

FAMILY OFFICES DIRECT THEIR OWN PRIVATE EQUITY INVESTMENTS

EDITED BY THE DEAL

Family offices represent a monumentally large, extremely savvy and extraordinarily potent investment force. Those specialized wealth management firms, which manage the money of individual families, are investing capital in more active, direct and creative ways. Private equity has become one very important arena.

A growing number of family offices are making side-by-side investments with private equity firms. Some have moved on and take minority stakes without any PE firm middleman. A few are actually making control investments, either by themselves or in clubs, sometimes with a single outside manager to oversee the portfolio company on behalf of multiple family offices.

They are investing in a range of industries and sectors, although the sellers tend to be family-owned companies whose heads have reached retirement age.

For family offices, “all these trends are coalescing: Direct investments and not just being passive, willingness to invest in early stage and across different industries, more control rather than less control, more in-house management and less outsourcing,” said **Irwin Latner**, a New York-based partner with **Pepper Hamilton LLP**, with longtime family office experience.

As family offices make the switch to active investing, they are taking charge of more of their investment decision-making, either in-house or through reliance on a multifamily office operation. For private equity investments, family offices are increasingly employing seasoned PE professionals to lead the charge.

Family offices “are hiring talent internally for multiple asset classes, and there’s a continued evolution by families to manage their own assets,” said **Ward McNally**, co-founder and managing partner of **McNally Capital**, a Chicago-based merchant bank that advises wealthy families on their private equity investments. “There’s a significant shift in allocation towards in-house as opposed to out-of-house,” he said.

That multifaceted move away from passive investing should

continue to develop. “It’s a trend that’s accelerating, but it’s by no means mature. It’s being facilitated by the increasing number of online platforms and family office networking events that enhance a family investor’s access to deal flow and investment talent,” Latner said.

“I can say with assurance that investing in operating companies is not the flavor of the month, but a systemic change, really reverting back to what [wealthy families] used to do, which is investing in and operating companies,” McNally added. “These are really operating guys, not financial market investors. They want to own companies and build companies again.”

A few family-office acquisitions constitute a 100% buyout where management is replaced. Many more leave some management in place, with the sellers continuing to hold an equity stake in the business.

Those selling stakes in family-owned businesses welcome family offices as investors. “They want long-term, patient capital and partners that are going to be there as they grow,” Latner explained. “There’s mutual receptivity to family businesses attracting and looking for family owned capital as opposed to private equity firms looking for short term profits and liquidity events. Also family offices often have more flexibility in structuring their investments.”

There’s another big advantage. With a direct investment, a family office can make its own determination of the company in question, without an outside filter. Family offices whose principals have background in, say, manufacturing, already understand the business. “They have their thumb on the pulse of the industry,” said **Stephanie Pindyck-Costantino**, a Princeton-based member of **Pepper Hamilton’s** corporate and securities practice group with extensive experience representing family offices in their structuring, operations and investment activities. With a direct investment, “they’ve removed some of the chatter that occurs when a middleman handles their deals.”

That doesn’t mean family offices will cease to be limited partners and shut down investments with outside private

equity firms completely. “There’s still a lot of limited partner passive investments going on. That’s certainly not dead,” Latner said. “The families are looking at that more strategically, and they’re accessing niche areas where they don’t have the expertise or access to deal flow. By maintaining relationships with traditional PE firms, families can increase their knowledge of underlying industries and often gain access to co-investment opportunities alongside those firms which can be a bridge to the family’s eventual entry into more active direct investing.”

Family offices remain a critically important source of funds for PE firms. According to a Preqin study released earlier this year, family offices allocated, on average, 26% of their wealth to private equity funds as of January 2015. That figure skyrocketed from 6% in 2010 and represents the single-largest allocation of any investment class among family offices, Preqin reported.

The large percentage stems from a flexibility that family offices have, compared to institutional investors like pension funds or insurance companies, to allocate among asset classes as they see fit. However, even those passive investments in private equity are more directed than in past years.

“Family offices have become highly selective; they find those private equity teams that they think are worth investing in,” Pindyck-Costantino said, “and they demand more from those teams.”

Those demands could include advisory board representation, more information on a particular investment and education, Pindyck-Costantino detailed.

According to one adviser, family offices may continue to support their current private equity sponsors but aren’t aggressively pursuing new funds in which to invest. Family offices are also looking to outside fund managers to gain exposure in new geographies and sectors. “The strategies are more targeted and more thoughtful,” the adviser said.

The family office universe is vast and growing. Due to the premium on privacy, the number of family offices and how much wealth they represent are, at best, rough guesses. In the U.S., there’s a fair chance a family with at least \$100 million in investable assets has a family office and a better than even chance of one with more than \$250 million.

A Cap Gemini study two years ago put the number at about 4,100, of which 3,000 were located in the U.S. Last year, a blogger for Family Office Exchange estimated that, based on the number of ultra-wealthy individuals, the U.S. alone

probably had upward of 6,000 family offices. The Family Office Club earlier this year put the number of family offices globally at “at least 7,000.”

Those offices manage, conservatively, \$2.4 trillion, according to an estimate Family Capital published in July.

There’s no hard-and-fast rule about what size a family office needs to be to make direct private equity investments though the larger size offices are more likely to have the in-house capability to diligence and manage the deals. Nor is there a typical investment size, although Latner said that family offices tend to have, because of their ability to hold investments for the long term and their ability to use creative investment terms and structures, more competitive advantages when pursuing direct PE investments in lower middle-market companies, i.e. companies generating EBITDA of \$2 million to \$9 million.

The 2008-09 financial crisis marked the turning point in the family office approach to investing. Like most other investors, family offices lost significant amounts of money in the stock market, as well as investments in fund management firms. They began to question not only investment strategies but also fees paid to outside firms and what they were getting for those fees. They demanded more transparency and more control. That led to a greater emphasis on direct investments in private companies.

“With direct investments, the family office has greater ability to look into where the money is going, how it’s being put to work, and have a quicker access to information,” Pindyck-Costantino said. “With the direct investment there’s very little potentially between the family office and the investment itself.”

Family offices offer patient capital. “Multigenerational families are almost universally seeking to preserve wealth across generations. They’re usually organized according to a common vision and values,” Latner said. “Most of them are very conservative investors, and they’re looking to protect and preserve their capital for future generations. That said, after the market crisis, they became very much more attuned to non-correlated types of investments.”

“They don’t need a 25% [internal rate of return],” McNally added. “They’re willing to accept less for higher predictability, stability, capital structure.”

“Many times there are just a lot of common bonds and synergy between the spirit of the family office and a seller,” Pindyck-Costantino concluded.

AS FEATURED ON

The Deal
TheDeal.com

TheDeal.com (ISSN 1547-7564) is published by The Deal.
© Copyright 2015 The Deal. The Copyright Act of 1976 prohibits the reproduction by any means of any portion of this publication except with the permission of the publisher.