Co-Investing in Direct Private Investments

Family Office Series – 2021 # 2

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Summary –

Increased DPI Allocations Among Family Office Investors

Since 2015, the number of, and wealth represented by, family offices have grown dramatically. So, too, have their levels of sophistication and professionalism matured. This includes adding or increasing direct private investment (DPI) allocations to the portfolios to meet their long-term goals.

Traditionally, family offices have relied on passive investments – blind pools, or funds, managed professionally by fund managers – as their primary strategy.

But that is shifting. In 2019, family offices were allocating roughly 16% of their investment portfolios to private equity – over half of which was through direct private investments (DPI). Moreover, a Barrons article, drawing upon a study by Fintrx, found that two-thirds of single family offices (SFOs) established since 2015 are investing directly in private opportunities. That sharply contrasts to those founded between 2006 and 2010 – 52.4% – and only 25% among the pre-1985 vintage. The same study noted that 83% of SFOs worldwide consider making direct allocations to private entities.

As this investor category matured, so has its style of investing: 42% now invest alongside other family offices, venture capital, private equity and real estate investors. Each of **co-investment** and "club" investment has become more popular.

But don't confuse the two. Club deals typically involve "members" who contribute, or pool, capital to the investment and agree ahead of time on terms of the structure. Co-investing, on the other hand, usually has a lead, or principal, investor who attracts others because of their perceived expertise in the transaction.

This paper examines:

1. Increasing DPI allocations within family office portfolios;
2. 6 reasons for investing in DPI;
3. Factors driving co-investment in DPI;
4. Challenges to DPI; and
5. 4 family office approaches to DPI co-investment.

2 6 Reasons for Investing in DPI

While venture capital and private equity funds have consistently delivered alpha to families for many years, family offices have recognized that this approach to private investing also has had its limitations.

Cost is a weighty factor. Compensation for fund Managers – annual management fees with trailing profit participations – reduce the net return for investors, while, admittedly, contributing to a misaligned of interests. This, as well as performance issues and tax inefficiencies, is a contributing factor to the decreasing allocation to hedge funds. They now represent only six percent of family office investments, down from nine percent only two years ago.

Funds are blind pools. Each Manager has unilateral investment discretion, albeit within certain stated objectives. Consequently, a family, having derived its wealth from one industry, or one that has sector expertise, is precluded from choosing which companies to support within a fund structure.

While private investors continue to utilize funds, a Forbes Magazine article notes that family offices are focusing on direct investments for the following reasons:

1. **Greater control and decision-making authority:** Current or former entrepreneurial families increasingly want to choose whom they support – and they want a more active role in those investments. This is particularly pronounced in the generations now inheriting the reins from their predecessors;
2. **Better alignment:** A fund's investment time frame typically is 7-10 years. Conversely, family office capital generally has a much longer time horizon. Most of a Manager's compensation is tied to "realizations" (the sale of an investment), which can lead to misalignment between the Manager and the fund's investors. In direct investing, on the other hand, families can align investment strategies with their values and interests over decades and across generations;
3. **Avoiding fees:** As noted above, direct private investments often carry no management fees;

4. **Growing investor networks:** By drawing on their networks, family offices are combining resources and interests with other like-minded family offices;

5. **Impact Investing:** This is particularly prevalent in venture-stage equity investing where families can support impact investments – environmental, social and governance issues (ESG);

5. **Portfolio diversification and higher returns:** In Carofin's estimation, direct private investing (DPI) also allows an SFO to diversify its risk exposure, as well as capitalize on the inherent illiquidity premium and market efficiencies.

3 Factors Driving Co-Investment in DPI

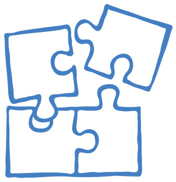
> "...the past three years have seen a concerted drive by family offices towards high risk, more illiquid investments in the pursuit of yield."
>
> -- Sara Ferrari, UBS Global Family Office Group

Over the last decade, as the strategy of using DPI has accelerated, family offices have adapted. According to First Republic's 2021 family office study, *nine out of 10 family offices are active co-investors,* with the most active making 20 investments per year.

Becoming more comfortable with direct private investing, family offices are recognizing the challenges associated with going it alone. Nevertheless, the same study also notes that only one of every four family offices employs a dedicated co-investment professional.

Despite increasing sophistication within SFO organizations, many haven't the time, the expertise, the human capital, the infrastructure or reporting mechanisms in place to do an effective job alone in direct investing.

Consequently, co-investing, particularly with other SFOs or multi-family offices (MFOs), has become more common.



Carofin actively supports this trend by sharing DPI opportunities among its family office relationships because it makes so much sense.

Motivating factors behind co-investment include:

1. **More frequent, higher value opportunities:** The leading investor may already be a long-time stakeholder in the company needing financing. Alternatively, it may have specialized expertise in the sector or an adjacent industry that presents an opportunity to the co-investor. Uniting with lead financiers in institutional-quality private investments affords incentive..

2. **Commonality:** Many appreciate combining forces with like-minded family offices with whom they share similar interests, backgrounds, and principles.

3. **Better due diligence:** Many SFOs lack in-house capabilities to conduct thorough due diligence, both on investment analysis as well as issuer evaluation and background searches.

4. **Pooling resources:** Smaller SFOs can "hitch a ride" with the lead family office, relying on its more advanced capabilities. They also are less apt to have experience structuring securities, drafting documentation, negotiating safeguards, and tracking on-going developments and issuer reporting.

5. **Governance discipline:** The sponsoring family office likely has fashioned a process shaped from years of hard lessons that will accrue to the co-investor's benefit. In a 2020 study by Campdenfb.com, particularly in relation to early stage venture investing, SFOs:

    - Provide strategic guidance – 72%
    - Facilitate investment networking – 70%
    - Participate on boards – 70%

By partnering with a highly involved family office, co-investors can reap the benefits.

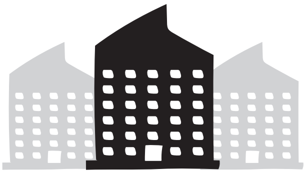
4 Challenges to Direct Private Investing

As with all investments, challenges exist. Understanding the stages of each direct private investment is vital groundwork towards a successful DPI experience.

STAGES OF DIRECT PRIVATE INVESTING

ORIGINATION

- ***Sourcing investments –*** Family offices may find it challenging to create sufficient **and suitable** "deal flow" that is aligned with their specific goals. As with any purchase, the more deals seen, the better the likely outcome across the DPI portfolio allocation. Making 4-6 new investments each year means that a family office will consider hundreds of companies. The more completely vetted before reaching a family office, the simpler the task.



- ***Evaluating the offering –*** As noted above, few SFOs have dedicated in-house investment professionals with expertise in DPI. Time and expense are limiting factors. Three-quarters of family offices are likely to staff up to manage direct private invesments over the next three to five years. Drawing on a third-party expert with DPI experience and industry expertise can help offset some of those limitations.

- ***Determining the appropriate form of investment –*** Experience structuring private investments is critical. Each offering is structured with provisions, often subtle, particular to the underlying business being funded. Nuances within the Summary of Terms negotiated for each will directly affect the unique rights of the investor and the eventual return outcome.

SYNDICATION

- ***Portfolio allocation –*** Setting proper limits for how much capital the investor should allocate to a given investment can be challenging.

- ***Other co-investors –*** SFOs sometimes don't consider that issuers regularly require additional infusions of cash, often unexpectedly … (witness the effects COVID-19 had on thousands of companies in 2020). In general, having more deep-pocketed investors in an offering is better … subject to having too many cooks in the kitchen.

- ***Closure –*** As noted above, smaller family offices are likely to have the desired expertise to fully understand the details within closing documentation. These specify the contractual obligations integral to the security structure, as agreed to by all parties.

INVESTMENT SUPPORT

- ***Monitoring –*** Once an investment has been made, it is vital to establish the means to stay current with the issuer. Investors must be prepared to move quickly when necessary to protect their stakes.

- ***Distributions*** – Creating an efficient mechanism for managing distributions of interest and principal (for debt investments) or dividends and principal (for equity investments) is also necessary. To monitor the investment, family offices must know what distributions are due and how they are to be made.

  Building or buying proficient reporting programs that offer a comprehensive dashboard of investment returns is essential for the serious investor in DPI.

- ***Legal support –*** DPI are, by their nature, high-risk investments. Legal and other professional resources should be in place before making any investment. These may be needed to conduct forbearance (resetting the terms of the investment to accommodate the Issuer), restructuring (a more extensive recapitalization of the underlying business), or, in a worst case, foreclosure (a court process that can involve liquidating the business).

For more information on this topic, please refer to "Considerations for Family Offices in Direct Private Investing."

5 Four Family Office Approaches to DPI Co-investment

Family offices are actively participating in DPI co-investment, and their approach to the private markets seems to be evolving into four models:

1. Go It Alone
2. Growing an In-House Team
3. The Crossover
4. The Carofin Model

1 GO IT ALONE

SFOs, new to direct private investing, may rely on existing staff to manage various aspects of the family's needs. However, few SFOs, and even some multi-family offices (MFOs), retain dedicated investment professionals.

In Carofin's experience, these families, by their own admission, may have not yet wholly defined their strategy. Consequently, they many not have secured the resources necessary to apportion meaningful capital to this investment approach. More than likely, they are attracted opportunistically to financing opportunities and learn "on the job" the requirements to manage them, which can be painful.

Before long, they are taxing their existing human capital who lack training, infrastructural support, and are trapped in a maze of spreadsheets to manually establish returns.

Carofin recommends our Knowledge Base for those Family Offices seeking to abet their understanding of direct private investing.

② GROWING AN IN-HOUSE TEAM

As noted above, effectively managing the three stages of direct private investing requires a facility with corporate finance, deal structuring acumen, and due diligence capabilities on the front end. This is coupled post investment with the ability to monitor investments, quickly draw on legal resources to conduct forbearance, foreclosure, or restructuring, and produce synthesized reporting results.

Building a team of professionals takes time, talent, management, and resources, adding significantly to the operation's balance sheet.

③ THE CROSSOVER

This model seeks to avoid staffing up and "rents" outside capabilities from a third party. If fund-focused, some invest alongside PE funds in a "side pocket." Others commit capital to direct investments and share overhead with a third-party Manager. Because the Manager's compensation is back-end, the family office limits overhead costs.

④ THE CAROFIN MODEL

Carofin is as unique as your family office. We invite you to take this opportunity to examine our family office program.

Speak with our team

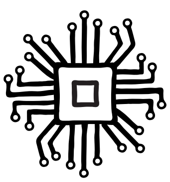
Carofin offers family offices support across the three stages of direct private investment:

Origination –

- Co-investment in institutional-quality private opportunities with other lead family offices
- Experienced investment bankers who conduct robust due diligence, evaluate the investment's merits, structure the security, and prepare documentation

Syndication *(bringing other investors into the offering)* –

- Dedicated sales team working in a highly coordinated and finely targeted, results-oriented investor marketing program
- Existing relationships with many other family offices and institutional investors
- Creation of summary offering materials, PPMs and closing documents
- A proprietary CRM, created by Carofin, to efficiently target appropriate investors for each offering



Investment Support –

- Monitoring – When acting as Administrative Agent to protect investors' interests post-investment, Carofin manages the flow of information between issuers and investors, providing online access to all communications.
- Distribution management – When Administrative Agent, Carofin manages distributions from Issuers to investors with payments, related investment returns, all available to investors online displayed on a consolidated dashboard.

Conclusion

Family offices are participating more and more in direct private investments (DPI), a strategy that helps fill some gaps in a family's investment platform. Co-investing with other family offices offers a way for a family office to efficiently build this part of their portfolio by leveraging the expertise and prior deal experience of other family office investors

Anticipating the 3 stages within the life cycle of a private investment – and lining up the right resources ahead of investing – is important if allocating to DPI. Carofin and its affiliates specialize in the origination, syndication and support of DPI for family offices.

Carofin invites you to learn more about our direct private investment platform...

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Carofin – Unique DPI Co-investments

Equity & debt co-investment opportunities

- Co-investment alongside industry-focused family offices and sector-specific funds
- Loan investments providing working capital to established businesses
- Equity supporting acquisitions, business expansions, etc.
- Later-stage venture capital investment in next-generation technologies and services
- Industries represented: business services, consumer products, telecommunications, software & internet applications, aircraft repair, healthcare technologies, agriculture, etc.

Rigorous due diligence process available for online investor review

- Management background checks, lien & judgement searches
- Financial analysis & modeling
- Marketing, sales & customer reviews, and much more

Post-investment investor support, including:

- Issuer performance monitoring, including distribution processing;
- Investor updates, posted online; and
- Investor protection and, as necessary, legal representation.

Carofin Follow-up

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Financial terms used herein are more fully defined in the Carofin's Glossary of Investment Terms.

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