Hedge Fund Administration M&A 2017

Challenges for fund administrators seeking M&A
Consolidation helps independents focus on service levels
Enabling managers to gain from nimble flexible approach
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Superior client service tempers appetite for acquisitions

By James Williams

On 19th October 2017, Deutsche Bank announced that they had sold their Alternative Fund Services business to Apex Fund Services (‘Apex’). It is the latest example of consolidation in the alternative fund industry as organisations decide whether to stick or twist in the fee-based – as opposed to transaction-based – world of asset servicing, where margins are less attractive that investing banking activities.

The transaction will add USD170 billion in AUA, propelling Apex to become the eighth largest administrator in the world and the largest independent administrator.

Peter Hughes, Founder and CEO of Apex, says that the aim is to become a top-five global fund administrator, and confirms that around 10 acquisitions are being targeted over the next 24 months.

“It comes down to making the right acquisitions and properly integrating them,” says Hughes, when asked what it takes to become a leading fund administrator. “Every acquisition should make your business offering stronger. That’s the way we are looking to do it and we are progressing well to reach that target. We expect to be a top-five fund administrator within two years. We have a few other deals in the pipeline which are close to finalisation.”

Apex has the backing of Genstar Capital, a leading middle-market private equity firm and is not alone in joining forces with a PE group to support its expansion plans. Other examples include Conifer Financial Services, which has the backing of private equity behemoth, Carlyle Group.

Some in the fund administration industry feel there are pros and cons to private equity money coming in to support acquisition
deals. On the one hand it can inject administrators with capital to broaden their service offering at a time when alternative fund managers are running a wide range of multi-jurisdictional products spanning hedge funds through to PE, private debt and infrastructure funds.

They are no longer ‘pure play’ managers as it were, diversifying their business models to capture a global investor base.

Administrators are expected to keep pace with this change. As one administrator spokesperson says, asking to remain anonymous: “This is largely a technology play and it means you have to spend a lot of money. We’ve always invested 15 to 18 per cent of our revenues on technology. If you don’t have that capital base, and you have to attract money from a third party – i.e. a PE group – that will invest in your people and technology, that’s fine.”

On the other hand, some argue that private equity groups are potentially creating misalignments of interests between administrators and their investors. These are money managers. They want to make their IRR over six years and get out.

“I believe private equity is playing a greater role in the acquisition of fund administrators with the opportunity of owning them as investments and ultimately flipping them, a number of years later,” comments Christine Waldron, global head of the Alternative Investment Solutions team at U.S. Bancorp Fund Services.

“The level of private equity activity in this space has not been seen historically and it is impacting multiples, but I think there will still be large acquisition deals announced.”

In many ways, U.S. Bancorp has gone out of its way to openly comment on its long-term commitment to fund administration. Like other custodian-backed fund administrators - Northern Trust, BNY Mellon, MUFG Fund Services - U.S. Bancorp has enormous scale and does not see itself as a potential acquisition target. However, clients appreciate hearing the bank’s long-term strategy on a regular basis. It dispels any rumours.

“When someone is selecting an independent administrator, it’s important to understand the management’s strategic view of the business. Is this a long-term

“Every acquisition should make your business offering stronger. That’s the way we are looking to do it and we are progressing well to reach that target. We expect to be a top-five fund administrator within two years.”

Peter Hughes, Apex Fund Services

eendeavour or are they going to be looking for an exit strategy at some point? When it comes to a bank-owned administrator, the questions should centre on the overarching commitment, oversight and management involvement from the top down. “An administrator’s organic growth is critical to its longevity. If you’re not growing organically it could be a sign that you are facing challenges, maybe not immediately, but in the future. Your acquisition strategy should be a complement to that organic growth and not a detractor from it,” suggests Waldron.

The industry has gone through a period of substantial consolidation in recent years, with many investment bank-owned administration businesses having been sold. Still, there continues to be plenty of room for new entrants. In particular niche independent administrators who are looking to service specific parts of the industry.

One example of this is Socium LLC, a New York-based independent private equity administrator established by Beth Mueller and Michael Von Bevern last year.

“We recognise that in the industry today, PE funds specifically and closed-end funds generally (private debt, VC, real estate), are highly underserved by fund administrators,” says Mueller, Socium’s COO. “If you are a closed-end fund manager looking to outsource your fund accounting, there aren’t many options outside of the biggest fund administration groups; and the large admins are not particularly interested in taking on smaller or emerging managers as clients.

“There are literally hundreds of independent administrators who focus on hedge funds but very few who focus on
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Tak ing a disciplined approach to M&A strategy

Interview with Christine Waldron

One of the dangers of analysing consolidation trends in the fund administration space is that all firms are treated on a similar footing. However, rather than treating them all with the same brush, the industry needs to separate the actions of investment bank-owned administrators from those owned by the large, traditional custodial banks and those operated by non-banking independent organisations.

“Custodial banks continue to invest in this space,” says Christine Waldron, global head of the Alternative Investment Solutions team at U.S. Bancorp Fund Services. “I do think investment banks, which have historically driven their revenues off of transaction-based services, have used a different service model compared to more traditional bank service organisations.”

“The custodial banks have said that they need to increase their fee-based revenues, and M&A is a great way to do that. Investment banks, on the other hand, want to continue to grow their transaction-based revenues; fee-based models don’t nest very well within those organisations.

“Consequently, fund administrators shouldn’t all be treated the same. We are not constantly looking for the next client transaction. We build a partnership and a service model that fits better inside a custodial bank,” explains Waldron.

When it comes to consolidation, U.S. Bancorp Fund Services runs a disciplined M&A strategy, in the sense that any potential target must be a good strategic and cultural fit. Both elements are equally important, says Waldron.

“Strategically we consider increasing our scale in a particular product suite - be that private equity, middle-office, or other types of services that we’d like grow - by finding the best target acquisitions providing those services. Culturally, they have to align with our belief systems around customer service and employee focus.

“In addition to strategy and culture, and equally important, is the financial position of the company. Mergers and acquisitions rarely work when one partner has to rehabilitate the other. If you’re walking into a situation that is already challenging, it can lead to issues around client as well as staff retention. That’s not what you want when making an acquisition,” warns Waldron.

This focused approach is necessary to reassure U.S. Bancorp clients and maximise retention. Both the acquisition of AIS Fund Administration in 2012 and Dublin-based Quintillion in 2013 proved hugely successful in this context.

“Both acquisitions involved a lot of commitment on our part to help reassure clients that our goal and strategy was to keep the existing service team in place while becoming a stronger unit, as opposed to replacing what they already had,” confirms Waldron.

This ability to service clients, which U.S. Bancorp Fund Services does by using a dedicated multi-disciplinary team for each manager, is crucial when one considers the depth and breadth of fund products managers typically run today: both in the registered and private fund space, across multiple fund jurisdictions.

“We bridge the gap for some very large managers who might have a unique product - for example, a direct lending product - that requires a lot of in-depth knowledge. There are some standardised processes that you would get at a large administrator; however, the client also gets a degree of nimbleness and flexibility that one would associate with an independent administrator,” concludes Waldron.
the closed-end fund market. Historically closed-end managers have done their own accounting and haven’t outsourced as much as hedge fund managers."

That trend is changing, mostly driven by institutional investors, she says. They want to see someone independent looking at the books and records, as they’ve become accustomed to with their hedge fund allocations.

This could explain why some administrators are actively pursuing an acquisition strategy. They want to be certain that they can tap into new growth markets, and given that the majority of hedge fund managers already have an administrator, the closed-end fund space is still hugely under-represented.

"We are having a tremendous amount of success in the US private equity market and the European real estate market, not to mention Asia,” says Jay Peller, Head of Citco Fund Services. “There is a lot of room for future growth; only around 25 per cent of private equity managers are currently outsourcing their administration activities."

This has prompted SS&C Technologies and MUFG to make a series of acquisitions in recent times. MUFG Investor Services, the global asset servicing group of MUFG, announced last year it had completed the acquisition of Rydex Fund Services, a 1940-Act mutual fund administration business, from Guggenheim Investments, adding USD52 billion in AuA to bring the total AuA for MUFG Investor Services to USD422 billion.

In May last year, the group also acquired Capital Analytics, the private equity administration business of Neuberger Berman Group to bring its private equity and real estate AuA to USD 145 billion.

Likewise, SS&C Technologies acquired Wells Fargo Global Fund Services in September 2016 adding an estimated USD42 billion in AuA and the capability to support a wide range of complex strategies traded by global portfolio managers including credit, structured credit, private equity, private debt, real estate and hybrid structures.

On 13th October 2017, SS&C also announced it had expanded its footprint into the Canadian market with the acquisition of CommonWealth Fund Services Ltd. ("CommonWealth"), an award-winning Canadian fund administrator servicing over USD8 billion in assets.

Hughes says that Apex Fund Services is pursuing a similar acquisition strategy but is following its own approach to execute on it.

"With Genstar’s expertise, we will be careful as to which businesses we target in this space. It will be a cohesive approach. We will be appointing third party advisers on legal and accounting due diligence every step of the way so that we avoid falling into any potential compliance risk traps. We won’t be taking any short cuts,” confirms Hughes.

He says that when considering an acquisition target, one of the most important red flags focuses on compliance risk. Administrators that are a bit smaller tend to have higher compliance risk in their book of business, “and that’s something we are very careful of. We did buy the Pinnacle business three years ago, which was a smaller business but it had a lot of good quality clients. The risk with any acquisition is that the book of business you pick up just isn’t of a high enough quality,” adds Hughes.

**Buy or Build?**

There is no right or wrong approach to building a successful fund administration business. For some, it makes perfect sense to buy other businesses and create a ‘mega administrator’. This gives them access to diverse revenue streams and a roadmap to create economies of scale.

But this is not as easy as it may seem and not without its challenges.
As a result of unprecedented organic growth since its establishment in 2003 and with the addition of recent acquisitions, Apex Group Ltd. will be administering circa $300 billion in assets.
More to come as latest acquisition nearly doubles AuA

Interview with Peter Hughes

With offices in 35 locations worldwide, Apex Fund Services has grown into one of the financial industry’s largest independent fund administrators since it first opened its doors in Bermuda back in 2003.

And with plans to make upwards of 10 acquisitions within the next 24 months, Apex has its sights set on becoming a top five global fund administration group within the next five years.

This follows the recent announcement this summer that Genstar Capital, a leading middle-market private equity firm, has recapitalised Apex, whilst simultaneously acquiring Equinoxe Investment Services and merging it into the Apex Group.

“FTV Capital, a private equity investor, had been invested in Apex for the last five years with a minority stake and as with any PE fund, as it approaches the end of its life you need to give them liquidity,” explains Peter Hughes, Founder and CEO of Apex. “I wanted to make sure I was running a fund administration business through the next phase of its growth. We talked to a number of private equity managers and Genstar was the most impressive. It has a clear strategy in terms of how it wants to grow, and our platform was ideal for them owing to the fact that Apex has expansive global coverage.”

With the addition of Equinoxe, Apex increases its suite of middle office solutions. Moreover, its AuA has grown from USD50 billion to USD80 billion. “Our strategy is to continue doing more of the same,” says Hughes.

In his view, consolidation is good for the industry. A vacuum is being left as bank administrators keep looking for the largest clients they can find, and as a result the mid-tier space is not as well covered. That creates an opportunity, says Hughes, “but you need to be big enough yourselves to ensure you can provide everything the big bank administrators can provide. To do that you need to have scale.

“You can’t do it as a niche, independent fund administrator.

“By consolidating as an independent administrator, it allows you to get to the scale necessary to deliver everything that a bank-owned administrator delivers, but with a more focused approach towards service levels. The important thing for us, going forward, is to be a global institution and still provide great service; as we grow, our strategy will also focus on maintaining the tailored and personal approach to service that our clients truly value.”

At the time of the Equinoxe announcement, Genstar’s Managing Director, Tony Salewski, commented: “We are excited to support Peter and his team in driving accelerated growth through strategic add-on acquisitions and expansion within high growth areas of the fund services market.”

In many ways, this illustrates how the sands of fund administration have shifted in recent years. Private equity groups have become far more prominent, adding administration businesses to their growth portfolios. At the same time, it has given independent administrators like Apex access to deal expertise to further support them in making their own acquisitions, thereby fostering further growth.

Hughes says that being able to reach out to Genstar’s team is certainly helpful “with respect to making sure you don’t make mistakes and ensuring you’ve done the right diligence and making sure the cost of capital is structured the right way.”
So why Equinoxe?

“This was a business that was built on the same ethics as Apex’s: putting the client first, making sure the service levels are high,” confirms Hughes. “We tracked their growth and we knew Equinoxe had a good team of people. That is key to ensuring that clients continue to be well serviced.

“There were various benefits and synergies to doing the acquisition. In six locations that we operate, Equinoxe had an office too. By putting people together and creating one big team, we can become more efficient. Equinoxe also has a strong middle-office product, using Calypso which enhances what we can offer to our clients.

The deal only closed on 29th August so Apex is still going through the integration phase. This is likely be a 12-month process in order not to disrupt client service. “It’s something you always have to be mindful of,” says Hughes.

Such has been the level of consolidation in the hedge fund administration space in recent times, managers have to be careful that they select with the right long-term partners.

Investment banks running profitable prime brokerage business divisions thought it would make sense to set up administration arms, but while they were making money from PB they weren’t necessarily making money from administration services. Culturally speaking, owning asset-servicing businesses has never really been a good fit.

“Investment banks are having to consider whether it makes sense anymore. The ones that set these divisions up as a nice complement to their prime brokerage business...that’s not the right reason to run these businesses,” says Hughes.

He is very clear in his belief that M&A has to be a catalyst to win more business organically and attract larger better clients. “Your average revenue per client should increase in proportion to the size of your business. The organic business that you win should rise as you build a bigger, stronger reputation,” suggests Hughes.

“Just because we are independent it doesn’t mean we don’t have a strong product offering to rival bank administrators in many different areas,” says Hughes. He adds that a local presence, the right price point and good technology are all attractive features for fund managers.

“When you’re doing M&A you want to try and keep staff in the same place and only change technology if it improves on what was there before. You want to make sure it’s a better user experience for the manager; if it ends up being worse, and you have clients leaving you, your decision to do the acquisition becomes questionable,” remarks Hughes.

Going forward, he thinks technology will continue to play a key role in how fund administrators operate, but caveats the point by emphasising that managers don’t want everything to be pushed through automatically. They still want the personal touch.

“Our model has always looked to deliver that rather than move towards complete automation. Personally speaking, I don’t want to be serviced by robots and while some administrator’s might be moving toward doing everything automatically, I think there is a lot of value to be had in retaining the personal touch to go alongside the best technology,” concludes Hughes.
“The way I see it, and the main reason we stay out of doing acquisitions, is that it causes too many operational issues,” comments Peller. “Different accounting processes, different general ledgers, different technology systems and so on. What then ends up happening is you find yourself running six, seven separate administrators on different platform infrastructures, each with different processes and data to manage.”

With complex regulation such as MiFID II coming down the line, coming up with a new product to make sure those clients remain compliant is a tall order. It may well give the administrator access to new lines of business, but as these deals tend to be more acquisitions than mergers, the ability to streamline people and processes into one multi-faceted entity can become arduous.

“The way we look at it is ‘One team, one dream’; we think that’s how you are able to deliver superior client service,” says Peller. “We look to handle anything in the alternatives space which meets Citco standards; that’s our niche. If a client opens up a hybrid loan fund, we want to be in a position to handle it.

“Ultimately, you have two choices: buy or build. Our philosophy is a simple one. We build it from the ground up. We hire the people with the expertise and we build our own proprietary technology.”

On the mutual fund side, Peller thinks that is out of the firm’s scope.

“A lot of what we previously referred to as our hedge fund clients have become alternative asset managers running a range of strategies using different vehicles. We want to be able to handle any type of trading strategy in the alternatives space. If you try and start supporting non-alternative asset classes you could land in trouble.”

That ability to handle multiple fund products across multiple jurisdictions has always been core to Apex Fund Services and as such is not one of the drivers behind its acquisition strategy. Even before it received new private equity backing, Apex was covering 25 different domiciles for fund structuring.

“What we need to do now is layer in fund-of-funds custody and depositary services in Europe as we evolve to the next stage,” stresses Hughes. “If you look at the number of EU-regulated funds on our books, we have more than most bank-owned administrators. We’ve been doing administration work for a long time in Ireland, Luxembourg, Malta as well as covering the Channel Islands.

“We already had the platform in place. Now, we just want to scale up our services in Europe.”

The point that Citco’s Peller makes about staying focused on core strengths is an important one when one considers the need for any administrator to maintain a high quality client service experience.

Service quality is key
Over at U.S. Bancorp Fund Services, which has a similarly conservative approach to acquisitions as Citco, Waldron believes that...
In recent years, established alternative fund managers have increasingly migrated business to fund administrators with a broad geographic footprint and extensive product expertise. The cost pressures faced by most managers in a low return environment have also been translated into continuing demands to improve efficiency.

The good news is that allocations to alternatives are growing globally with private equity seeing the most robust gains. The combination of rising assets, globalisation and increasing complexity has created a ripple effect for fund administrators. The need to deliver operational excellence to asset managers, while boosting efficiency and providing scale benefits is real.

One result is that mergers and acquisitions among fund administrators have continued at a robust pace. Leading deals have included MUFG Investor Services acquiring Rydex Fund Services, while SS&C GlobeOp acquired Conifer Financial Services and other asset servicing businesses.

Fund administrators often use mergers and acquisitions to bulk up and add scale to their existing business. This is usually designed to accomplish one or more objectives:

- Gain market share;
- Buy EBIT;
- Acquire a specific service to expand the client offering.

A deal can help an acquirer grow market share, scale or increase the breadth of its offering quickly. Sometimes, however, the consideration paid can be very high. This can result in the acquiring firm, perhaps faced with financial pressures arising from an acquisition, having to adjust budgets and capital spend for corporate reasons rather than for what will provide clients with the best service and platform capabilities.

Acquisitions can also create complex operational issues. Integrating different technologies, for example, can be time consuming and leave teams focused on internal challenges instead of client service demands. Drawing together different corporate cultures can also prove time consuming and difficult. In some cases, a merged company may look unified from the outside but still operate as a series of separate entities.

Citco has always taken a conservative view of M&A. Instead of growing by acquisition, Citco Fund Services has sought organic growth by investing in technology, facilities and service innovation. This has created many process and scale benefits which have been shared with clients.

In 2011, Citco struck a strategic alliance with OpHedge - the only such deal it has ever done. The attraction of OpHedge was that it had developed specific middle office services such as collateral management, settlements and treasury. These expanded upon capabilities Citco offered with reporting trade positions and cash breaks, desktop technology for real time P&L calculations as well as real time security masters and over-the-counter security set-ups. Moreover, the synergy created by the alliance helped to accelerate the rollout of enhanced services to clients.

Clearly, it is important for fund administrators to consider client needs and how the market is evolving. Although Citco’s focus continues to be on organic growth (and not acquiring market share), the firm - as it did with OpHedge - will always look at how to incorporate specific services to help clients.

In the last few years, Citco has built up its fund administration lines in private equity and real estate. We did this by focusing on bringing in the right people and the right technology. This has helped Citco achieve tremendous growth, while positioning the firm to deliver a range of valuable services to existing and new fund clients in the years ahead.
**Jack of all trades?**

Socium’s Mueller thinks that there is a tendency in the industry to focus on maximising assets under administration, without necessarily prioritising the client experience. While administration services in the hedge fund industry have become commoditised, there are, she says, still plenty of fund managers who appreciate high-touch client service and consistent coverage on their account.

“You can’t be all things to all people. It’s important for an administrator to be knowledgeable and experienced in the complexities of the funds they’re servicing. Complex waterfall and carried interest calculations can be easily mishandled without the proper systems and controls. The accounting staff should have expertise in the accounting and calculation complexities of the funds they serve.

“I feel that level of expertise gets watered down when an administrator is servicing hundreds or thousands of clients. It gets harder to put the proper controls in place,” states Mueller.

To Peller’s earlier point on the challenges of integrating multiple administrators and IT systems, the complexity and risk of trying to meld cultures and technology can, if done poorly, lead to a distraction in terms of servicing existing clients.

“I’m not saying it can’t be done well, but acquisitions can dilute the quality of the work you are doing. Maintaining quality at the highest possible level - that to me is the most important thing,” extols Mueller.

**Organic growth**

By focusing on organic growth, Citco has managed to grow its private equity AuA to more than USD275 billion in committed capital. Of Citco’s total USD900 billion in AuA, Peller says that hedge funds continue to grow “but over the last six years, private equity has become a core part of our business. If I look at the pipeline and the deals we are closing, that’s where institutional investors are putting their money right now. We’re either lucky or good; or both!”

“What organic growth does is keep you grounded in terms of what your core business is,” says Waldron. “It’s critical for any manager that they see good organic growth in their administrator. It gives them a good idea of where the administrator’s management team is focused.”

That’s certainly the approach that new entrants like Socium are taking. In fact, given the exacting demands and reassurances that private equity managers need from their appointed administrator - and, by extension, a high-touch level of support - there could well be a large ecosystem of niche administrators servicing the smaller and mid-sized manager community, while at the other end of the AuA spectrum, large administrators focus their efforts on large, established fund management groups.

“Having access to our many years of experience is a value-add to our clients,” says Mueller. “They have a partner to run things by, to ask for advice. We pair that with enterprise technology solutions, which is the same, and in some cases better, than what the largest administrators use.

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**You can’t be all things to all people. It’s important for an administrator to be knowledgeable and experienced in the complexities of the funds they’re servicing.**

Beth Mueller, Socium
“We combine those two things (expertise and technology) with high-touch customer service. It’s what drives us. Excellent client service generates client referrals, which will help you grow your business. It’s not just about acquiring other firms. You have to be smart about it, so that you don’t sacrifice the level of client service you offer, just for the sake of growth.”

As far as scalability goes, Mueller hopes that Socium will flourish just by virtue of the fact that outsourcing now makes so much sense to a lot of PE fund managers.

“The outsourcing trend is catching on. If we stick to our knitting and offer great client service then we will continue to grow organically,” she adds.

The role of technology
Peter Sanchez is CEO of Northern Trust Hedge Fund Services, one of the more prominent custodian bank-owned fund administrators. Speaking about technology, Sanchez says that Northern Trust has a technology framework that allows it to handle all types of investment strategies and portfolio complexities.

“Our technology utilises one data set throughout the trade and NAV lifecycles. Trade capture, fund accounting, performance attribution and P&L, investor accounting and investor reporting are all done on the same platform,” comments Sanchez.

This is helping Northern Trust to respond to the convergence in the alternative funds space as hedge fund managers develop more private equity-like structures and PERE managers add hedge fund-like satellite strategies to their core offerings.

“We have been investing into the back end of our system, focusing on sophisticated investor servicing tools as well as leveraging our existing tools to track performance and cash flows at the investment level. For example, private equity firms today ask for the return not only on a Limited Partner, but the return on a specific asset including all the cash flows and expenses and the return on a legal entity that holds that particular investment or portfolio,” adds Sanchez.

More and more capabilities that leverage powerful data tools, such as tagging attribution tools, are becoming an important part of the portfolio and investor services.

“Some of the largest traditional asset managers have multiple administrators and I could see that happening in the alternatives industry.”

Peter Sanchez, Northern Trust

Looking ahead
As a core competency of an asset servicing business, a trust/custodial bank is going to continually invest in that business because it is their core business. This goes to the ‘stick or twist’ point made earlier; Deutsche Bank ultimately decided they didn’t want to throw more money at their Alternative Fund Services business and opted to sell to Apex.

“I think the investment banks looked at the administration business as a back-office business that they could make annuity fees on, but once they began facing balance sheet restrictions, they decided to look at what their actual core competency was, and it became quickly apparent that asset servicing was not part of it,” says Sanchez.

Whilst there will likely be fewer independent administrators in future, they will still exist and play an important role (especially in terms of pricing) to smaller fund managers.

“I could see a situation where the biggest managers become so big that they start to move into multi-administrator relationships. Some of the largest traditional asset managers have multiple administrators and I could see that happening in the alternatives industry, perhaps based on strategy, or investors’ requirements,” says Sanchez.

GP’s want to select administrators that are a good fit for them. That’s why it’s important, concludes Mueller, “that if you grow through M&A you have to make sure it is the best possible strategic fit for your firm and isn’t going to compromise the service you provide.

“Only owners of administrators who are truly in this for the long haul are going to keep that in the forefront of their minds.”