Hedge Fund Administration 2015

M&A reshapes hedge fund administration

Independents need to be brave on pricing

Large funds rely on bank-owned administrators
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According to a report produced last August by PwC entitled “Hedge Fund Administration - The quest for profitable growth”, there have been 27 HFA acquisitions since 2006, with 11 of those targets running USD20 billion or more in AuA. As the report points out, this helped bank-owned administrators increase their market share of outsourced hedge fund AUM from 47 per cent to 64 per cent.

State Street AIS acquired Goldman Sachs Administration Services in 2012 creating the world’s largest HFA with USD780 billion in AuA (as of October 2014); it remains the largest single manager HFA, having seen its assets grow 14 per cent year-on-year between October 2013 and October 2014.

In 2014, BNP Paribas Securities Services announced it would buy the fund administration arm of Credit Suisse creating an administrator creating a combined AuA of USD231 billion. And most recently, Citigroup announced this year that on the back of lower than expected earnings it was selling its HFA business.

Whilst investment banks consider their options, transaction-based banks are upping their game. US Bancorp Fund Services acquired Dublin-based Quintillion in 2013, having already purchased AIS Fund Administration in 2012, while Mitsubishi UFJ Financial Group acquired Butterfield Fulcrum and Meridian and is looking to make further acquisitions as it diversifies away from servicing long-only funds.

Big custodial banks are likely to dominate the HFA space in years to come, forming one part of a barbell with a number of well-run, well-capitalised independent HFAs on the other end. Mark Hedderman is the CEO of Custom House Fund Services. In March 2015, Custom House announced that it had agreed with TMF Group – a global provider of business services – to go back to being a fully independent administrator.
The deal, signed at the end of 2014, will allow Custom House to acquire TMF Group's Fund Administration Services business.

Speaking about the consolidation taking place at the top of the market as investment banks pull out, Hedderman says: “When margins are being squeezed, and the risks remain as high as ever, there comes a point where they decide it’s no longer worth the hassle to be in this space at the wholesale level. One small mistake can put them out of business.

“However, if administration is your core focus, which it is for us and our independent contemporaries, we don’t have the same pressures as bank-owned administrators where they are just one small cog in a much bigger machine. Even with advances in technology, it’s not getting any easier to be a fund administrator. Regulation such as AIFMD and FATCA is quite onerous and more challenging to keep on top of.”

For a big investment bank, the idea of sweeping all before them and building HFA businesses a decade ago made a lot of sense; they could leverage complementary services such as custody, prime brokerage, treasury services and so on. Now, however, they need to account for every dollar being used on their balance sheets. Administration has never been a high margin game and the integrated model they pursued previously no longer works in a Basel 3 world.

Indeed, JP Morgan decided to exit its unprofitable UK fund transfer agency business last year. One of the bank’s key objectives is to improve its return on equity to approximately 15 per cent over the next two years. That is why custodian banks are becoming more acquisitive; they are better able to cope with the risks and complexities of administration. It’s a better fit for their business model.

“Various lawsuits and regulatory actions that have been filed against the banks in the last two years will likely have factored into their decision. We’ve just seen authorities in the US and the UK impose a record GBP3.7 billion in fines on five major banks for rigging the FX markets.

“Banks are taking a closer look at their business, their product lines, the respective risks, how they use their balance sheets, and reassessing what they do and how they do it,” suggests Robin Bedford, CEO of Opus Fund Services.

Bedford agrees with the barbell reference above in terms of the future landscape. In his mind, independent administrators like Opus have a crucial role to play supporting emerging managers with between USD10 million and USD250 million in AUM. “A lot of managers are simply not big enough to attract serious interest from an institutional administrator. They will continue to focus on servicing the largest managers, who pay the largest fees, and who need to stick with tier-one HFAs, because their institutional investors demand it,” adds Bedford.

Back in January 2014 Opus completed the acquisition of AlphaMetrix360, acting as a White Knight and providing a home to some 25 managers. But Bedford confirms that currently the focus is on growing organically.

“Valuation is dependent on who the buyer is. If the acquirer is pursuing a roll-up strategy, buying up other administrators, then they will likely focus on projected EBITDA factoring in cost savings. However, it’s a very difficult strategy to execute successfully, as price competition has caused margins to be significantly tighter than historically earned. With sellers therefore preferring to focus on top line revenue, and buyers looking at a calculation based on EBITDA, it’s difficult for parties to reach an agreement.

“Given tight margins, the payback of buying an administrator today is likely longer now, than it has ever been. Therefore for transactions to be successful, other factors have to be considered such as technology platforms, highly skilled and experienced workforce, and industry reputation,” confirms Bedford.

Michel van Zanten is a director of Circle
According to Mark Hedderman, CEO of Custom House Fund Services, the hedge fund administration industry needs a moment to reflect and think long and hard about what the preferred model to conduct hedge fund administration should be. It’s time to take a deep breath and look at how the evolution of the hedge fund administration business model has altered.

The genesis of the fund administration business was to function as a fully independent part of the investment management process, separate from prime brokerage and custody to perform a singular role. However, over the course of this century, that core function has become somewhat diluted. This has been caused by the proliferation of investment banks and technology specialists, even law firms, entering the space with a belief that fund administration could be bundled together with other services.

That desire to offer a menu of services was pushed even further by the wave of regulations that emerged post-financial crash in 2008. Investment banks were quick to seize on the opportunity to roll out more of a consolidated model when fund administration could be offered in addition to custodial services, clearing and execution, financing and so on.

“What is ironic is that in the last two years we’ve seen investment banks washing their hands of their fund administration businesses. My assertion is that at some point the true ethos of what it means to be a fund administrator will return; it was simply lost earlier this century.

“Being inside the eye of the storm, I’ve seen very little thought and consideration given to determining what is the preferred model to conduct hedge fund administration. Our move away from TMF Group earlier this year is part of a wider discussion that needs to take place within the industry. I can’t help but have a degree of Schadenfreude when I hear about investment banks wanting to return to their core attributes.

“That’s what the hedge fund administration industry needs to do as well: it needs to return to its core values and re-assess its role as an integral part of the investment management process and what is the best way for firms to position their services, and I say that for two reasons:

“First, the industry needs to take a better look at the landscape. Second, administrators need to reflect what type of a role they want to play,” explains Hedderman.

Back in March, Custom House announced that it had agreed with TMF Group – a global provider of business services that merged with Equity Trust in 2011 – to go back to being a fully independent administrator: Custom House Fund Services. The deal, signed at the end of 2014, will allow Custom House to acquire TMF Group’s Fund Administration Services business and is, in a way, a reverse M&A deal, giving Custom House the ability to operate unconstrained as a fully independent administrator with no ties to a parent company.

“One of the reasons TMF acquired CHG was because they weren’t quite sure what to do with their own fund services business. It became quite clear during 2014 that the better interests of TMF and Custom House were for us to operate independently. That was the genesis of our discussion. We were both heading down different paths and had become different organisations.

“Strategically, and philosophically, we believe that an independent fund administrator is the preferred model to support hedge funds. We strongly believe that the ability to calibrate our entire strategy and internal organisation purely on the provision of hedge fund administration means that we can position ourselves as a viable alternative to incumbent
administrators,” comments Hedderman.

Hedge fund administration has become a highly commoditised business in recent years. Bank-owned administrators engaged in a race to zero as they competed to win mandates. The net result has been that fee margins have continued to compress. To compete, smaller administrators have aggressively pursued price-driven strategies without necessarily thinking about how they are trying to support clients. It has all become rather myopic and in Hedderman’s view, administrators have work to do reclaiming that lost ground.

“This is a significant bug bear of mine. A lot of what we’ve seen has been self-defeatist activity, and continues to be the case. Administrators are devaluing the perception of our industry by getting involved in a race to the bottom by pushing forward the commoditisation of administration services; offering services for free to attract clients. If you don’t respect the role that you play, how do you expect your clients to respect the role that you play?

“We need to reassess the value that we offer managers and change the industry perception of hedge fund administration; it’s getting to the point where managers can’t see any difference between administrators or the service being offered,” states Hedderman.

The reality is, administration is a core component of the hedge fund cycle. It is, in many respects, the lynchpin of the investment process. “We support the manager, we support the investor, we support the fund’s directors, and yet that value proposition has been eroded both internally and externally,” adds Hedderman.

Being a truly independent administrator that is 100 per cent focused on providing core services, not merely adding them to an extended mix of broader services that only the investment banks are capable of providing, is likely to become a much stronger value proposition moving forward.

This is already evidenced by the fact that managers are increasingly partnering with technology specialists to provide customised solutions, or fund platforms that specialise in structuring and distributing regulated funds: point being, these are pure-play specialists. It’s their day-to-day focus. Their bread and butter.

“The industry has become a mishmash of players – some independent, some bank-owned, some technology-owned – that I think it is now beginning to become clear to people that actually, this is not as straightforward a business to be in as they originally thought. It’s not without its risks and challenges.

“I’m sure other administrators would echo my opinion that calculating the NAV has now become a small part of an administrator’s role. The cost of having the privilege to do that means that you have to do so much more; for a large investment bank, they don’t really want the pressure of providing multiple services beyond merely calculating the NAV and keeping on top of what are a significant number of moving parts.

“At Custom House, our aim is to create an administration business that reflects the value of what we do, rather than just offer a service that is part of a broader suite of services,” says Hedderman.

This is a brave approach. What Hedderman is saying is that administrators need to move away from offering services at the lowest price and start to re-assert their value. To underscore this, Hedderman confirms that the sales and business development teams at Custom House are instructed to make sure that all client discussions are service-led not price-led.

Small administrators are just cutting each other’s throats and that’s where the space faces a real challenge: and could ultimately lead to further consolidation as these firms struggle to keep their heads above water.

“It is harder to take a stance like ours but we have a long-term business strategy. We’re not looking to prostitute our services to the industry as the lowest bidder.

“Becoming independent was a deliberate strategy to help us win new clients by following a service-driven rather than price-driven model. People see us for what we are; we’re up-to-date with all the various technologies, bit we’re not a befuddled part of a larger organisation. We’re not some outlier.

“We offer straightforward fund administration services. And that has almost had a cathartic effect when entering into discussions with prospective managers. We don’t have to explain how our business interacts within a wider business group,” concludes Hedderman.
Partners, an independent HFA who last year acquired Caledonian Global Fund Services Limited based in Florida, the BVI and the Cayman Islands, enabling it to extend its administration services to the US marketplace.

Referring to the opportunity set for finding new acquisitions, van Zanten notes that the de-merger of Custom House Fund Services from TMF Group could happen elsewhere in the market, particularly if a private equity group is looking for an exit strategy.

“One always has to be on the lookout in this business. You have to be active in this space, even if it is just to validate your own thoughts about valuations, your own ideas about growth, set priorities and how to build a profitable business,” says van Zanten.

Growing the business just for the sake of it is a dangerous precedent for independent players. It’s fine for bank-owned groups to pursue this strategy because even if it doesn’t work out, they’ve still got their core businesses in place. They’ve got the balance sheet.

For an independent HFA, it’s all or nothing. They have nothing else to fall back on if an acquisition goes wrong. The stakes are much higher, which is why van Zanten and others take a cautious approach.

SEI is one of the largest non-banked owned HFAs with approximately USD135 billion in single manager hedge fund AuA and USD73 billion in FoHF AuA.

As Ross Ellis, Vice President and Managing Director of the Knowledge Partnership in the Investment Manager Services division at SEI confirms, "we are always open to discuss potential partnerships but we wouldn’t want to grow by acquisition just to gain scale. It would make more sense to look at something that was inefficient, using our workflows and integration to make them more efficient where we are able to clearly add value and make it a $1 + $1 = $3 proposition."

"Any transaction or partnership would need to give us something we don’t already have that would increase our solution set and benefit our clients: i.e. a different jurisdiction, a different product, access to a different investor base."

One of the issues that HFAs have had to deal with is the expectation among managers for cheaper costs; they want more bang for their buck. This race to the bottom was partly down to the ability of bank-owned HFAs to offer bundled services (mentioned above), thinning their margins on administration services and making up for the shortfall elsewhere in the organisation.

This has hindered independent firms because they’ve not been able to rely on other revenue streams; administration services are their bread and butter. As such, independent firms have to take a more courageous stance. Those that succeed are the ones that can offer high quality customised services that may cost more but give managers, large and small, greater peace of mind.

“If you’re going after sophisticated fund managers who have institutional investors, they know that it makes no sense for them to join up with lower quality service providers and that if they want the best they are generally willing to pay for it.

“It’s all about value. Forward-looking managers aren’t against paying more, per se. They just want to see value from their payment. If a manager is getting charged 10 basis points from Administrator X, for example, and isn’t getting good service, and another firm is charging 13 basis points but offers a higher service level, then the manager may well go with the more expensive option if it gives him the confidence to launch new products. To me, it’s all about partnership based on mutual success rather than just choosing the cheapest option,” says Ellis.

This is an important point. As the PwC report highlights, Citi Prime Finance estimates that liquid alternative products will exceed USD900 billion in AUM by 2017.

“At this rate of growth, the administration
Benefiting from admin musical chairs

Interview with Jorge Hendrickson

There are plenty of push and pull factors influencing hedge fund administrators but whilst there are those who are getting distracted by M&A activity, one administrator that is taking advantage of the situation to win new business is Opus Fund Services, which serves over 200 fund managers and 300-plus funds with a combined AUM exceeding USD10 billion.

“We are in discussions with larger managers than perhaps we would have been a couple of years ago; largely due to the continued build-out of our institutional grade technology, service and brand,” says Jorge Hendrickson, Director of Sales and Business Development.

Regulation is creating a lot of the push and pull dynamics as hedge fund managers find themselves being culled by prime brokers under Basel 3. Switching prime brokers is, in turn, leading to some managers to switch their administrator. The dynamics are constantly shifting.

“Clearly, there’s been a lot of consolidation activity in the PB and hedge fund administration business recently. A few years ago, managers were able to get a lot for very little fees. As primes cut their fees, administrators did likewise,” notes Hendrickson.

Regulation is now reversing that trend. Primes are raising their fees and revenue expectations from clients and suddenly administrators are taking a step back and questioning the long term viability of their own operating models.

“As clients leave their existing prime brokerage relationships, administrators have to look at who is the new custodian and PB and think: What does that do to our connectivity and workflow, our reporting systems? There’s a lot of pulling and pushing going on right now.

“It’s become a game of musical chairs. As clients evaluate one of their service providers, it oftentimes becomes an opportunity to re-evaluate and right size all their service providers.

“That creates an opportunity for us,” says Hendrickson, who points out that by operating as an independent administrator, Opus Fund Services “can make fast decisions and take an entrepreneurial standpoint rather than having to take six to nine months to make strategic decisions and steer the oil tanker. Clients benefit directly from that: whether it’s custom reporting, custom regulatory enquiries, increased delivery times, we can implement them rather than push back.”

Using a fund analogy, Opus Fund Services is the equivalent of a small and nimble fund that can react quickly to the markets.

“The things that make us nimble make our clients happier and help keep their costs down,” says Hendrickson.

With respect to costs, bank-owned administrators are applying the same approach as their prime brokerage partners by culling clients who are no longer economically attractive.

This is helping mid-tier administrators like Opus Fund Services consolidate their position.

“Whereas typically 75 per cent of the work we did was fund launches and 25 per cent conversions, I would say that right now that percentage is closer to 50:50.

“Some administrators have thrown spaghetti against the wall to see what sticks. We’ve kept our focus, offering reasonable fees and not tripping over our skis with unsuitable services. Implementing a consistent strategy and not diverting from our target client base is now reaping rewards,” concludes Hendrickson.
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As one of the oldest, continuously operating financial institutions in the world, BNY Mellon has endured and prospered through every economic turn and market move since our founding over 230 years ago. Today, BNY Mellon remains strong and innovative, providing investment management and investment services that help our clients to invest, conduct business and transact with assurance in markets all over the world.
BNY Mellon is a prominent investment company in the financial industry. It has a market capitalisation of USD45 billion and is one of the world’s largest investment managers with USD1.7 trillion in AUM.

More specifically, BNY Mellon is best known for its expertise in investment services. This side of the business accounts for approximately 70 per cent of the Company’s revenues; whether that’s core custody capability, administration – both traditional and alternative – corporate trust work, issuing depositary receipts and so on. It currently has approximately USD743 billion of alternative AuA and/or custody.

Despite its size, BNY Mellon is acutely focused on servicing the various assets and fund structures of its clients, whether they be pension funds, mutual funds, hedge funds and other alternative asset managers.

“We aren’t just growing our business organically. We continue to make strategic investments to build out our capability. In February this year, for example, we announced an outsourcing arrangement with Deutsche Asset & Wealth Management’s direct real estate and infrastructure asset management and servicing business; that’s a really powerful addition to our fund administration business,” says Frank La Salla, CEO of BNY Mellon Alternative Investment Services.

The deal adds roughly USD46.3 billion in AuA and demonstrates a commitment by BNY Mellon to broaden its capabilities across alternative asset classes.

“Wouldn’t it be better to find a partner that can deliver back to an organisation, over time, economies of scale through extending that capability into our broader franchise and at the same time build out a multi-client proposition based on that capability?

“Deutsche Asset & Wealth Management are among the largest real estate and infrastructure asset managers, so we went from being on the periphery of that business to quickly having real scale,” explains La Salla.

La Salla confirms that outsourcing arrangements such as these, as opposed to out-right acquisitions, could be the future model for BNY Mellon but certainly not exclusively “because if we take on costs at the same time as we take on business we’re not achieving any scale benefits.

“Should we pursue a future transaction, we might want the assets but we probably wouldn’t want all of the technology and people costs; we don’t want all of those costs coming to us every time we do a deal. We now have a core skill-set in place to service these real estate and infrastructure assets so let’s leverage on that,” states La Salla.

Indeed, La Salla confirms that they are already getting interest from some of Deutsche’s peers who are deciding whether they too should remain in the fund admin space. “It’s early days but we expect that to turn into more business in due course,” adds La Salla.

Currently, about 30 per cent of real estate managers outsource their fund administration. With European regulation bedding in, and investors looking for greater accountability from managers, that percentage is expected to climb.

“In the hedge fund space we announced the Bridgewater transaction a couple of years ago which gave us additional capabilities around derivatives processing and hedge funds. What this Deutsche deal does is push us into another really important asset class. We’ve also done significant deals in the long-only space.

“We will continue to build out the fund administration franchise and capability so that regardless of the asset class or market managers are trading in, they will come to BNY Mellon,” concludes La Salla.
industry could capture incremental revenue in the range of USD600 million to USD825 million on an undiscounted basis for the period of 2013 – 2017”, writes the PwC report.

Ellis believes that the mindset of managers is changing. The risks have increased to such a level that they can’t afford to cut corners, or risk getting sub-standard service by saving a few basis points.

“Managers are looking to do the right thing for their businesses and their investors; if they want to be successful they need to ensure that their service provider partners including administrators have the revenues to also be successful,” adds Ellis.

Over at Custom House Fund Services, Hedderman is passionate about recovering some of the lost ground in terms of the way that managers perceive HFAs, particularly in respect of costs.

“Our discussions with managers are service-led not price-led. It’s important that you align your services with the client’s expectations. If there’s a mismatch in those expectations then you’re going to run into problems.

“We’ve walked away from pitches where we feel we can’t compete on price, or where we feel there’s an over-expectation on us. We won’t get drawn into discussions on reducing fees simply to match those of a competitor, unless it is for a compelling reason. I fail to understand why smaller administrators have such a simplistic approach to pricing: to win at all costs without taking the time to understand the nuances of what the client actually wants.

“You have to be brave and to be focused on relationships and service quality. Our strategy is to take our time to understand our clients, understand what it is we can and can’t do, and base our discussions on that as opposed to price and wrapping our services up, which has devalued the way managers view administrators. You’ve got to be free from the pressures of a larger financial construction to be able to do that,” comments Hedderman.

A decade ago, there were huge inefficiencies in the way that HFAs operated. Bluntly speaking, they could make money and be profitable without being that good. Technology advancements have changed that, helping reduce the barriers to entry and the costs of doing business; and subsequently the fees being charged.

Opus Fund Services takes a unique approach with respect to its price model. Instead of taking a punt on 10 different managers, charging say 12 basis points in the hope that one manager will be successful, grow their AUM, and then allow the administrator to jack up its fees, Opus has come up with a more ethical way of pricing.

“We go through a detailed sales process to understand every element of a manager’s business and to identify the cost drivers that affect our work. We then use a proprietary model to determine our fees, based on those cost drivers. We consider such an approach ensures fees that are fair to both parties, preventing sudden right-sizing down the road which can leave managers feeling aggrieved.

“The point is this: rather than taking a gamble that required fees will be obtained as a manager grows its AUM, as long as those cost drivers stay the same, our fees work regardless of a managers success. With no need to give managers AUM growth ultimatums, we think it’s a more ethical way of working with our clients,” says Bedford.

Today’s fund manager is increasingly looking for a hedge fund administrator that they can partner with for the long-term as they look to launch new fund vehicles. This will benefit mid-tier administrators who have the capital to evolve their operating and pricing models, as well as the custody-based fund administrators who have the scale and global footprint needed to support LPs, AIFMD-compliant funds, liquid alternatives etc.

Ellis believes that managers are now looking at HFAs who will not hinder their growth but rather facilitate it.

“If a manager is teaming up with an administrator that is capital constrained, there’s a risk that they’re not going to be able to implement the right procedures, or possibly upgrade the necessary technologies. Whereas if the manager is working with an administrator with a history of innovation and investment, they are more likely to be investing on an ongoing basis for the long-term, building the best operational platform for the benefit of their clients,” says Ellis.

“As large managers look for alternative administrators that can offer a high quality service, we hope to step in to support them going forward,” concludes Hedderman.
There should be little surprise regarding the on-going trend of bank-owned hedge fund administration businesses being sold or put up for sale. There should be even less of a surprise to find that banks have been the acquirers of most hedge fund administration businesses, both bank-owned and independent, that have been sold. Both sides of this trend will continue.

Sellers will continue to exit the business primarily for financial reasons. Some banks have already reached this point due to a declining client base, a need for capital for other businesses or regulatory purposes, or simply the unwillingness to further invest in the business.

Hedge fund administration, while providing an attractive annuity-like revenue stream, is a relatively low margin business. As a result, in addition to having a quality offering, administrators who are successful in creating a profitable business in the near term will take at least one of three paths: #1) establish economies of scale; #2) cross sell other products and services; #3) create a highly differentiated offering. Medium term success will require either #1 or #2, slowly leading to the demise or consolidation of independent administrators who will struggle to continue to differentiate their offerings. Long term success will require both #1 and #2 – which, over many years, will result in an oligopoly broader but similar to that in custody, trust and other securities services businesses.

Certain administrators and non-strategic buyers, e.g. private equity funds, will continue to drive industry consolidation in the near term and perhaps even longer, by acquiring, restructing and consolidating multiple fund administration businesses. However, the ultimate long-term survivors will not only have a quality administration offering and the economies of scale required for profitability but also offer the breadth of financial products and services that their clients require.

While bundling administration with other complementary securities services, such as custody and trust, will provide a competitive advantage to some degree, the most successful administration businesses will have one thing in common: the ability to extend balance sheet to their hedge fund and private equity clients. This would require offering, in addition to fund administration, the banking products and services that many hedge funds and private equity firms require such as: treasury services, prime brokerage, derivatives clearing, repo and securities lending, subscription financing, asset backed financing and commercial real estate and specialised lending. In turn, given regulatory driven balance sheet limitations, many banks have begun to look at their overall or potential relationship with a fund management company in aggregate when determining whether to offer them certain balance sheet-intensive products and services. Whether a manager purchases fund administration and other products and services that do not utilise balance sheet is now an important element in measuring the value of a relationship.

Reflecting dramatic changes in the banking industry, some of the basic products and services that managers require to run their funds are now, in many cases, effectively in limited supply. For example, due to new liquidity and capital requirements some banks have recently begun to inform certain hedge fund and private equity clients that they are closing their bank accounts (e.g. operating and sub/red accounts) and in some cases leaving the market entirely. Suddenly treasury related products, which were once perceived to be basic commodities, are now being offered only to select clients.

The quality of the hedge fund administrator offering will continue to be the primary factor in choosing an administrator. However, there are now other variables that must be considered before making that final decision.
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U.S. Bancorp Fund Services LLC (USBFS) is finalising two significant integrations: AIS Fund Administration, which it acquired in 2012; and Dublin-based Quintillion Ltd, acquired in 2013. The two transactions combined added approximately USD43 billion in AuA to their existing business along with several organic growth opportunities.

“Our alternative investment fund AuA is approximately USD120 billion right now. Although not included in that AuA number, it’s worth noting that we are one of the leaders in administering liquid alternative mutual funds. There are approximately 500 liquid alternative funds and we are the full service provider to 150 of them,” comments Joe Redwine, President, U.S. Bancorp Fund Services.

While the firm has remained open to potential acquisitions to increase scale, in the last business cycle, most of USBFS’s growth has been organic. According to Redwine, the business has delivered a 5-year compound annual growth rate north of 50 percent.

Three years ago, USBFS featured in the high 20s among hedge fund administration rankings. According to an industry survey, it is now ranked 15th in AuA among its peers. Redwine feels that breaking in to the top 10 is eminently achievable. “Our goal is to continue to improve on our industry ranking via a combination of acquisitions and organic growth.”

“Many fund managers are far from parochial these days, and often will offer numerous investment products worldwide. Knowing this, our overall strategic goal is to be a full-service provider to virtually any and all commingled products,” says Redwine.

USBFS is ideally positioned to extend its capabilities, not just in hedge fund administration, but in all alternative asset classes. Historically, it has forged a leading position in servicing registered funds. It has been operating in the mutual fund space since 1969, and applying that expertise to hedge funds was a logical decision made 15 years ago.

This is especially true given that one of the key business lines at U.S. Bancorp is Securities Services. U.S. Bancorp Fund Services sits within the group that includes Institutional Trust and Custody, Global Corporate Trust Services and Trust Technology and Support Services.

“Our Global Corporate Trust Services is a top tier trustee in all products. Most important, as it relates to USBFS, they are ranked number 1 in the CLO category, both here and in Europe. We share a lot of clients in the credit space and there is a lot of synergy between our two business lines, benefiting existing clients and leading to significant new business opportunities,” says Redwine.

He notes: “The Quintillion transaction is critical to our overall growth plans. When we look at Europe, as with any other region outside of the US, the question we face is ‘Do we build or buy?’ We’ve done a number of acquisitions over the years, in both the registered and unregistered space, and the cultural fit we achieved with the Quintillion acquisition is as solid as we’ve experienced.”

The pressures of Basel 3, an increased focus on ROE and maintaining profitability: while these are pinch points for some bank owned administrators, they’ve become points of differentiation for USBFS.

“U.S. Bancorp, our parent, has the highest return on equity among our peer group, we have the highest return on assets among our peer group, and we also have the best efficiency ratio. What we have built is a strong, streamlined business model to the benefit of our clients and partners,” concludes Redwine.
In a report published by eVestment last March (Alternative Fund Administrator Survey 2014), 95 per cent of respondents answered ‘yes’ when asked if mergers and acquisitions were expected to play a role in the hedge fund administration over the next few years, citing the desire for economies of scale as the most likely driver of future deals.

“We agree with the eVestment findings. This is absolutely a scale game. Think how much regulation is being thrown at the funds themselves, the governance structure around those funds, the reporting requirements, compliance overlay. This is an expensive business to be in, and is becoming increasingly so.

“It’s all about scale and if you are a universal bank, where fund administration isn’t core to your business, you might think about whether this is an important enough piece of your broader franchise to continue investing in,” says Frank La Salla, Chief Executive Officer, BNY Mellon Alternative Investment Services.

“There’s a bit of an arm’s race to add functionality, add capability, stay compliant; you can’t afford to do that unless it is absolutely core to your enterprise, as it is at BNY Mellon, or you’ve got an existing book of business with good margins to keep funding you.”

Although the pace of acquisitions at the top of the food chain has slowed, the types of institution engaging in those acquisitions has become dominated by large transaction-based banks that are able to offer a slew of complementary services that large alternative fund managers come to expect today.

“We continue to look at acquisition opportunities in the market as and when they arise,” comments Chris Kundro, head of Wells Fargo Global Fund Services.

In the last couple of years, US Bancorp Fund Services, which sits within one of
the best capitalised US banking groups, has acquired AIS Fund Administration and Quintillion Ltd. According to Joe Redwine, President, US Bancorp Fund Services LLC, any future acquisitions would likely be to extend the group’s footprint in Europe as well as in Asia.

“With respect to Asia, this will require lengthy deliberation and analysis. That said, we need to be where the growth is and Asia is clearly in our sights. This will bring to the forefront the “build or buy” question with the latter the likely direction in Asia. I see further expansion in Europe, Luxembourg for example, which will include both build and buy,” says Redwine.

Speaking of Asia, one bank that has been particularly active in broadening out its hedge fund administration business is Mitsubishi UFJ Fund Services, part of the Japanese Mitsubishi UFJ Financial Group. In a bid to widen out its expertise beyond long-only funds and pension plans, the firm has acquired the like of Meridian Fund Services and Butterfield Fulcrum, which, according to spokesperson Blair Henderson, are part of a wider growth strategy to become a leader in the global investment services industry.

“This will happen both organically, as we invest in our team, technology and product offering, and inorganically, as the right opportunities emerge. We have very longstanding relationships with our clients, who have responded to the quality of our service and the solutions we offer. We are now focused on taking this success and growing our presence across Europe, the United States and Asia with the aim of becoming a top-three fund administrator;” says Henderson.

Henderson says that any acquisition target must add value in terms of shared industry relationships and expertise: “As part of the Mitsubishi UFJ Financial Group we are fortunate to be in the position of being able to consider administrators of all sizes, but must be confident that any acquisition proves a valuable addition to our business.”

The hedge fund industry, in all facets, is a highly cutthroat industry in which to survive and thrive. Small hedge fund managers are struggling to stay in business, the added costs of regulation and operations forcing many to exhaust their burn-through capital and go under before they’ve even had time to get going.

The same pressures are being felt within the hedge fund administration space. Smaller administrators who can’t invest in technology, provide an array of customised solutions, respond to regulatory developments, support multiple fund structures (both regulated and unregulated), etc, face an uphill task remaining in business.

In the last five years, this has caused a great deal of consolidation at the lower end of the market, as well as at the top end where some investment banks have made a tactical withdrawal.

“While the cost of doing business has led to some larger competitors bowing out of the sector, the impact has been most keenly felt at the opposite end of the spectrum. With compliance and operational costs rising, it is often no longer viable for a fund with less than USD100 million of assets to stay in business.

“This has caused a concentration of larger funds, which only want to be serviced by the largest fund administrators, fuelling consolidation in the fund administration industry. As a top-ten administrator owned by a global bank, we can continue to provide services for a range of fund managers,” says Henderson.

The dynamics at work are no surprise to BNY Mellon’s La Salla. As he points out, banks today have to pass liquidity stress tests to avoid another Lehman’s situation from occurring. This is causing them to look forensically at their business mix to ensure that sufficient capital is set aside to protect against risks that are built into different business lines.

“For some universal banks, I think fund administration businesses are just tangential”
Independents must guard against choking talented start-ups

Interview with Michel van Zanten

Focusing on bank-owned administrators, nobody knows the precise reasons as to why investment banks have been vacating the hedge fund administration space other than the banks themselves. One possible explanation is that the integrated model they have been running for years perhaps no longer aligns well enough with both clients and the ever-changing market regulations.

At the start of the century, investment banks were ideally positioned to build out fund administration as part of a bundled service including prime brokerage, research, execution and clearing, custody services and so on. Since then the risks to running a fund administration business have become inexorably different and according to Michel van Zanten, a Switzerland-based director of Circle Partners, an independent fund administrator, the future of M&A in this space will be influenced by who is able to offer a better integrated fund model for fund managers.

“What I mean is if you were a prime broker 10 years ago, the integrated business model was a great opportunity because even though you made not a huge profit on the fund administration, transfer agency or custody side, you always had financing, securities lending and trading from which you could earn enough margin over the whole relationship whilst leaving out the need for other 3rd parties and almost keeping the fund and the manager a private relationship. *

“Even though these functions and services may have been quite well separated from each other, the regulators are now making sure that the integrated business model should be funded, sourced and serviced alike. If you look at the capital requirements related to prime brokerage business in the UK and Europe, it doesn’t necessarily make it attractive for banks to be active in all spaces when they should be able to make enough in their (core) space.

“Indeed, if you are able to make high margins on the financing side of prime brokerage, why add a lower margin business in the same environment and introduce a whole new additional set of risks in relation to regulations and rules?” comments Van Zanten.

The added liability of engaging in fund administration as well as depositary and custodial work, providing leverage, financing and securities lending is, as a result of Basel 3 and Mifid II, putting significant added pressure on banks’ balance sheets. The balance sheet of the bank is clearly still important for hedge funds but is also becoming a bigger burden for investment banks and losing relevance as a selling point for fund administration services. Today, every dollar counts, and has to be accounted for.

Some of the beneficiaries of this de-risking exercise are the larger transaction-based banks: the Wells Fargo’s and State Street’s of this world. Fund administration seems to be a better fit for these institutions and provides greater economies of scale for them to leverage. Fact is that Mitsubishi UFJ Financial Group bought up Meridian and Butterfield Fulcrum and BNP Paribas Securities Services acquired Credit Suisse’s administration business and so on. Some of the larger investment banks seem to have made the decision to move on,” says van Zanten, who continues:

“I think that a lot of investment banks have operated in the past in such a way that high AuA was perceived to increase the
prestige and valuation of their organisations. However, not much of that actually converted into value increase of their share price (much the same as the share prices of these banks did not suffer when fund administration businesses were sold) and under the new Basel 3 rules and MiFid II rules every USD1 billion needs to also be properly funded on the capital side in investment banks.

If you then look at the return on investment of having USD1 billion AUA versus having all the inherent risks on the regulation, reporting, compliance and possibly the capital side, that AUA number might not be as attractive anymore."

Service businesses, like fund administration and transfer agency are in need of significant investment, adapting to the ever changing regulatory reporting and tax environment in global operating environments require significant investment with long term return horizons. Given the high pace of change and some of the local requirements, some require a change on change investments.

Large global project teams, long time horizons and funding: these are not easy changes for an investment bank that also needs to make necessary investments in the front office to support higher margin business.

Transaction-based banks, on the other hand, look at this business somewhat differently. State Street has an asset management arm and a bit of investment banking but by-and-large its core focus is getting as many billions of assets under administration and under custody as possible. That approach no longer seems to hold water for the investment banks. In addition to the larger investment banks getting out of fund administration, private equity investors who have taken a position in the (mid sized) administration space have been looking for their exit.

Aside from the greater synergies for transaction-based banks in buying businesses that operate in a similar way to their existing core business, they also seem better able to capitalise on providing custodial and depositary services to the underlying managers they take on board.

Whichever way you cut it, fund administration on its own has become a commoditised business. Margins have fallen and in that sense or otherwise better explained more services are expected for the same dollar, in that respect custodial bank owned fund administrators have a somewhat similar issue as investment banks.

However, by making acquisitions in different time zones and reducing operating costs due to greater synergies, they are at the same time able to extend their custodial services and network and are in a better position to manage the level of returns they may or may not be making on fund administration services. Fund administration in that sense acts more as a protector towards the core custody business.

Thus comparing bank owned administrators, these transaction based banks are now better positioned to offer a more balanced integrated business model where costs can be more easily assimilated going from owning a super manco down to reconciling the transfer agency transactions and where headcount is not the main concern. That business model today makes for a better fit.

“We are an innovating administrator that supports large and complex managers, but the fact is there are plenty of smaller fund managers sub USD100 million that need independent boutiques like Circle Partners to exist. Start up managers and (multi-)family offices need a great service at a good price,” says van Zanten.

If these administrators get consumed into larger entities, even if it is for the right reasons, the risk is that smaller managers will get cut adrift.

Back in the 1950s, the Dutch had waterlogged areas of land and they had two choices: either close them all off and build huge dykes or leave them open. They chose to leave them open because they acted as a chamber for fresh fish.

It is no secret that Circle Partners found its origin in the Netherlands, but “I like to think about independent administrators delivering a boutique style service in a similar way; building bridges and implementing smart solutions, because without them, you run the risk of choking off that fresh influx of new talent; whose going to be there to support them?” concludes van Zanten.
to their core business. At the bottom end, small administrators don’t have the capital adequacy challenge they just have a basic investment rate challenge and they need to get a return on their technology and compliance investment.

“The drivers at each end of the barbell are different but the net result is the same: namely, consolidation around a core set of players, both bank-owned and independent,” says La Salla.

Kundro is in no doubt that the demands from larger managers, in particular, mean that it is a logical place for fund administration to sit within bank organisation who want a variety of other services and products; whether it is a complementary service such as custody and trust services, or financing arrangements and capital introduction services via the prime brokerage.

“It seems to me to be a natural place for the business. On the other hand, many of the banks are being run in different ways and for some they are taking the decision that it’s no longer a business they want to be in; it’s incidental whether it is a bank selling or a non-bank,” says Kundro.

La Salla notes that the way the chips are falling as the HFA industry continues to consolidate is simply a repeat of a pattern that the custody business went through in the 1980s. Back then, there was a proliferation of custodians, but by the mid-90s consolidation had taken hold and the wheat had been separated from the chaff.

“Then we saw it in the mutual fund administration space with around a 10-year lag, and now you are seeing it happen in the alternative fund administration space with a further 5-year lag. It always becomes a scale game and only a limited number of players have the capability, investment appetite, and the right credentials and experience to survive.

“Who’s in it for the long haul? Who has the right focus, experience? Are they willing to invest? To keep up with the regulatory spend needed?” questions La Salla.

“I think some of the small niche administrators can continue to succeed and remain profitable,” says Redwine.

“When you are small, though, you always incur the risks associated with a limited balance sheet. It can have a major impact on client retention as well as gaining new clients. Larger AIFMs are hesitant to turn too large a "share of the wallet" over to smaller firms. We’ve benefitted from this phenomenon in both the AI and US registered space. Quintillion is a great example; a phenomenal firm in virtually every aspect but one prior to our acquiring them with limited balance sheet. That is no longer the case and many more opportunities have arisen, including increasing “share of wallet” with current clients.”

The trick for independent administrators is not to allow concentration risk through a small number of managers dominating the firm’s total AuA. This is a relationship business at the end of the day. If they’ve delivered exceptional service and supported the manager, they will likely maintain the partnership but it’s a careful balancing act nonetheless.

“I suspect many hedge funds are going to non-financial institutions for administration and quickly realising that when they go to get other services from a bank they’re going to struggle to get that balance sheet from the bank; they’re not simply going to hand over balance sheet anymore without non-balance sheet products being part of the product mix such as administration;” says Kundro.

“It’s going to be a struggle to get banks to extend as much balance sheet if the manager isn’t using them for admin services or other non-balance sheet intensive services.

“Many of our clients are not just using us solely for fund administration services, they are using multiple services at Wells Fargo; it could be financing from a variety of businesses, it could be custody, trust services, it could be subscription financing
Mid-sized HFAs reduce the size advantage of bank-owned peers

Interview with Ross Ellis

Over the last 15 years the fund administration industry has been dominated by the big banking behemoths at one end of the scale and small niche players at the other.

Gradually, some of those smaller entities have been consumed.

Yet at the same time, those operating in the middle tier of fund administration — those in the USD10 - USD100 billion AuA range for example — have grown organically and taken away some of the size advantage of the bank-owned administrators; remaining flexible, innovative, and able to adapt responsively to managers’ ever-changing needs.

“"In today’s marketplace, you don’t have to be the biggest to be successful. Instead, you have to be big enough to have scale, to be efficient, and to offer leverage; the key is to retain an intimate client focus and an ability to constantly innovate, that’s where the fund administration model is evolving.

“"There are always going to be smaller administrators who focus on a niche segment of the market, but our ability to anticipate and evolve with the constantly changing needs of the investment managers we serve has enabled us to achieve substantial growth organically. As a result, we’ve pretty much taken away one of the advantages of the big banks and that’s size," explains Ross Ellis, Vice President and Managing Director of the Knowledge Partnership in the Investment Manager Services division at SEI.

“"As an outsourcer, you need to ask if you are able to align yourself to the manager; do you think like them? Do you talk the same language? Do you operate like them? Or does the manager walk away from the first meeting thinking that you are going to put them into a cookie-cutter solution? For us, it’s first about understanding the manager’s unique needs and challenges, then offering them customised services atop of a leverageable asset-class agnostic operating platform.

“"We feel we are an extension of their asset management organisation, not a separate add on, and as such, we need to think and act as they do, not provide them with a standard ‘our way or the highway’ solution.”

One of the challenges that bank-owned administrators face is that on the one hand, they’ve grown into enormous business divisions with hundreds of billions in assets under administration by driving costs down and thinning out their margins. This has been made possible by offering a bundle of additional services such as custody, prime brokerage, securities services etc. But on the other hand, hedge fund administration has grown into a complex animal and managers today need more than cost efficiencies; they want to know that their administrator is on top of every aspect of the industry.

In Ellis’s view, some banks took an approach somewhat akin to the Roman Empire or the early development of the fund supermarkets; a land grabbing exercise, taking on as many managers and funds they could in order to grow as big as possible. Some succeeded for a time, while some failed spectacularly, so the strategy clearly cannot be said to have worked consistently.

Part of the rationale of bank-owned administrators was that they could afford to take a hit on profitability knowing that they could at least make up the shortfall in other parts of the business, such as custody, F/X, and treasury services.
more substantial and these are affecting the whole organisation, not just their fund admin businesses,” says Ellis.

Additionally, because of the volumes and the constraints they have from a capital perspective with respect to Basel 3, bank-owned administrators have balance sheet issues independent players don’t face, and as such, cannot afford to offer the highly customised and more costly solutions managers seems to be increasingly demanding.

Ellis also senses that the mindset of managers is changing. They no longer want everything done in one place with a single bank entity as their primary counterparty. Increasingly, managers are opting to appoint specialist fund administrators, regardless of size, just as they are partnering with technology specialists to handle a plethora of front- and middle-office services.

SEI is seeing the benefits of this. According to eVestment’s 2015 Alternative Fund Administrator Survey, SEI administers over USD320 billion in alternative assets alone, yet acts like a smaller, specialist shop.

“To date, we’ve managed to grow by partnering with sophisticated forward-looking managers who understand that turning their operating infrastructure into a source of competitive advantage can enable them to gain economic leverage, better meet the demands of investors and regulators, gather new insight into business dynamics and fuel product development."

“In the first quarter of 2015, we’ve received more RFPs than we did for the whole of 2014. We’re speaking to managers who are looking to pick someone who is of institutional quality yet is nimble, able to quickly customise and have a proven culture of innovation,” concludes Ellis.

Changes in the competitive terrain, whether it be through industry consolidation, M&A, or solution development, will no doubt continue, yet to what end is unclear.

What is clear, however, is that the administrators who succeed in the years ahead will be those who can best distinguish themselves in terms of customised solution development, client experience and continual innovation. For banks to remain relevant, they must start taking a page from their independent brethren. ■
for PE funds etc. There are many things that a hedge fund or a PE manager can acquire from a banking organisation and I think that’s what they’re looking for now.”

One criticism that has been levelled at more of the investment bank-owned HFAs is that over the years their strategy has been to cast their nets wide and bring on as many managers as possible. This has pushed costs down, without careful consideration of the returns on assets.

Redwine is quite clear when he states that at U.S. Bancorp Fund Services, regardless of whether they are servicing registered funds or hedge funds, every service is priced competitively and to make a profit.

“We don’t give away one service and try to make up the margin somewhere else. That strategy will work up to a point, but when it stops working it can quickly become very painful. Because we are profitable, and have a high return on equity and on assets, we are able to add the resources we need, when we need them. Those resources fall primarily into three categories:

- Risk management
- People, and
- Technology.

“Technology is obviously a given so when you are trying to differentiate yourself, it really comes down to your people - the quality and breadth of services they provide, and your ability to add people through the growth cycle.

“A key to any successful acquisition is acquiring talent. If you look at our fund services business across all business lines, we had approximately 600 employees in 2007. Now we have 1,300 employees. All but 250 of those people have joined the firm to support the significant organic growth we’ve experienced. That’s important because investment management firms see our level of commitment and our capability to add the people we need to service them well,” explains Redwine.

Over at Wells Fargo Global Fund Services, care is taken not to get fixated on the AUM number alone. The depth and breadth of the client relationship is key.

“We run every potential client through a series of sophisticated models to determine what we need to bid on that relationship and what the minimums need to be to support the relationship, regardless of the size of the manager.

“Then, on a month-by-month basis we re-run the numbers through those models to see what, if anything, has changed. Is the nature of the fund different? Are they trading differently to what we thought? Are they not growing as much as we thought?” states Kundro.

La Salla believes that the bifurcation process in HFA industry – the barbell analogy made earlier – is well underway. Speculative niche players will continue to be successful by support small- and mid-sized managers, “while administrators like ourselves will continue to align with the largest fund managers running multi-asset class, multi-fund businesses that are more sensitive to the scale and stability of their service provider.”

Mitsubishi UFJ Fund Services is emphasising the need for a data-driven approach to succeed under today’s industry dynamics.

“The fund administration landscape is changing significantly under the pressure of increased demands on data quality and aggregation from regulators, managers and investors. We are investing in technology which will efficiently extract, organise, import, enhance, transform and load data from clients, third parties and in-house systems to provide a consolidated view of information for fund managers.

“A successful fund administrator must constantly improve the technology it uses to ensure its offering is in line with managers’ needs,” concludes Henderson.