

Family Values

Family offices are searching for higher returns. An increasing number are finding them by investing directly in private companies.

This is **part one** of a four-part series on the powerful new role that family offices are playing in private equity.

As family offices grow in size and power, they are searching for new opportunities that can earn ever-higher returns. One of the most promising of these opportunities is direct investment in private companies.

In other words, they're cutting out the middle man. Wealthy families that once stood on the sideline and let asset managers handle their investments are now acting more like private equity firms. They're investing directly, or co-investing, in deals rather than investing in private equity firms as limited partners.

There are several reasons for this. The primary reason is that family offices are increasingly looking for ways to avoid the fees associated with private fund managers, such as the 2 percent management fee and the 20 percent carry, where the managers takes a full fifth of the profit from investments.

Another reason is transparency. Families are getting away from black box investing where they give their money to an investment management company as a traditional limited partner and let the firm conduct all deal-making activity. After the Great Recession of 2008, family offices started paying close attention to what's going on inside that black box. They don't want to cross their fingers and hope that the investment firm makes the right moves. They want a larger say in decisions.

A third motivation is general misalignment with the objectives of the traditional investment management firm. This misalignment can occur in different places. One is in the investment timeframe. Private equity and venture capital firms, for example, typically prefer a shorter time frame from sourcing a deal from execution to exit. This schedule is often not aligned with the longer-term wealth building objective of family offices which tend to see investment as a way to build wealth over the years via a dividend or income strategy.

For all these reasons, more family offices are now going their own way. Last year, the Family Office Exchange surveyed 80 family offices and found that 70% were engaged in direct investing. And, interestingly, they were outperforming buyout firms by a sizable margin. The family offices surveyed reported that their direct deals returned an average of 15% in 2015—more than double the returns of private equity firms that year.

So, should every family office climb into the driver's seat and start investing directly? Not without some serious preparation.

"Before they do their first direct deal, they need to take a step back and create a coherent strategy," advises Francois de Visscher, founder of de Visscher and Co. LLC, an independent financial advisor to single-family offices. "What kind of returns are they looking for? Which megatrends do they want to be exposed to? Are they trying to develop a legacy business for the next generation? Are they looking for a job creation vehicle for younger family members? This all needs to be codified in a formal investment policy statement."

Designing an effective direct investment program needs to be job one for a family office. And one of the first steps should be to implement a policy statement that's agreed upon by all family participants. It should also specifically state what the family wants to achieve from its new program such as increasing its wealth for the next generation or diversifying into new lines of businesses.

Once the policy statement is designed, the planning process can begin in earnest. This next phase includes determining the types of investment the family office wants to pursue, the size of those deals, the industries the family wants to operate in, and the desired holding period.

For instance, the family might decide it only wants to support socially responsible companies or invest in a specific industry in which it has unique expertise and insight—typically the industry in which the family amassed its wealth in the first place.

"You don't want to be in a position where you are sitting around waiting for deals to come over the transom," says de Visscher, who is also a director and shareholder of his own family's \$5 billion global enterprise, N.V. Bekaert S.A. "It's much better to have a very clear strategy in terms of the kinds of deals and opportunities you are looking for. This way, you can be more proactive in finding those deals."

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Another critical element in a successful direct investment program is the internal staffing that the family office must put in place to execute on its deals. Many family offices are not sufficiently well-equipped to do direct investments and they underestimate the work that a private equity manager must do to create value. They don't appreciate all that's involved in monitoring an investment and significantly improving a company.

Success in the field of family office direct investment requires more than a policy statement. It also requires trusted advisers who can help execute on the program, support transactions, mitigate risk, and build ongoing value through the direct investment process.

"I believe family offices need at least one experienced PE professional who can lead their direct investment program internally," de Visscher says. "This person can also help build out and manage an external team of advisers who can help with sourcing deals and performing the due diligence function."

He further advises family offices that are new to direct investing to dip a toe in the water before diving in—a partnership, perhaps.

"It makes sense to partner with another family office that has some experience doing direct deals. That way, you can ride the coattails of a family office that already has an active direct investing strategy and learn the ropes a bit."

This is why family offices are increasingly joining together and doing "club deals." A club deal provides access to an investment through a lead family office that may look like, and market itself like, a traditional private equity fund. The lead family office shares investment opportunities with a small number of other families to raise the capital needed for the investment. This also provides a test for family offices—a time during which they can decide if it's feasible for them to work with other co-investors and perhaps even to gain some experience sitting on a board post-close.

Family offices are an increasingly important source of capital for private companies in the market for investment. "From a seller's perspective, family offices represent an avenue they may not have thought of before," says Jeremy Swan, Managing Principal—Financial Sponsors & Financial Services Industry Practice at CohnReznick. "For some businesses, there are real advantages to working with a family office compared to another financial sponsor."

But, as more family offices take on the challenges and responsibilities that they once entrusted to private equity firms, they need to adopt many of the strategies embraced by private equity firms. They need to conduct the proper due diligence, strive for operational efficiencies, and better manage risk.

"That is why they also need trusted advisers who can help them execute on their strategy, support transactions, and build ongoing value through the direct investment process," says Swan. "That is how they can ensure success and maximize the value of their investments."

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