Starting a family office direct investment function

Best practices for building a family office direct investment function and why scale matters

We're seeing a rising number of family offices allocating resources to direct investing. We discussed this trend in our white paper, "**The new family office 5.0 model**," noting that the execution of this strategy varied among family offices, from building internal resources like a fund sponsor to, on the other end of the spectrum, complete outsourcing. More commonly, we're seeing family offices combine the fund sponsor type of approach and outsourcing to create a boutique-hybrid approach unique to each family's needs.

It's often a successful entrepreneur family that pursues a direct investment strategy. This family likely accumulated its wealth through the family business, which may or may not have been sold. This family appreciates the control and value-added feel of direct investing. The family may also believe it can achieve superior returns in the private market and better diversify its public security holdings.

Building a family office direct investment function usually starts with the pooling of significant assets across multiple generations, creating scale to execute a long-term diversified portfolio in real estate, venture, buyout, or other private assets classes. Families that can't achieve scale will continue to invest in private assets utilizing the expertise of fund sponsors and the fund of funds approach.

Committing the time to establish a direct investing strategy

It can take several years for a family office to build and execute a direct investment function. Some families decide on a particular investment thesis but may not be able to find suitable targets at a price they believe is fair. After testing the waters, many families change their investment strategy, hire new talent, decide they need more help from outside professionals, or all of the above (boutique-hybrid approach).

One key factor that determines how quickly a family office builds its direct investment function is the family's experience with direct investments. Understanding a particular industry and having contacts in that industry can be a competitive advantage. However, running a successful business is different from building a diversified portfolio of multiple operating companies or real estate.

A family can jump-start building its direct investment function if one or more family members or existing family office staff have significant experience in investment banking, private real estate, private equity, or other mergers- and acquisitions-related experience. If the family doesn't have this expertise, the building process will take longer.

Several issues are key for family offices to consider as they incorporate best practices into building or improving the direct investment function for a portfolio of private companies. These issues include deal flow generation, due diligence for potential direct investing targets, control over the holding period and exit strategy, structure and management, and building your team, among others.

Generating deal flow for family office direct investing

Successful investors may look at more than 1,000 companies in a single year. Filtering those down to a select few that best meet their criteria and offer the greatest opportunities for growth can be a significant challenge. To create this level of deal flow, some investors dedicate a business development team to this function. The business development team focuses on communicating the key investment criteria (industry focus, size, location, etc.) to investment bankers, potential sellers, and others within the deal community. The team needs to create enough awareness so when the right company comes to market, these sources will send the opportunity to the family office to evaluate it. Awareness is created by developing relationships with investment bankers in multiple geographies, especially those that focus on the industries identified. The team cultivates relationships through in-person meetings and attending deal- or industry-focused conferences and similar activities.

Many investors also strive to develop relationships directly with companies before they decide to sell, with the hope of creating proprietary deal flow and avoiding competitive bidding processes. Many family offices may have an advantage in this respect, creating proprietary deal flow due to the family's history in a particular industry, leveraging its reputation and preexisting relationships.

Family office due diligence to assess direct investing targets

Once deal flow is generated, the family office will need resources to evaluate the opportunities on an ongoing basis. This can be done by various members of the family office, including the business development team, deal execution team, and the portfolio management team. When compared to a fund, this vetting process will usually be done by fewer people, with each likely playing multiple roles. Companies that fall far outside the investment strategy can be discarded quickly.

Potential acquisitions that look promising will require the next level of analysis. If the decision by the family office leadership is made to proceed, the deal execution team will prepare a valuation and letter of intent and begin to line up resources to conduct due diligence, which may include legal, quality of earnings, human resources, information technology, and commercial, industry, and customer diligence.

As part of the valuation, the family office will need to determine how it wants to structure the transaction (stock, asset, etc.) and prepare a detailed valuation model.

Most investors outsource the various due diligence functions due to independence and financing requirements. In addition, outsourcing can alleviate internal resource limitations. Legal teams can help with the letter of intent, structuring the transaction, drafting the purchase agreement, and conducting legal due diligence on the company.

Quality of earnings

The quality of earnings team will focus on analyzing the accuracy of the financial information, adjusted EBITDA and working capital, and the sustainability of the results. The team generally analyzes the last two to three years of information, including the current year to date and trailing 12 months, to understand the historical trends of the business and provide the family office with information to support or adjust the valuation. This report can also be shared with lenders to aid in financing efforts.

Tax due diligence

Tax due diligence is generally coupled with the quality of earnings and is focused on understanding the historical tax filings of the business and identifying areas of concern or potential liability.

IT due diligence

Additional diligence efforts may be undertaken depending on the individual characteristics of the target company. For example, IT due diligence may be needed to understand and evaluate the company's IT infrastructure, including key software and hardware, budget, and team. The scope of IT due diligence efforts can be tailored depending on whether the target company will be a platform acquisition or an add-on to an existing platform to ascertain how the IT systems will integrate.

Commercial due diligence

In addition, the family office can conduct commercial due diligence to understand the company's overall strategy, its position within its industry, and to gain a detailed customer and product analysis, beyond what is included in quality of earnings analysis. Commercial due diligence may also include customer interviews to evaluate the current status and overall strength of these relationships.

Controlling the exit strategy

Another benefit that attracts family offices to a direct investment strategy is the ability to control the time horizon and overall exit strategy to align with their specific investment, tax, and estate planning needs. Private equity typically operates with a five- to seven-year hold before moving to an exit strategy such as an IPO or secondary sale. However, with more control over the investment, the family may opt to hold for a longer period of time, sometimes even decades. Family offices can utilize a more patient investment strategy, which can make them a more appealing partner to a family business seeking a long-term investment partner. While this may be an advantage for the family office investor, it may be viewed as a disadvantage for other stakeholders — such as key employees with incentive compensation (carried interest) tied to the sale — who have a shorter time horizon. In either situation, family offices making direct investments will need to understand the time horizon for the family, the portfolio company, and the stakeholders to best align the interests of all parties.

Building the direct investment team

With this increase in flexibility comes an increase in complexity. Family offices require more in-house expertise to analyze holding periods, exit strategies, and the impact these decisions have on the rate of return, liquidity needs, and the family's overall investment strategies.

As mentioned above, many families moving to direct investment need to hire qualified professionals to help source the deal flow, manage the investments, and report to the family on the various investment results. Professionals with this skill set may come from investment companies or private equity funds. They may be highly compensated and require a "piece of the action" and ownership interest in the family investments consistent with what they might otherwise receive under a private equity structure. As a result, many family offices structure the direct investment function in the family office using models similar to those found in private equity, including a management fee and profits interest model. This offers the ability to attract top-notch talent to the family office but can create complexity around compensation, fund ownership, and aligning staff and family interests.

Structuring and managing direct investments

Family offices building a direct investment function will need to identify the best structure in which to own and manage the investments. Many families create partnerships that emulate a private investment structure. These partnerships are owned by various family vehicles — trusts, family limited partnerships, individual family member ownership, and others. Some families create multiple funds, each with its own investment strategy. These families might have a direct real estate fund, an early-stage venture fund, or a technology fund, for example. Having multiple funds allows flexibility within the family office to structure deals, manage investments through a centralized structure, and offer incentives to family office employees who oversee the investments. In addition, the multifund approach allows individual family members to select specific investment allocations to meet their individual needs. For example, if Generation 1 desires a smaller allocation to the technology fund compared to the real estate fund, it can accomplish this using multiple entities. This strategy is more common among established family offices with multiple generations and that have a robust direct investment strategy in place.

However, maintaining and operating these entities and funds requires accounting, tax, and legal expertise. Family offices need to evaluate the internal infrastructure and internal controls necessary to operate these structures and determine whether the functions are best suited to be performed inside the family office or outsourced to other service providers. As we discussed in our article, "**Family office best practices for selecting enterprise software**," family offices should consider a multitude of factors when analyzing accounting tools and software options. The right solution must encompass the family's existing needs and be robust enough to meet the future needs of a growing family office.

Family offices and direct investment: Additional considerations

In the current environment, families are thinking about potential tax rate changes, SPAC vehicles, rising multiples in certain industry sectors, inflation, and geopolitical risks. For example, a rise in capital gains rates and the retention of the step-up basis at death may make direct investments more attractive to certain family offices. Family offices that control the timing and exit strategy may enjoy more flexibility to take advantage of preferential tax treatment such as qualified small business stock, opportunity zones, or other tax incentives. Family offices that have control over their direct investment function may be able to time the exit of their investments to align with other tax and family strategies.

Final thoughts

We see more and more family offices building a direct investment function, while mature family offices are either scaling up to compete with traditional funds or scaling down to a more boutique-hybrid approach. This increase of activity is the result, among other factors, of new technology, the use of best practices, and the ability to outsource many direct investment functions.

As part of the evolution of the overall investment function and changing asset allocation models, many families are increasing their allocations to direct investments. Many families will continue to use traditional fund sponsors or fund of funds to fill this private asset allocation. Others that have scale will choose to build an in-house direct investment function hoping to acheive superior returns with greater control, better diversification, increased flexibility across a multigenerational time horizon, and potential income and estate tax benefits.

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