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Benchmarking Insights

PwC's asset management perspectives and analysis

Hedge fund administration

The quest for profitable growth

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Summary



There's little doubt that hedge fund administration (HFA), or back-office outsourcing, is a maturing industry, as over 80% of hedge fund AUM is administered by a third party. Unsurprisingly, over the past seven years, 43% of the asset growth among top 10 administrators came from acquisitions.

However, despite 27 acquisitions of hedge fund administrators since 2006 (11 involving firms that administer at least \$20 billion or more in assets), M&A activity in 2013 slowed due to an increase in valuations and a decrease in the number of viable acquisition candidates.

Because HFA demand is triggered primarily by external forces – such as post-crisis investor pressure placed on hedge funds to outsource their books and records – organic growth in hedge fund administration will be challenging as firms are forced to compete for a relatively static group of clients.

What's Next?

As organic and inorganic HFA growth opportunities decrease, will there be new demand for administration services? And if so, where will this demand come from?

The answer lies in the competitive forces now shaping the asset management industry. We've found that four trends in particular appear poised to drive new growth in hedge fund administration (see below).

As these trends take hold, administrators will invariably follow different paths toward growth, many of which will be influenced by such characteristics as size, ownership structure, and service mix.

Small, undercapitalized administrators may focus on making improvements to both cost efficiency and their core competencies as a way to increase profit margins.

And well-capitalized administrators, small or large, may pursue one or more of these four growth opportunities to the extent they are not already doing so. However, it's important for well-capitalized administrators to remember that their financial capital will enable the pursuit of growth, but it will not guarantee the creation of value. Achieving profitable growth and shareholder value creation will come from a strategy that focuses on creating and sustaining a competitive advantage.

We believe the HFA firms that define a growth strategy which complements their core competencies, activities, and assets will create more value over the long term.

1	Increased need for regulatory reporting	Demand for regulatory reporting services, such as AIFMD, Solvency II, and Form PF, remains strong.
2	Manager and product convergence	Strong growth in assets under management (AUM) is expected for liquid alternative products. Citi Prime Finance estimates that these products will exceed \$900 billion in AUM by 2017. ¹ At this rate of growth, the administration industry could capture incremental revenue in the range of \$600 million to \$825 million on an undiscounted basis for the period of 2013 – 2017.
3	Cost-efficient fee operations	Asset managers are looking to become more cost-efficient in response to pressure from institutional investors. Administrators may want to develop new services that help asset managers achieve higher levels of operational and cost efficiency.
4	Expanded outsourcing	Opportunities exist for administrators to offer private equity administration services. The US addressable market for private equity administration remains large, at 73% of invested capital (or ~\$1.7 trillion) . If private equity outsourcing were to reach 50% by 2018 (it's currently at 30% today) then the incremental revenue opportunity for the fund administration industry is \$660 to \$880 million on an undiscounted basis for the period of 2014 – 2018. Middle office outsourcing is another organic growth opportunity for HFA firms. We estimate over 50% of hedge fund managers use an inhouse middle office function.

¹ Citi Investor Services whitepaper, "The Rise of Liquid Alternatives & The Changing Dynamics of Alternative Manufacturing and Distribution," May 2013

Hedge Fund Administration (HFA) Industry Perspective



Hedge Fund Administration Industry Analysis

Hedge fund administration, which consists of functions such as fund accounting, tax administration, financial reporting, and investor servicing are the back-office activities that support the running of a collective investment scheme. Historically, many hedge fund managers opted to perform some or all of these functions using in-house staff.

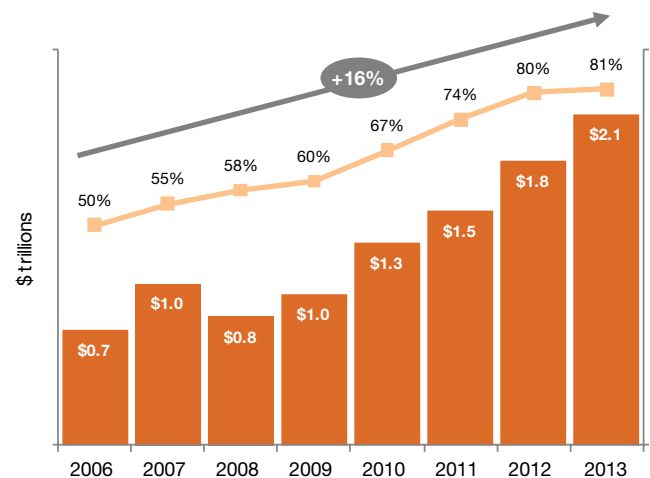
However, insource models shifted to outsourced following the wave of investment scandals that surfaced during the credit crisis.

While investor demands were the primary determinant, hedge fund managers found several other benefits to outsourcing, such as:

- **Cost avoidance:** eliminating the need to invest manager capital to develop capabilities in non-core functions
- **Cost control:** the potential to transfer back-office costs from the manager to the fund
- **Regulatory complexity:** increased sophistication of regulatory reporting
- **Transference of operational risk:** transitioning the cost of operational errors to a third-party
- **Pass-through benefits:** benefitting from ongoing capital investments made by hedge fund administration firms in their platform
- **Time-to-market:** benefitting from an expanded set of features and functionality offered by HFAs

The confluence of these factors led to a sharp increase in new outsourcing mandates, which fostered an environment of rapid growth for hedge fund administrators. **From 2006 – 2013, the percentage of hedge fund AUM administered by HFAs increased from 50% to 81%**, (~\$1.4 trillion in new AUA) – a compound annual growth rate (CAGR) of 16% (see figure 1).

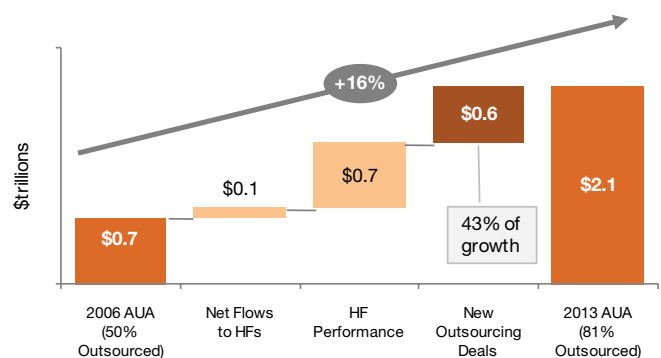
Figure 1: Estimated HFA Share of HF Assets (2006 – 2013)



Sources: PwC estimate based on analysis of ADV regulatory filings, discussions with hedge fund managers, review of industry publications, press releases, and analyst reports.

PwC Analysis based on data from Hedge Fund Research

Figure 2: HFA Share of HF Assets – Estimated Sources of Growth



Sources: PwC estimate based on analysis of ADV regulatory filings, discussions with hedge fund managers, review of industry publications, press releases, and analyst reports.

PwC Analysis based on data from Hedge Fund Research

Constraints on Organic Growth in Hedge Fund Administration

Since 2006, the primary source of growth for HFAs was new back-office outsourcing mandates; however, this no longer represents the most viable path to organic growth.

- Exogenous Demand:** Demand drivers for the administration industry are exogenous, meaning they are triggered by external forces. An example of an exogenous demand driver is the pressure that investors placed on hedge funds to outsource their books and records in the wake of the credit crisis investment scandals. Because industry demand cannot be created internally through product and service innovation, growth cycles are often varied and unpredictable. As such, achieving growth in the administration industry can be challenging, as firms are forced to use rivalry tactics to compete for the relatively static group of constituents that buy the industry's services.
- Shrinking Addressable Market:** 81% of single manager hedge fund AUM is administered by an HFA currently (see figure 3). As such, the remaining addressable market is limited to just 19% of hedge fund AUM (or 9% for managers with more than \$1 billion in assets). The addressable market for fund of hedge funds (FoHF) is also 20% with limited AUM growth prospects expected.
- High Client Switching Costs:** For the hedge fund managers that have outsourced back-office operations, the switching costs, which come in the form of transition costs and business disruption risks, are relatively high. Moving books and records to a new administrator is a complex activity that carries the risk of errors and service level degradation if the data isn't transitioned correctly. As such, high client switching costs limit a firm's ability to compete for market share.

We recently conducted a survey on alternative administration with 84 hedge fund, private equity, and hybrid managers (64 of which used an outsourced model). Our survey confirmed that managers rarely switch administrators. In fact, 54% of hedge fund and hybrid managers cited high switching costs as a top reason for staying with their current provider, second only to satisfaction with service levels (see figure 5).

We also gauged hedge fund and hybrid manager satisfaction and found that 74% of survey participants are generally satisfied with their current administrator, while only 4% are looking to switch providers (see figure 6).

For the reasons above, we believe the organic growth prospects in hedge fund administration are weak.

Figure 3: Total Addressable HFA Market – Hedge Funds (\$T)

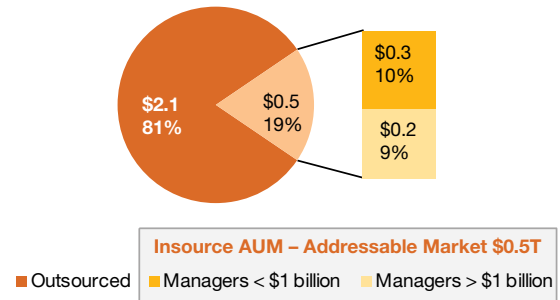
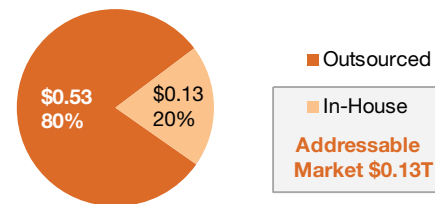
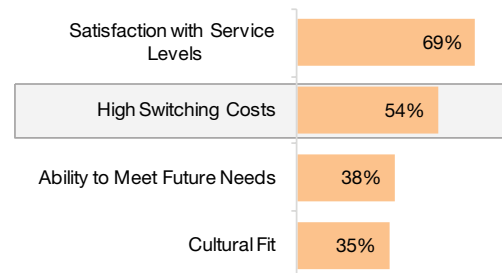


Figure 4: Total Addressable HFA Market – FoHF (\$T)



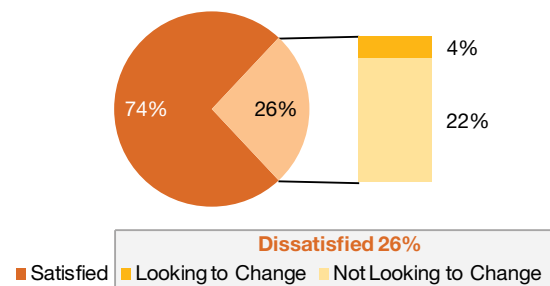
Source (figure 3 & 4): PwC estimate based on analysis of ADV regulatory filings, discussions with hedge fund managers, and review of industry publications and analyst reports. Hedge Fund market size data as of 2013 and sourced from Hedge Fund Research.

Figure 5: Top Reasons for Staying with Current Provider



Source: PwC's Alternative Administration Survey. Multiple responses allowed. Graph truncated to show top 4 reasons cited. Graph reflects hedge fund and hybrid manager responses only.

Figure 6: Administrator Satisfaction



Source: PwC Alternative Administration Survey

Outcomes of the Constrained Growth Environment

The limited opportunities for growth have led to competitive practices that are typically found in more mature and/or commoditized industries. These practices include:

- Price Competition
- Increased M&A Activity

Price Competition

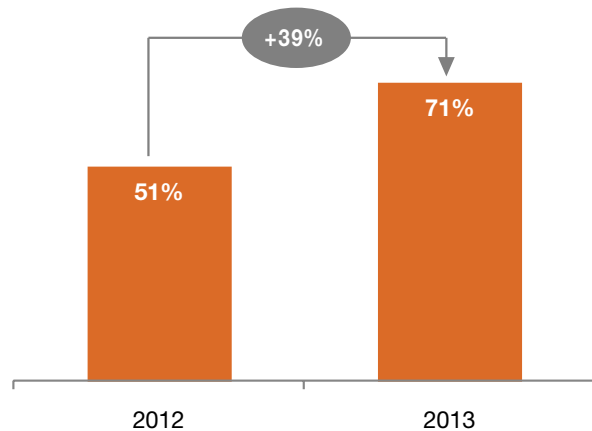
Since the credit crisis, institutional investors have increased the rate at which they negotiate lower management and performance fees with hedge fund

managers. According to a survey by Deutsche Bank², over 70% of institutional investors reported negotiating fees with hedge fund managers in 2013, which was a 39% increase over 2012 levels (see figure 7 below).

This increase in fee negotiations may be responsible for the reduction in hedge fund management fees, which have fallen from an average of 1.58% in 2010 to 1.53% in 2013, according to HFR³ (see figure 8 below).

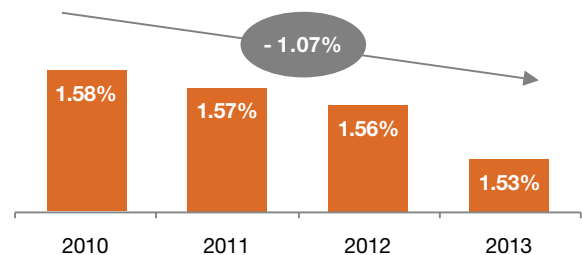
In response, hedge fund managers are reducing their own costs to offset the effect of management fee compression on their bottom line. Hedge fund administrators are a target of these cost efficiency initiatives because they often represent a large percentage of a hedge fund manager's cost structure.

Figure 7: Investors Negotiating HF Fees (2012 – 2013)



Source: 11th Annual Alternative Investment Survey, Deutsche Bank

Figure 8: Hedge Fund Management Fees (2010 – 2013)



Source: Hedge Fund Research

² "Alternative Investment Survey," Deutsche Bank, February 2013
³ "Market Microstructure Report," Hedge Fund Research (HFR), 2010-2013

Increased M&A Activity

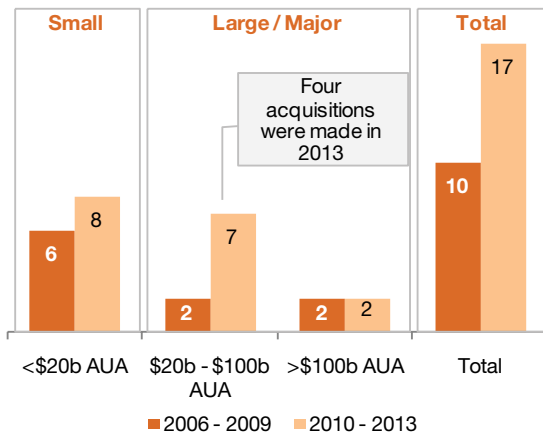
Since 2006, there have been 27 acquisitions of hedge fund administrators, 11 of which involved HFA targets administering \$20 billion or more in AUA (see figure 9 below).

These acquisitions drove a profound shift in industry market share. In 2006, bank owned administrators held approximately 47% of outsourced hedge fund AUM. By 2013, the market share of bank owned administrators increased to 64% of outsourced hedge fund AUM. Conversely, non-bank owned administrators saw their market share shrink dramatically from 53% in 2006 to 36% in 2013 (see figure 10 below).

Large banks have been the most acquisitive, because hedge fund administration complements core services, such as custody and/or prime brokerage. The most common value driver for large bank acquisitions was increased profitability from:

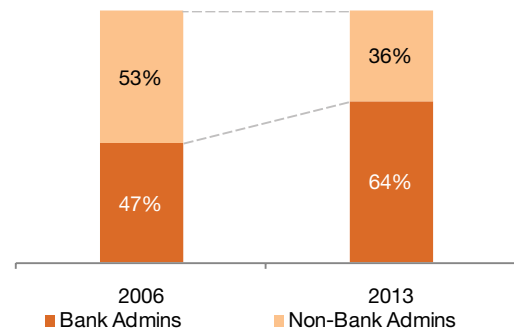
- **Cost synergies:** A reduction in unit costs by eliminating redundancy in technology and operations
- **Revenue synergies:** An increase in the cross-selling of services, such as custody, foreign exchange, and collateral management to new and legacy clients

Figure 9: HF Administrator Acquisition Breakdown '06 – YTD'13



Sources: PwC analysis based on analysis of HFM Week, discussions with hedge fund managers, review of industry publications, press releases, and analyst reports.

Figure 10: Hedge Fund Administration Market Share Reallocation



Sources: PwC analysis based on analysis of HFM Week, discussions with hedge fund managers, review of industry publications, press releases, and analyst reports.

To assess the impact of increased M&A activity on industry concentration, we analyzed industry market share and industry concentration (HHI).

From 2006 – 2013, the share of industry AUA held by the top five HFAs increased from 44% – 59%. The largest increase occurred between 2010 to 2012, when seven major acquisitions drove the collective share of the top 5 administrators from 49% to 59% (see figure 10 on the prior page and figure 11 below).

Our HHI analysis indicated the hedge fund administration industry remains competitive. HHI was formally adopted in the federal merger guidelines of 1982. It is one of the preferred methods for measuring industry concentration because it weights the market shares of largest enterprises most heavily. An industry is considered highly concentrated when its HHI exceeds 1,800, moderately concentrated between 1,000 and 1,800, and competitive when below 1,000.

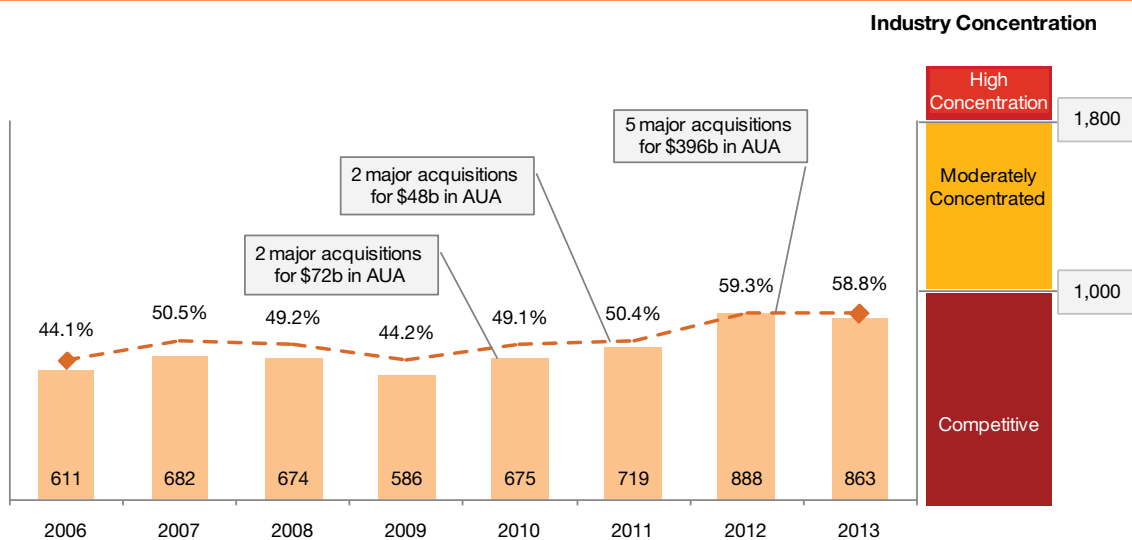
From 2006 to 2013, HHI for the hedge fund administration industry increased from 611 to 863 (see figure 11 below). With a concentration ratio of 863, the HFA industry is classified as competitive. However, continued M&A activity will inevitably push the industry toward a moderately concentrated classification.

More concentration will likely result in increased market power, in the form of cost-side economies, for the largest firms. Cost-side economies are achieved when a firm creates a sustainable cost advantage that cannot be easily replicated by competitors. HFAs that eliminate post-merger redundancy can achieve these cost-side economies.

Conversely, HFAs that fail to integrate acquisitions and eliminate redundant costs may not achieve these benefits. Therefore, it is important for administrators to remember that acquisitions, if not integrated efficiently, can result in shareholder value destruction.

As the HFA industry consolidates, small and mid-sized firms will find it increasingly difficult to compete against the large cost-advantaged firms. As such, a cost-efficient offering targeted at specific segments is paramount for smaller administrators to retain clients and achieve future growth.

Figure 11: Hedge Fund Administration Industry Concentration 2006 – 2013



Source: HFM Week, PwC Analysis

The Path Forward for HFAs

The results of our industry analysis suggest that HFAs are at a crossroads. HFAs should consider the following two options as they formulate their next growth plan: 1) focus on providing new specialized services to hedge fund clients, or; 2) expand administration capabilities to include new services and/or new client segments.

- **Focused Path:** HFAs that choose to focus on hedge fund managers should target opportunities to leverage their core competencies as they develop new specialized services.
- **Diversified Path:** HFAs looking to diversify should offer expanded services, (e.g., regulatory reporting) and/or target new client segments, (e.g., PE/RE managers). These HFAs should evaluate their competitive position and core competencies to determine whether a transition from focused to diversified is achievable.

The remainder of this paper will focus on the external forces that represent growth opportunities for alternative fund administrators.

The goal of our paper is to help HFAs chart a path toward profitable growth.

Asset Management Industry Perspective



Asset Management Industry Analysis

Since 2008, the asset management industry has undergone tremendous change. There are four trends in particular that will likely have a material impact on the growth of the fund administration industry. We define these four trends as:

1. Increased Regulation
2. Convergence
3. Cost Efficient Operations
4. Demand for Expanded Outsourcing

Increased Regulation

Since the credit crisis, asset managers have been challenged to meet an ever expanding set of global regulatory requirements, which require asset managers to file reports in multiple jurisdictions. The information needed to complete these regulatory filings is generally difficult to procure and compile.

The need for regulatory reporting creates a growth opportunity for fund administrators, as they are well positioned to assist asset managers with aggregating the data required.

However, the extent of this growth opportunity will vary. For example, many asset managers use Form PF reporting solutions from third-party providers, limiting the potential for organic growth among the administrators. By contrast, AIFMD, a European regulation with a reporting component, offers stronger growth prospects for administrators.

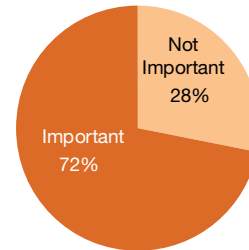
NOTE: AIFMD also includes a depositary requirement, which is another significant growth opportunity for administrators.

Time to market is a critical success factor for regulatory reporting solutions. Administrators that were late in developing a Form PF capability were ultimately preempted by other competitors. Where this occurred, clients of the late moving HFA usually selected another provider, resulting in lost revenue and increased competition for the incumbent.

When timed appropriately, the incumbent administrator should have an advantage over other third-parties, when selling their regulatory reporting services to clients. In fact, 72% of participants in our administration survey felt it was important for their current administrator support their regulatory needs (see figure 12 below).

Figure 12: Administrator Regulatory Reporting Demand

Is it important that your administrator support your reg. reporting needs?



Source: PwC Alternative Administration Survey

Convergence

Prior to the credit crisis, the asset management industry was bifurcated into two distinct product segments: 1) regulated funds and long-only SMAs, and; 2) private funds, such as hedge funds and private equity.

Today, both private and regulated fund managers offer “liquid” alternative products to the same investor segments.

For public managers, liquid alternatives offer healthy management fees and strong growth potential.

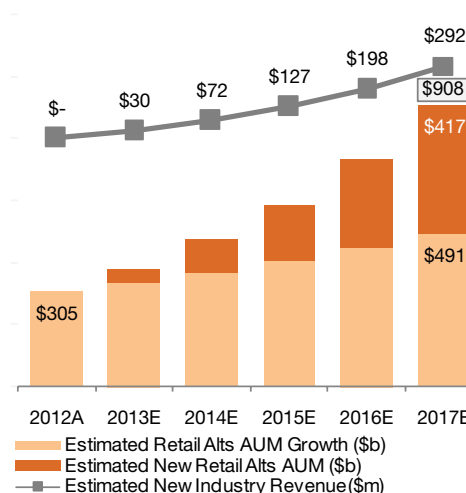
For private managers, liquid alternative products provide access to large asset pools, such as defined contribution plans, which were unavailable to this segment previously.

Overall, the growth opportunity with liquid alternatives appears to be significant.

According to Citi Prime Finance⁴, total AUM in retail alternative products could increase to \$908 billion by 2017. If this occurs, it would represent an increase of \$603 billion over 2012 AUM levels (a CAGR of 24%).

Using these projections, we estimate that the total incremental revenue opportunity for the fund administration industry could range from \$600 million to \$825 million (average \$720 million) on an undiscounted basis for the period of 2013 – 2017 (see figure 13).

Figure 13: Estimated Industry Revenue Opportunity – Retail Alts



Source: Citi Prime Finance, PwC Analysis.

Notes: Assumes 6bps to 8bps for retail alternatives administration. Graph depicts average estimated revenue opportunity.

To capture a share of this growth opportunity, administrators must demonstrate an ability to:

- Support 40-Act fund product attributes that are not found in private alternatives, (e.g., daily expense accruals, daily NAV, increased regulatory reporting demands, etc.), and;
- Administer these funds in a manner that is commensurate with 40-Act fund administration standards, (i.e., high accuracy and efficiency).

Administrators that support 40-Act mutual funds presently will have an advantage over firms that focus exclusively on private alternative managers. As such, firms should consider whether they have the core competencies necessary to support mutual fund accounting and administration before pursuing this source of growth.

⁴ Citi Investor Services whitepaper, “The Rise of Liquid Alternatives & The Changing Dynamics of Alternative Manufacturing and Distribution,” May 2013

Cost Efficient Operations

The asset management industry is facing a period of increased fee pressure, as institutional investors continue to push for lower management and incentive fees on their investment mandates.

To offset these fee pressures, asset managers have initiated their own cost efficiency efforts, which are centered on reducing expense in non-revenue generating areas of their business, (e.g., operations).

Administrators should consider the development of tools that help asset managers to achieve higher levels of operational and cost efficiency.

One example is a set of workflow tools and reports that provide improved transparency into the accuracy and timeliness of accounting and administration activities. Developing these tools could allow asset management staff to monitor administrator activities without using a full in-house shadow function.

We believe this represents a strong opportunity since shadow accounting continues to be used pervasively across the industry. In fact, 83% of managers reported maintaining an in-house shadow accounting function in our alternative administration survey (see figure 14).

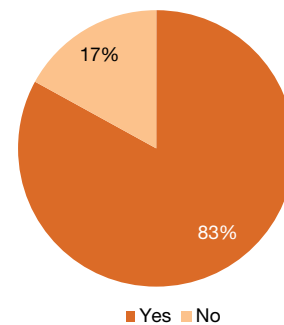
Providing tools that enable managers to reduce their reliance on shadow functions should produce material savings for the manager and the asset management industry.

Creating products that improve operational efficiency for asset managers provides two key benefits for HFAs:

- These products and services provide an opportunity to win through service differentiation, as opposed to price competition; and
- These products provide an economic benefit to asset managers by allowing them to reduce their internal expenses.

If HFAs can demonstrate that their solutions allow managers to become more cost efficient, then this may provide an opportunity to charge pricing premiums for these services.

Figure 14: % of respondents with shadow accounting



Source: PwC's Alternative Administration Survey.

Demand for Expanded Outsourcing

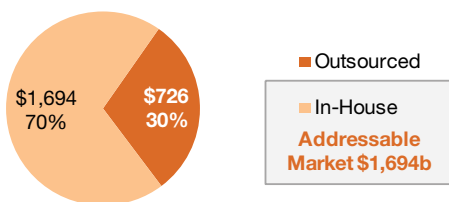
Increased regulation and the desire for cost efficient operations have triggered demand for third-party private equity administration services.

We define private equity (PE) administration broadly as the back-office accounting and administration services for closed-end, limited life, draw down funds with a GP/LP structure. Private equity administration can support a broad range of PE strategies, including, but not limited to, leveraged buyout, growth equity, real estate equity, real estate debt, venture capital, venture debt, infrastructure, tradable credit, direct lending, secondary funds, etc.

PE Back-Office Outsourcing

In the US, private equity fund managers have yet to adopt back-office outsourcing to the same degree as hedge fund managers. This is because private equity managers did not face the same outsourcing demands as hedge fund managers. As a result, we estimate that only 30% of US PE invested capital has been outsourced to a third-party administrator.

Figure 15: Total Addressable PE Admin Market – PE (\$b)



Source: PwC estimate based on analysis of ADV regulatory filings, discussions with private equity managers, and review of industry publications and analyst reports. Market size data from Preqin. www.preqin.com

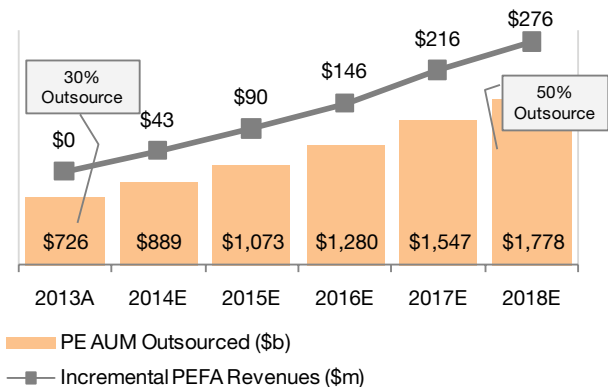
Private equity total market size excludes dry powder.

However, as regulatory requirements and cost pressures continue to mount, PE managers are looking to third-party administration.

When coupling the rising levels of demand with a large addressable market, (i.e., 70% of invested capital), the growth opportunity for private equity administration is significant (see figures 15 and 16).

At current levels of demand, we believe outsourcing levels could increase from 30% to 50% of PE invested capital over the next five years. Should this occur, then the five-year industry revenue opportunity for fund administrators could range from \$660 million to ~\$880 million, on an undiscounted basis for the period of 2013 – 2017 (see figure 16).

Figure 16: PE Admin Industry Revenue Opportunity



Source: PwC estimate based on discussions with private equity managers, and review of industry publications and analyst reports. Market size data from Preqin. PE total market size excludes dry powder.

The five year revenue opportunity in the graph is \$770 million (undiscounted), which represents the average of our low (\$660 million) and high (\$880 million) estimates.

While the emergence of a new segment represents an opportunity for growth, administrators should consider the unique needs of private equity fund managers. Activities such as IRR/waterfall calculations, capital calls, and LP accounting are not prevalent in hedge fund administration. As such, entry into this asset class will require resources with specialized knowledge.

Additionally, private equity and real estate LP agreements (LPAs) are highly customized. This lack of standardization makes it difficult to systematize some of the operations and accounting work in this asset class.

Lower levels of process automation indicate that a PE administration function/business may be limited in its ability to scale without adding additional skilled resources. As such, PE administration is more resource dependent (versus hedge funds) making organic entry into PE administration more difficult.

To address this barrier, fund administrators entering PE administration should consider a “lift-out” strategy as their method of entry. A lift-out strategy consists of moving the operating model, (e.g., people, processes, and technology) from a PE manager to a fund administrator. Once transitioned, this operating model typically serves as the foundation of the third-party administrator’s new offering.

It should be noted that lift-out strategies are not without risk. Because PE administration is skilled resource dependent, the retention of the staff transitioning from the asset manager is paramount. As such, administrators should incorporate a strong communication plan and retention strategy into their lift out approach.

Key Takeaways from AM Industry Analysis

Changes in the competitive forces of the asset management industry have created new sources of growth for alternative administrators.

Because these growth opportunities are material in size, the rivalry among industry participants will be intense. Administrators will aggressively pursue new AUA mandates because their operating leverage provides the added benefit of higher profit margins on incremental sources of revenue.

As administrators contemplate their growth strategy moving forward, they should be mindful of their market position, core competencies, and capital position.

Small undercapitalized administrators should avoid pursuing these growth opportunities. Instead, these firms should improve profit margins by targeting underserved hedge fund segments in a cost-efficient manner.

Well-capitalized administrators, small or large, should consider pursuing one or more of the four industry growth opportunities – to the extent they are not doing so already. However, it is important for well capitalized administrators to remember that their financial capital will enable the pursuit of growth, but it will not guarantee value creation. Achieving profitable growth and equity value creation will come from a strategy that focuses on creating and sustaining a competitive advantage.

We believe the firms that define a growth strategy that complements their core competencies, activities, and assets will create more value over the long-term.

Administrator Segment Considerations



The fund administration industry can be segmented across several dimensions, including ownership structure, service mix, and size. Our analysis shows that several firms have begun repositioning to capitalize on future growth opportunities.

We segmented the top 50 alternative administrators across three dimensions

		I		
		1 Bank Owned	2 Non-Bank Owned	3 Independently Owned
II	Multi Asset Class	AUA < \$100b – 2 firms	AUA < \$100b – 1 firm	AUA < \$100b – 2 firms
	Single Asset Class	AUA > \$100b – 6 firms	AUA > \$100b – 0 firms	AUA > \$100b – 9 firms
III	Multi Asset Class	AUA < \$100b – 12 firms	AUA < \$100b – 2 firm	AUA < \$100b – 0 firms
	Single Asset Class	AUA > \$100b – 2 firms	AUA > \$100b – 1 firm	AUA > \$100b – 15 firms
Total		64% of AUA AUA < \$100b – 14 firms AUA > \$100b – 8 firms Total – 22 firms	14% of AUA AUA < \$100b – 3 firms AUA > \$100b – 1 firm Total – 4 firms	22% of AUA AUA < \$100b – 24 firms AUA > \$100b – 2 firms Total – 26 firms
		● AUA > \$100b	● AUA < \$100b	

Fund Administrator Segmentation:

We segmented the fund administration industry using three dimensions to evaluate the different challenges and considerations facing these constituencies:

I. Ownership Structure

II. Service Mix

III. Size

Bank Owned Fund Administrators Observations

Business Driver for Fund Administration

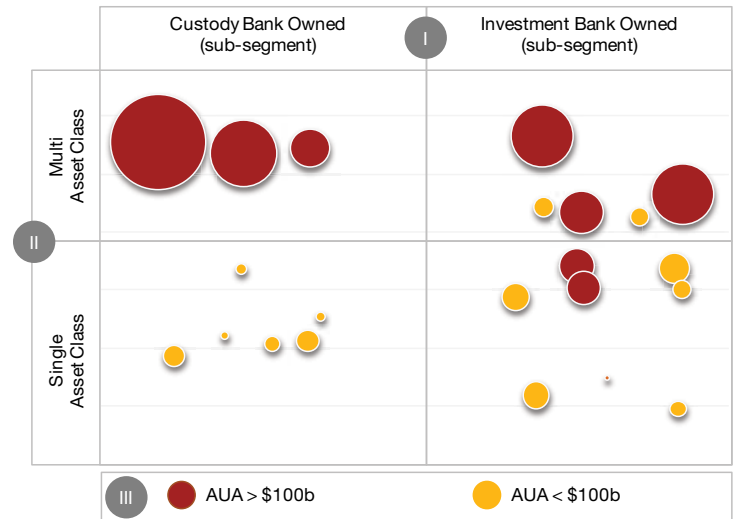
Potential to cross-sell other banking & prime brokerage services.

I. Ownership Observations

- Increased regulatory capital requirements making retention of non-core businesses more difficult, particularly for the investment banks
- Access to corporate capital for acquisitions and business transformation efforts currently competing with share repurchase programs, limiting investment at some banks
- Efficacy of cross-selling efforts varies across the bank-owned segment. The most successful models focus on client experience and ease of doing business across the bank
- Cross-selling focus is on large hedge fund and hybrid managers
- Bank owned administrators have grown inorganically, by making 14 of the 27 acquisitions since 2006

II. Service Mix Observations

- There is a clear bifurcation in size between single and multi-asset class fund administrators
- Multi-asset class bank owned administrators have the most extensive capabilities in hedge funds, private equity, real-estate, and mutual funds



III. Size Observations

- Large bank-owned administrators view administration as core to their business, which differs from some of the mid to small bank-owned administrators
- Small to mid-sized bank-owned administrators have a larger exposure to less attractive client segments, such as low-AUM hedge funds and/or fund of hedge fund managers, making them unlikely acquisition candidates for large bank-owned administrators

Non-Bank Owned Fund Administrators Observations

Business Driver for Fund Administration

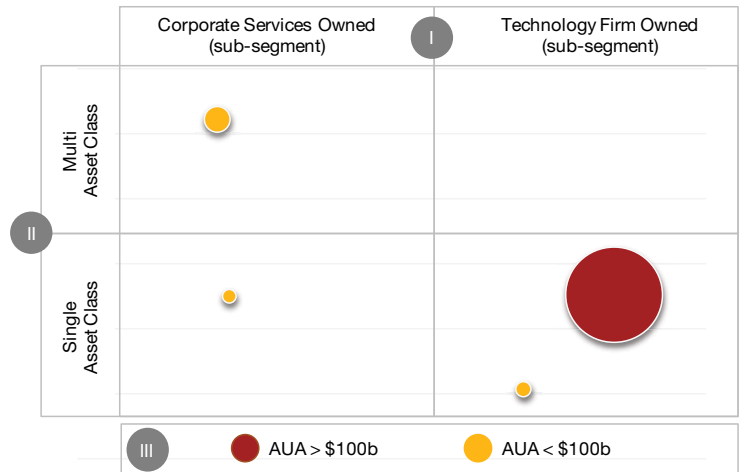
Stable source of revenues with potential to cross-sell core services to administration clients. Core services range from HR and legal (corporate services owned) to front-office and in-house reporting systems (technology owned).

I. Ownership Observations

- Cross-selling opportunities are more tempered than those in the bank-owned administrator segment
- Growth in this segment has been largely inorganic, as all four firms have made an acquisition in the last three years

II. Service Mix Observations

- Non-bank owned administrators use a single asset class model predominantly. The non-bank owned administrators focus almost exclusively on single manager hedge funds
- The large technology owned administrator has been proactive in developing new services in regulatory and middle-office outsourcing for hedge funds
- Technology and independent owned administrators appear to be the most nimble when it comes to developing advanced capabilities, such as Flash P&L or dynamic reporting



III. Size Observations

- Three of the four firms in this segment focus on smaller alternative managers and have less than \$100b in AUA as a result

Independently Owned Administrators

Observations

Business Driver for Fund Administration

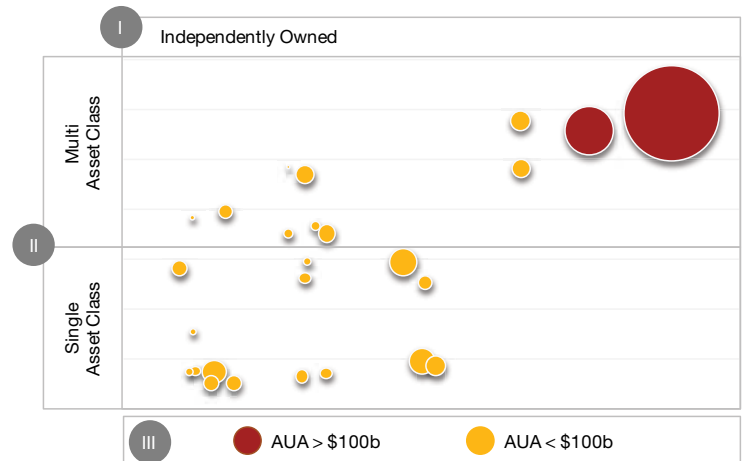
Administration represents the core business of the independently owned firms.

I. Ownership Observations

- Independently owned administrators have the fewest opportunities for cross-selling outside of fund administration, because their non-administration offering is limited
- Current non-administration services include basic corporate services and non-US custody and banking (offered by the largest administrator only)
- Growth in this segment has been largely organic with firms making only four acquisitions in the segment since 2006

II. Service Mix Observations

- Independently owned administrators are evenly split between single and multi-asset class servicing strategies
- It is unlikely that the small multi-asset class firms will have the capital to compete head-to-head against the larger and better capitalized multi-class administrators
- The largest two administrators have the most well developed multi-asset class offerings. These firms use their size and significant investments in technology to compete in the hedge fund, hybrid, and private equity administration sectors
- Technology and independent owned administrators appear to be the most nimble when it comes to developing advanced capabilities, such as Flash P&L or dynamic reporting



III. Size Observations

- The segment is highly fragmented with 24 firms below \$100b in AUA

Segmentation Considerations – Ownership Structure

Dimension	Considerations
General (All Dimensions)	<p>Consider implementing or extending operational efficiency initiatives to lower unit costs, improve profitability, and strengthen the firm's current position in advance of the potential acceleration in fee compression</p> <p>Invest in a model that applies cost drivers to key activities across the value chain and details profitability by activity, service, fund, and client relationship</p>
Ownership	<p>Evaluate the level of success with cross-selling non-administration services to clients. Determine if adjustments should be made to improve the client experience, making it easier to do business across the firm</p> <p>Determine whether the administration business generates an ROIC that exceeds its cost of capital (positive economic profit)</p>
Service Mix	<p>Evaluate the division's current strategy and position in the context of the changing asset management industry dynamics (see section 2) to determine where there are opportunities for growth that align with a firm's core competencies. For example:</p> <ul style="list-style-type: none"> • Large administrators should evaluate whether their current position can be extended to capture emerging opportunities, such as retail alternatives without compromising current positioning • Small administrators should evaluate opportunities to capture the remaining addressable market of low-AUM hedge fund managers
Size	<p>Small administrators should focus on a strong competitive position that centers on service-levels and cost efficiency</p> <p>Small administrators should determine whether there are any underserved segments that align with their value proposition and core activity set</p> <p>Large and medium-sized administrators should evaluate acquisitions opportunistically. Management should review all prospective acquisitions closely to determine whether they align to the firm's strategic position and core activity set. Acquisitions that are misaligned should not be undertaken.</p> <p>Large administrators might consider the use of a platform segmentation strategy that focuses on servicing certain segments, (e.g., lower AUM hedge funds) more cost effectively</p> <ul style="list-style-type: none"> • The offering could be targeted at managers setting up new funds or current managers with less than \$500 million of AUA to capture the remaining 50% of the addressable HFA market. The offering provides the added benefit of being able to migrate managers that grow beyond \$1 billion in AUM to the administrator's full service platform • Consider the acquisition of a small administrator to gain these capabilities, provided there are sufficient revenue and/or cost synergies to justify the buyer's premium

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