## DIRECT INVESTMENT

# The Latest Family Office Trend

By Anna Maria Nekoranec

Single-family offices currently account for more than $2.4 trillion in investable capital, according to Family Capital, making them sizable competition to the private-equity industry.[1] Over the past five years the trend in this capital base has been toward direct investing. Historically, family offices have focused on fund investments. The 2008 downturn negatively impacted those allocations. Driven by poor performance, high fee structures, and a lack of transparency, family offices increasingly have allocated away from private-equity funds and toward direct investing. The projected future low-return environment for traditional private equity groups has further fueled this interest.

### The Direct Investing Environment

Direct investing can be described generally as a private investment in real estate, operating businesses (growth capital or leveraged buyouts), venture capital, and direct lending. Each asset class brings with it a different risk-return profile and requires a broadly skilled investment team. These asset classes historically have been dominated by private-equity funds. As an increasing number of families monetized their assets during the 2000s, there has been a proliferation of family offices that are beginning to become a force in the direct market and competition for traditional private-equity funds. In addition, traditional registered investment advisors are seeing more interest from clients in this alternative asset class and are finding it challenging to access and vet transaction flow for them.

### Why Are Families Entering This Market?

Jeff Rupp, president and managing director of View Capital in Dallas, shared his thoughts on why family offices are entering the market. "Over the last five years people have become more leery of the big funds and have attempted to make their own investment decisions," Rupp said. "I think that the trend is people attempting to manage their own private-equity investments versus going with co-mingled vehicles." In addition to poor performance by private-equity funds, desire for more transparency and dissatisfaction with fee structures have led family offices to become increasingly attracted to the sector. Control is a major factor in this trend, Rupp said.

"Private equity is viewed as a sexy business because families believe that they can utilize control to affect a better outcome—the key is having the right tool kit to execute," Rupp said. "The key question is whether or not the returns will be as good as if you went with a financial manager."

Indeed, two key considerations—transparency and fees—compelled the Vinik Family Office (VFO) to develop a direct-investment program, said Noam Abrams, who works as vice president for VFO.

"We like to know what we are investing in," Abrams said. "We like to know where our money is going. Why pay a substantial management fee and carry for something that you don't know? We believe that we can get better alignment doing one-off deals."

Others start direct-investing programs as a means to educate the next-generation client families about risk-adjusted investing, according to Ryan Cortner, a principal at the Clearwell Group. "We believe that there is a moral imperative to teach family members how to take smart risk and expose them to the portfolio companies so that they can understand the dynamics of both entrepreneurship and investing. We want to build a family of businesses and continue legacies started by great family entrepreneurs."

Another dynamic that has caused Clearwell to use more direct investing is what appears to be a trend in the private-equity fund market. It seems that the deployment of capital from a fund perspective has not accelerated, but the cycle of raising funds has, Cortner said, and going more "direct" leads to more transparency and control.

### Challenges to Entering the Direct-Investment Market

A number of challenges face the family office seeking to do direct investing. These include portfolio strategy, staffing, deal sourcing, deal execution, competition, defining the investment process, and asset management. Many family offices prefer to maintain small professional staffs. As a result of the inherent intensive nature of the direct-deal business, these offices tend to struggle with the asset class. For example, deal sourcing can be a full-time job. If the family office is thinly staffed, then once a deal is sourced, the staff must turn its attention to diligence and execution, causing the sourcing process to grind to a halt. Similarly, once the deal is complete, it is necessary for staff to manage the investments and reporting. Again, without adequate infrastructure, this can put a significant strain on the office, particularly when the investments are performing subpar and require additional attention.

Family offices also face challenges through competition with existing private-equity funds. Most funds have well-developed infrastructure with significant staff. This infrastructure can give them a substantial advantage over a family office with a smaller staff. It will enable them to execute the transaction more quickly, which can be a major selling point for a deal that is being marketed by a broker or an investment banker.

As Abrams put it: "There is a lot of competition from private-equity funds and very high prices are being paid for large, mature buyouts. There are many players bidding up prices."

According to Cortner, another challenge facing family offices is defining investment parameters. A well-thought-out investment thesis coupled with stringent investment criteria helps mitigate the challenge of family members "lobbing bunnies over the fence for one to chase," he said. "We support high integrity entrepreneurs when we believe a business can generate a positive impact in addition to investment returns."

### Initial Entry into the Market

As a result of these challenges, a number of family offices enter the direct market through baby steps. This entails seeking co-investment opportunities with funds where they have existing relationships. Co-investments enable the family office to leverage the work of the fund's staff, they provide transparent transactions, and they generally have lower fee structures than the traditional 2-percent management fee and 20-percent carried interest that is the industry standard. The independent-sponsor model is another vehicle that has emerged for family offices. Independent sponsors are individuals with either industry or private-equity experience, who identify and put under contract single deals and then seek financial groups to provide funding. They often provide family offices with industry expertise or increased deal flow.

### Key Considerations for the Family Office Seeking to Do Direct Investing

The cost of entry is one key consideration for the family office seeking to enter the market. How much are they willing to invest in a team that will be able to source, do due diligence, and manage the investments once they are made? Direct investing requires a specific set of professional skills that includes sourcing, diligence, accounting, legal, and board/strategy experience. The professionals in the industry tend to earn significant compensation as a result of the need for years of experience to obtain the skills necessary to execute and manage deals. The team may need to be carried for a year or more before the operation makes its first investment and significantly longer before it breaks even. In addition, the teams tend to be specific to an asset class. For example, if a family builds a team to invest in real estate, that team may not have the right experience to make growth-equity investments in operating businesses.

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Another often-overlooked key consideration for the family office is how a direct-investment program will impact the estate plan of the patriarch/matriarch and the heirs. Because these assets are illiquid, it is critical to understand how their value might affect the estate at the time of the patriarch/matriarch's death, paying close attention to whether or not there is sufficient liquidity within the estate to cover the estate taxes. In addition, one of the most challenging issues of a direct-investing program is what happens if these illiquid investments are either inherited by a wife or by children who may not have a deep understanding of their nature or management. Without a developed family-office staff with experience in this area, less-than-optimal value maximization may result and create problems for the heirs.

### Inherent Advantages for Family Offices

Despite the reservations outlined above, family offices have a number of inherent advantages in this asset class. First and foremost, they can be flexible. Because most are not required to put money to work, as are funds, they can be patient and wait for the right opportunity. In addition, they have the ability to be more flexible from a structuring standpoint. They can be more conservative with leverage and can invest in different parts of the capital stack. In addition, they do not have a defined time horizon when they have to sell the investment. Unlike private-equity funds that need to harvest investments in a three- to five-year time horizon, family offices can hold investments indefinitely and can provide partners with liquidity when needed. In fact, as the result of tax efficiencies, family offices often are better served by holding investments over an extended period of time. "Without the time constraints of a traditional fund, we can support growing businesses with the right amount of capital at the right time," Cortner said.

Some families also have the advantage of industry expertise. In many cases, a family office that has created its wealth from a specific vertical can significantly outperform traditional private-equity firms in the sector. These families tend to see the best deal flow in the space, have well-developed networks that can be leveraged for sourcing, diligence, and staffing, and have deep operational expertise as a result of years in the industry.

### What Types of Investments Are Families Making?

The types of investments being made are as varied as the family offices making them. Rob Blabey, the former chief investment officer for the Collier family, put it this way: "If you have seen one family office, you have seen one family office." Some offices, such as Dobbs Management and Blue Water Worldwide, focus on specific verticals where they have in-house expertise or have developed expertise through partnerships with other families. Dobbs Management leverages years of experience in the automotive industry. Blue Water Worldwide (BWW) has created a holding company that makes specific investments in real-asset verticals in conjunction with other families that have expertise in those verticals. Currently, they are concentrating on the aggregates business, power transmission, and class A warehousing in emerging markets. Others, such as the Vinik Family Office, carefully analyze the market and have a more surgical strategy.

"We are opportunistic," said Abrams. "We are open to venture, buyouts, and real estate. The risk-reward trade-off needs to make sense. Who is the management team, what is their track record, and how much are they investing—these are all key considerations. We like a good opportunity for growth with a clearly identified downside and an aligned management team that is committed. We shy away from the fray and look for things that are off the beaten path."

## Current Trend—Family-to-Family Investments

More and more families are seeking to partner with other families in club deals or to leverage one family's expertise in a space. BWW, which is run by Benji Griswold, is a prime example. Griswold's family started Alex Brown and Sons and Brown Advisory. Struck by the entrepreneurial bug and the need to find an interesting long-term investment vehicle for the family, Griswold founded BWW about seven years ago with funds from his family and other families. The strategy was to create a Warren Buffett-like holding company to make investments that would grow and throw off significant cash flow far into the future. Integral to this strategy was investing in conjunction with families that have significant expertise in the targeted verticals. So far, this strategy has paid off. The company is targeted to make around $300 million in revenue with more than $50 million of earnings before interest, taxes, depreciation, and amortization in 2015; it has been able to grow net asset value at a compound rate in excess of 22 percent per year.

## Characteristics of Successful Direct-Investing Operations

Some of the larger family offices that entered the space early have become a force in and of themselves. A great example is MSD Capital, the direct-investing arm for the Michael Dell family, which opened in 1998 and has offices in New York, Santa Monica, and London. MSD Capital focuses on special opportunities, private equity, and real estate; it created the gold standard in the industry and has a reputation that surpasses that of some of the best funds. Others such as the Griswold family have created permanent capital-holding-company vehicles where family members oversee strategy, execution, and management.

## Conclusion

This trend toward more direct investing appears to be here to stay. How it evolves will be driven by the individual nature of the individual family offices. Whether family offices will achieve tremendous success in this sector or experience challenges that will be difficult to overcome remains to be seen and may never be known. As Rupp shared: "Part of the problem is that you tend to only hear about the family success stories. You never hear about the bad deals."

*Anna Maria Nekoranec is the chief executive officer and co-founder of Align Private Capital, LLC, which provides tailored private-equity solutions to families. She is the co-author of* How to Buy a Business: Entrepreneurship through Acquisition. *She earned a BA from the University of Virginia and an MBA from The Wharton School, University of Pennsylvania. Contact her at anna@alignprivatecapital.com.*

## Endnote

1. David Bain, Family Capital "Single Family Offices Manage a Lot of Money Here's a Guestimate" (July 15, 2015), www.familycap.com.

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