAL'

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KEY TAKEAWAYS

- Fund performance benefits - Spreadsheet-driven cash management makes accurate, timely and consistent cash projections next to impossible; improved modeling can lead to improved IRR through reduced cash balances.

- Investors are taking notice of cash management practices - Spreadsheets and manual processes cause unnecessary operational and cyber-security risks for treasury operations.

- Prepare for scale - Enhancing cash management practices to capture evolving trends requires robust, nimble and scalable technology solutions. Bank portal technology is adequate for a single bank but quickly breaks down when looking across a multi-banked private fund complexes.

- Regulatory scrutiny –Broadening appeal of private funds has increased the expectation of robust AML-KYC processes.

- The COVID-19 pandemic-fueled 'work from anywhere' environment has further strained shops with under-invested cash management infrastructures.

No one foresaw the business continuity event that is the COVID-19 pandemic. 'Work from Home' seemingly stretched from being measured in days to weeks to months, and now we can call it one-half of a year with some companies already announcing extensions to summer of 2021! If anyone would have asked in early March 2020 "how about everyone work from home for the rest of the year?" that question would have been met with unabashed, laughable skepticism. Yet, here we are, and business operations have admittedly run much more smoothly than anyone could have anticipated. The long-term ramifications of the pandemic on private funds finance, treasury and accounting operations is far from known; however, for a host of reasons, private funds firms are embracing a 'new normal' which includes a long-term, permanent shift to a sustained, partial remote operations workplace.

Perhaps no internal fund management process is as fundamental to private funds operations as the cash lifecycle – incoming investor cash contributions to outgoing cash for investments to investment realization and cash distributions back to investors. In between are a multitude of fund expenses and management fees, with cash flows following legal entity chains and complicated allocation matrices.

As successful private fund managers organically grow AUM over time, the number of depository bank relationships, credit providers, legal entities and corresponding bank accounts grow exponentially. This inevitably leads to operational complexity; without appropriate scaling of processes, technology and people, the opportunity for errors, fraud and suboptimal financial management also increases. ***Over 95% of private fund managers are managing the cash lifecycle with the same class of resources today as when their first fund was opened: individual banking portals, spreadsheets, email, share drives and human capital.***

This article addresses 'cash management' which is inclusive of 'cash operations.' *We distinguish sharply between these two terms – 'cash operations' is the process of collecting and disbursing cash through a controlled environment at a fund manager. 'Cash management' is the strategic management of not just cash deposits but also more broadly, all liquidity sources such as capital calls and credit lines – it is inclusive of cash projections, cash positioning, risk management, financing, investor interactions as well as 'cash operations.*

What Makes Private Funds Cash Management Unique?

The cash operations process (also referred to as "payments") itself is not terribly unique for a private fund management company, as compared to, say, a corporate business. But payments are where private funds' similarities with corporates quickly diverge.

Cash Management Objectives

1. Safeguard assets
2. Strong internal controls
    a. Preventative
    b. Detective
    c. Mitigating
3. Minimize idle cash
4. Maintain adequate liquidity for operations and opportunity execution
5. Operational efficiency

The Foundation of PE Cash Management: Cash Projections

To investors, cash really is king – it all comes down to cashflows netted to IRR, DPI and TVPI.

For private equity managers – both direct funds and fund of fund structures – the name of the game is 'just in time' ("JIT") cash management. Idle cash drags down returns and can create compliance challenges with investor agreements. Balancing JIT cash management is the need to have enough funding – cash and other liquidity sources – to meet obligations when due and to allow investment teams to take full advantage of opportunities as presented. While this may sound straightforward enough on the surface, executing against the JIT mandate is quite challenging in practice. Given the number of different actors involved across the fund and the management company coupled with the uncertainty of amounts and timing of many material cash flows, complexities mount quickly as the business grows.

The strategic role of cash management – best decisioning on liquidity positioning (cash, investor commitments and credit facilities) given currently known and probable future cash inflows and outflows - was a difficult task in 'normal' times and has become even more difficult in the remote work environment. Creating and maintaining a frequent, timely and accurate cash forecast by legal entity is an extraordinary challenge with only spreadsheets and email; there are simply too many actors, too many assumptions, and too much change to be accommodated in a spreadsheet. The value of optimizing finance decisions – and ultimately IRR – based on repeatable calculations and accurate information of fund flows compels fund managers not to short-change or over-look sound cash management.

Even those finance executives who are unable to leverage a timely and consistent cash projection acknowledge the value of having cash projections, particularly as it relates to when to call or return investor capital. However, the difficulties involved in preparing such analysis causes many fund managers to relegate their preparation to an infrequent (e.g., quarterly) or as-requested (generally by senior management) basis.

The Operational Imperative

The differences between the success of cash operations and cash management during the pandemic essentially comes down to the sheer number of business functions involved and the certainty of data involved. In cash operations, cash amounts and associated movement dates are known with certainty by a single business function, typically the accounting department. In contrast, cash management requires a multitude of inputs from not just accounting – but, investor relations, portfolio management, investment teams, and the finance team. And, often, future cashflows are not firm, their timing and amounts may change.

The COVID-19 pandemic has accelerated the digitalization of business processes across the many aspects of the private funds business -- from investor relations to investment teams to finance and treasury. Historically, nearly all private fund managers had invested in back office accounting systems, but the same is not true with cash operations and cash management. Managers have noted that maintaining the same level of internal controls over cash management while the operations team is dispersed remotely, has become more challenging and less efficient. Without the constant interaction that being a co-located team affords, the simplest of control activities -- such as reminding a cash movement approver to review and sign-off -- can become challenging.

The job of cash operations has proceeded throughout the pandemic with little interruption but with plenty of one-off mitigation to handle cash breaks, credit facilities movements, and increasing incidents of attempted cyber-attacks. By their very nature, cash movements had well-defined processes and internal controls that fork-lifted reasonably well to the remote work world with a few minor adjustments. The speed and automation of cash movements in the private funds industry has benefited from technology provided by the banks, corporate payments platforms and, in some cases, administrators. That said, frequently these technology solutions lead to inconsistent workflows across different providers and, inevitably, core cash and liquidity processes that are spreadsheet dependent; so, while these processes have become semi-automated, opportunities exist for standardizing and strengthening controls around cash movements.

The private funds industry, generally, and the smaller managers, in particular, are historically under-invested in technology resources. A few of the larger managers have begun ramping up investment in professional technology management – and talent generally. As business processes and supporting systems are put under review by experienced technology executives, several common themes emerge. First is the need to migrate to enterprise-scale technology with a cohesive and comprehensive architectural plan; the appropriateness of small business accounting systems and a siloed patchwork of spreadsheets to store common data is long past for all but the smallest managers. Second, is the need for a data management strategy, starting with a reference data framework. Establishing a 'golden source' reference data repository for all foundational data that drives cash management is critical – including, legal entity details, investor details, investment details, and bank/counterparty details. Third, is deployment of technology capabilities that will allow scaling without adding headcount – robotic process automation (RPA) is front and center in this journey.

One textbook example of RPA in action is the Cascading Cashflows challenge. As compared to other asset management strategies, private funds typically have a large number of legal entities surrounding the main fund. To preserve the integrity of the legal framework, cashflows in and out of the fund entities must conform to a strict chain of custody, with cash needing to settle in one legal entity before a transfer is initiated into the next entity in the chain. This laborious and time-sensitive task has been innovatively automated with RPA so that it becomes a monitoring exercise for the cash team rather than a potentially disastrous forgotten step.

Commercially available software to address straightforward cash operations does exist, however it is very limited in functionality, falling short of eliminating spreadsheets and providing higher-value, strategic cash management function and insights. A few of the largest and longest-standing private fund firms have invested over decades in proprietary technology to comprehensively manage cash and liquidity. However, with the increased complexity of fund structures, the expanded allocation of capital to the private funds market, innovative liquidity products, the cost of keeping proprietary technology updated and secure often outweighs perceived benefits causing managers to migrate in increasing numbers to commercially available solutions.

Investors are increasingly adding to the cash management focus during operational due diligence. The perils of semi-manual, spreadsheet-driven business processes are well understood and represent an unacceptable business practice to the more sophisticated allocators that understand the 'art of the possible' in treasury operations.

Its Never Done: Keep On Enhancing

Leading finance executives understand the importance of evolving business processes, controls and supporting infrastructure, continually. Private funds have not been subjected to intense regulatory mandates at a level approaching many other asset management classes. That said, private funds are subject to important regulations and monitoring compliance with the same is critical.

One area that has received increasing focus recently is anti-money laundering (AML) compliance. During investor on-boarding, one aspect of the know your customer (KYC) process is to link each vetted investor to a specific bank account. When capital is called, then, it is critical to ensure that the account funding the call precisely matches the KYC'd account.

Given the number of investors being called and the typical 10-day funding window, many operations groups are overwhelmed chasing down missing calls, and updating last minute deal flow changes. Cross-checking banking details with AML-KYC documentation adds another time-consuming process to an already stretched staff.

Recent concerns expressed by regulators has impressed upon the private funds industry the importance of ensuring that each and every inbound capital receipt and outbound distribution payment is linked back to the KYC account details. Technology solutions are evolving quickly to help private fund managers efficiently meet this challenge.

Right-Sizing Private Funds Cash Management Technology

A start-up fund manager's operations typically mirror the initial investment mandate –a relatively small, straightforward initial investor group with all the manager's focus and energy on fundraising and sourcing the right set of initial investments. The back office in the early days, understandably, has a lower priority in the allocation of time, headcount and dollars. Perhaps starting with just one core bank for deposits and a credit facility for financing cash operations are launched. With one fund, a few investors, and a deal or two, keeping control over cash projections, capital calls, and payments is all simple enough. That said, success quickly breeds complexity – adding clients and raising new funds corresponds to a proliferation of banks, legal entity structures, credit facilities, and investor relationships; portfolio management grows in complexity with the deal team, accounting and finance employees all having a small part of cash management. Spreadsheets, phone calls, and emails easily show strain with growth.

Clearly, there is 'no one-size-fits all' answer to the appropriate level of technology, internal/external system integration, and robotic automation for a given private funds manager. Regardless of firm size or operational maturity, managers must always keep the cornerstone objective of safeguarding assets and strong internal controls over cash at the forefront.

The common theme in addressing growth and increasing complexity of successful fund managers' cash management processes is the never-ending expansion of spreadsheets coupled with increasing headcount. While spreadsheets have a role to play in every organization's finance and accounting processes, creating a "System of Spreadsheets" for mission-critical business processes such as cash management leads to a multitude of potential shortcomings, as delineated to the right. These shortcomings are not unique to cash management or private funds and are studied and well-documented.

For most private fund managers, the entry point into the digitalization of cash management is the consolidation of all banks and other counterparties, across all accounts, into a single technology platform. The immediate advantages of this single platform approach are that analysts can redirect their time from decentralized, manual activities (logging into individual banking portals, copying or downloading balance and transaction activity, pasting it all into a master spreadsheet to normalize the data on a consistent basis across counterparties, etc.) to the achievement of daily transparency of all cash positions across all legal entities, organized in common framework. The second major, immediate, advantage of the single technology platform approach is the ability of fund managers to apply its own, consistent set of delegation authority workflow rules to cash movements, regardless of bank and third-party service provider (e.g., administrator) utilized.

Common System of Spreadsheet Shortcomings

1. Lack of robust data validation
2. Formula errors lead to decisioning on bad data
3. "Islands" of information, sometimes redundant and no golden source
4. Lack of secure collaboration
5. No time series trending across daily processes
6. No audit trails
7. Rudimentary security models
8. No consistent backups
9. Key person dependencies
10. Big data opportunities slip away

Beyond transparency and control, private funds managers that are leveraging a treasury management system (TMS) purpose-built for the private funds market, can take advantage of a large and growing number of integrated capabilities. A few specific examples include robotic processing that understands fund structures and preserves the integrity of cash movements through a chain of legal entities, managing subscription line activity, building cash projections that consider not just known cash flows from internal books and records but also probable investor and investment cash flows, and a multitude of similar, private funds specific capabilities.

Doubling-Down on Internal Controls

Every private fund manager is aware of the need for strong internal controls over cash operations and have implemented many controls, often with the oversight of their independent auditor. The new, pandemic-fueled 'work from anywhere' operating environment gives rise to the need to re-think cash controls.

The amount of information flow and formal and informal management oversight afforded in a co-located work environment went away – overnight – sometime in mid-March 2020. Conventional wisdom in March 2020 was this 'pandemic thing' might last a few weeks, perhaps a few months, but we have all come to realize that the operational impacts of the pandemic will be with us for quite some time. Most managers believe that many operational changes will sustain long after the pandemic crisis ends.

Many fund managers have noticed significant upticks in attempted cyber-theft through all channels – phishing, identity theft, social engineering, hacking, virus injection and more. The most concerned managers have enhanced cyber-security, added to employee training on controls and cyber-theft and migrated cash processes from a spreadsheet, banking portal and office tool "system" to an industrialized, enterprise-system that offers robust preventative and detective controls.

A Way Forward…

The cash management and cash operations processes are core to the smooth functioning of any private fund management firm. Fund managers have a clear fiduciary responsibility to diligently safeguard each investor's cash contribution, from the moment the first dollar of contributed capital is received to the moment the final distribution is made. LP and regulatory scrutiny in this area will only continue to increase.

Technology based solutions to support private fund managers' unique and onerous cash management challenges have evolved tremendously over the past few years. Investors are applying an ever-increasing level of scrutiny to cash management practices. In particular, investors are applying a risk management perspective when reviewing the cash lifecycle – errors and misappropriation, not to mention outright cyber-theft, are all too real risks to ignore and require diligent focus and continual monitoring and process evolution.

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