Choosing the Right Private Equity Investments for Your Family Office

By Thomas Payne, Managing Director, Harris myCFO Inc. and
John R. Smart, Managing Director, BMO Capital Markets Corp.

Private Equity has grown in popularity among both institutional investors and wealthy families.

Investors are attracted to the potential for higher returns in exchange for accepting a greater degree of risk. This article examines several established approaches for Private Equity investing, and one less obvious opportunity that may be new to most family offices.

INVESTING IN GROWING COMPANIES

A Private Equity investment is longer-term equity ownership in a privately-held or public company. In return for taking on this risk of ownership, there is the potential for substantial returns. Private Equity investments can be made directly to an individual company or into a fund category as outlined below:

- **Venture Capital:** A venture capital investment is usually one that creates a new enterprise or supports the growth of an existing company in the process of building its revenue stream and profitability. Venture capital investors seeking the next Microsoft or Genentech invest both their money and expertise into emerging companies. Funding companies that have nothing more than a few bright entrepreneurs, or a new product concept or technology and a business plan, is a high risk strategy. Because of the risks involved, venture capital investors expect substantial returns from their stake. The aim is to create value through disciplined deal structuring, continuous market and performance evaluation, and syndication of funding sources relative to a company's size and potential.

- **Leveraged Buy-Outs:** This strategy involves the acquisition of majority control or a minority position in a more mature company, using balance sheet leverage. This could involve a divisional or subsidiary management group in a public company buying the business and taking it private with a Private Equity fund sponsor. Alternatively, it could be the leveraged purchase by a Private Equity fund of a non-public company from the original owner or a Private Equity fund owner.

- **Special Situations:** Special situations include Private Equity investments in a distressed company, a mezzanine investment where the return is a combination of a cash coupon and warrants or a co-equity investment, or a company where value can be achieved as a result of a one-time opportunity such as changing industry trends, government regulations, etc.

Private Equity funds raise capital from limited partners (institutional investors, wealthy families and high net worth individuals) and invest in a portfolio of companies with the intent of owning and operating them for anywhere from three to as long as ten years before executing a liquidity event. The return objectives are accomplished by improving a company's management team, corporate governance, strategic market position, IT systems and infrastructure, access to acquisitions, and capital structure. The goal is to accelerate the growth and profitability of these companies and achieve targeted internal rates of return and return on investment capital on the portfolio.

The top performing funds in Private Equity today bring much more than capital and financial engineering expertise to their portfolio companies. These funds have deal partners with extensive industry sector experience, such as healthcare, information technology, business services or transportation. These funds also staff operating partners with functional expertise in systems, marketing, sales management and manufacturing operations. In addition, funds often have advisory boards comprised of former industry executives that originate opportunities and advise portfolio companies.

"The top performing funds in Private Equity today bring much more than capital and financial engineering expertise to their portfolio companies."

Private Equity investors typically realize a return on their investment in one of several ways:

1) A sale to a strategic buyer, or to another Private Equity fund;
2) An Initial Public Offering (IPO) where a portion of the company's equity is offered for sale to public investors;
3) A Dividend Recapitalization — recapitalizing the business through debt leverage to realize an interim return.

THE CHALLENGES OF INVESTING IN PRIVATE EQUITY

High risk, limited liquidity, taxes, and lack of regulation all make investing in Private Equity especially challenging.

First, there can be substantial dollar commitments and other entry barriers. For some accomplished and long-time Private Equity funds, the required equity commitment can reach upwards of $20 million. The better performing funds typically have limited partners that reinvest in subsequent funds and seek higher allocations, crowding out new investors.

Since many Private Equity investments are in the form of limited partnerships, the liquidity of the investment can be a risk factor. Once invested, the partnership interest is locked up until distributions take place. This happens only when fund holdings are sold or otherwise monetized. As a limited partner, an investor has little influence as to when these liquidity events take place. While some distributions may occur in as little as one to three years, investors should be prepared to have their capital locked up for as long as ten years.

In addition, there is 100 percent risk of loss if the direct private company or fund fails. This potential for loss is higher in venture capital, where one is betting on younger companies at the earliest stage of their development. Investing in more mature companies with proven business models that have already developed a revenue stream can mitigate loss experience, particularly as part of a broader portfolio.

For these and other reasons, Private Equity investing is best suited for those with "risk capital" who can: a) continue their investment activities with Private Equity capital locked up for long periods of time; and b) can afford to lose the amounts allocated to this portion of their portfolio. The higher-than-average risk with this investment class is measured against the potential returns which can range upwards of 20-30 percent or more per year.

Another key driver of this period's growth was access to the debt capital markets. The combination of low capital costs and high liquidity drove higher valuations of companies and enhanced their ability to grow. In addition, Private Equity firms injected sophisticated management expertise and operational talent into these deals, generating additional value in the targeted companies.

Since mid-2007, however, the weakening U.S. economy has slowed the pace of deals. Larger deals, where a significant amount of capital must be raised in the debt markets, have been particularly affected. As liquidity began to tighten, which was led early-on by the sub-prime mortgage crisis, the Private Equity space became impacted as many investors and institutions also held substantial positions in mortgage-backed securities in their portfolios. Liquidity still exists today, but since there is restricted access to liquidity through the capital markets, the pace of investment has slowed. Interestingly, given the amount of Private Equity available for investment, the funds have been a source of capital in special situations, i.e. for financial institutions.

Moving forward, several other factors may influence Private Equity returns. We are seeing a number of firms "packaging" Private Equity opportunities for retail investors. In addition, market turbulence and tighter credit has reduced the number of companies able to readily access capital. As a result, we may see more investors competing for the same or fewer Private Equity opportunities. This can distort valuations and further reduce potential returns.

ENTRY POINTS INTO PRIVATE EQUITY

The primary ways to gain exposure to Private Equity investments include:

- Fund of funds
- Direct private placements

Whichever option you chose depends, among other things, on your level of experience with Private Equity and your risk tolerance.

FUND OF FUNDS

Oftentimes wealthy families and individuals get involved in Private Equity through a personal contact with a company founder or lead investor. They may eventually find themselves with a significant and growing investment in an asset class that is completely different from any of their other holdings. Advisors and/or investors that concentrate on traditional equity and bond portfolios are usually not well suited for the proper evaluation of Private Equity holdings. Due diligence and oversight of these type of investments can be especially challenging. It is almost essential that one have access to a specialist who knows the market, knows the industry, can dig beneath the surface to uncover facts about the company and management, and is able to evaluate and monitor the investment over time.

For this reason, many families soon discover they need someone who is constantly searching for these types of deals and vetting the choices presented to the family. And rather than doing high-risk deals directly with entrepreneurs, the family decision is usually to diversify their Private Equity holdings, just as they diversified their traditional assets.

One of the best ways to do all this is through a fund of funds. With a fund of funds, you are hiring the expertise of a single manager to oversee the managers of several different Private Equity funds.

A fund of funds can provide the family office with the very practical option of outsourcing Private Equity investments to an experienced team. For many family offices, this saves the time and expense of establishing an in-house resource. It enables the family office to put its investment to work faster, and achieves broader diversification by fund type, sector, geography and vintage year.

A fund of funds can also, in some cases, provide access to Private Equity investments that are closed to other investors. This could be because specific individual funds are by invitation only, or perhaps the individual fund requires an upfront investment of many millions of dollars. An increasing number of funds of funds, on the other hand, accept investments of less than $1 million.

The fund of funds approach has been another benchmark of the growth of Private Equity over the last several years. According to Dow Jones, between 1996 and 2005, the money in funds of funds grew ten-fold to $13.9 billion[2]. Fund of funds professionals provide the due diligence expertise, reporting and risk management skills to manage pools of investments on behalf of their clients.

A consideration with fund of funds, however, is that these services require higher fees. Historically, fund of funds may charge up to 2% in annual management fees in addition to an incentive fee of up to 20% of the realized profits[3]. This fee structure has come under downward pressure in recent years, due to the increasing sophistication of family office investors.

"With a fund of funds, you are hiring the expertise of a single manager to oversee the managers of several different Private Equity funds."

DIRECT PRIVATE PLACEMENT

As mentioned previously, many wealthy families begin their experience with Private Equity not necessarily because the family was looking to expand into alternative assets, but because a family member or friend knew an entrepreneur who was looking for funding. The family member often invests directly in the new venture through these connections on behalf of the family. If they are fortunate and the investment increases in value, the family suddenly may have a substantial Private Equity investment as part of its overall portfolio of securities.

Private Equity Forums — Another Access Point for Direct Placement

There are private forums that enable families to network with their peers and discuss direct Private Equity investments with like-minded investors.

The first type of forum consists of venture capital groups that gather together for an audience of professional investors — other venture capitalists, angel investors and institutional investors. Their target is early stage companies. The participants in these forums often package these investments and resell them to limited partners, taking a percentage for their fee.

The second type of private forum may be better suited for family office investors. Participants in these forums share opportunities with the intent of getting other family investors involved, without the sales pressure or influence of an outside third party. Harris myCFO's exclusive *Dealflow* forum is one example.

For family offices and entrepreneurs who are presenting investment opportunities, this second type of forum offers an outstanding way to reach a broader group of highly qualified Private Equity investors without the expense and challenge of finding prospects on their own. In many cases, these forums represent a company's first foray into the "club capital" market that may be more patient with their capital than other sources of funding.

Nevertheless, direct private placements are extremely risky unless you have the ability to perform thorough due diligence on that prospective investment and its industry. A direct placement can lead to a concentrated or a heavily weighted position in one industry. For this reason, most individual Private Equity investors often choose a more diversified approach.

CHOOSING THE RIGHT PATH FOR PRIVATE EQUITY INVESTMENTS

From the standpoint of diversification and lowest assumed risk, a fund of funds approach may present the best entry point into Private Equity. This is particularly true if you are unfamiliar with the Private Equity sphere or you do not have in-house specialists who can perform extensive due diligence on a Private Equity investment. As mentioned before, a fund of funds may also be a more affordable way to test the waters of Private Equity than other approaches.

While having the right manager is important across all asset classes, it is especially important to invest in the right manager with Private Equity fund of funds because the single manager you hire performs the due diligence and oversees your investments. You are betting on that manager's track record and expertise, so you need to be very confident of that firm's approach. Choosing the right manager can greatly enhance the return from a median to top quartile performance.

Direct Private Equity investment—either one-on-one with entrepreneurs or discovering an opportunity through a Private Equity or venture forum—represents the highest level of risk. You must have the capacity to perform in-depth due diligence on the company and its executive team. You need someone who can dig beneath the numbers to uncover what is really happening in the company and the industry. In addition, you will probably have to invest substantial amounts of money and can wait up to ten years for your investment to pay out.

The upside of a direct Private Equity investment, of course, is that you are getting in before other investors. If you invest in the right company, at the right time, your returns can out-perform anything normally experienced in the traditional securities market. The overall return for a well placed, direct private investment can be well in excess of 50%. However, the poorly researched and/or ill-timed choice will most likely lead to significant losses.

Because of the high risk attendant with direct investments on individual companies, families generally try to invest in several direct Private Equity opportunities at the same time, expecting that perhaps one out of ten will be a major winner.

Endowments, foundations and institutions may make a strategic decision to have a large percentage of their holdings in Private Equity. Yale University is a famous example of what a well researched, disciplined approach can achieve when it is invested in alternative assets. But because of the risks involved, investments in Private Equity should be assessed based on the suitability within an individual or family's portfolio to ensure it is consistent with their risk profile.

Manager evaluation and in-depth due diligence are critical to long term success with Private Equity investing. For families looking to explore Private Equity opportunities, these very important ingredients can mean the difference between superior returns and no returns at all.

Thomas Payne, Managing Director, Harris myCFO, Inc., specializes in providing customized investment management and advisory, family office services, fiduciary services and private banking solutions exclusively to individuals and families of substantial wealth. Tom is also the Chair of Harris myCFO's *Dealflow* Forum for Private Equity investors.

John R. Smart is a Managing Director in both the BMO Capital Markets Financial Sponsors and the Business Services Groups, a unit of BMO Capital Markets Corp. He is responsible for initiating and executing capital raising assignments for middle market private financial sponsors and their portfolio companies, and is actively engaged in providing advisory services and capital to middle market education and business services companies.

Harris myCFO is dedicated to managing the complex issues that face individuals and families of significant wealth by delivering the guidance and services of a comprehensive family office, along with the freedom to use your own trusted advisors and other best-in-class service providers.

Harris myCFO provides family office advisory services, investment advisory service, tax and estate planning, philanthropic advisory services and lifestyle concierge services to individuals and families with $25 million or more in investable assets. For more information, please visit **www.harrismycfo.com**.

[1] Cambridge Associates LLC U.S. Private Equity Index.® As of September 30, 2007. End-to-end calculation based on data compiled from 690 U.S. Private Equity funds, including fully liquidated partnerships, formed between 1986 and 2007. Pooled end-to-end return, net of fees, expenses, and carried interest.

[2] *Private Equity Becoming Less of An Exclusive Club (American Banker),* by Rob Garver. November 8, 2007.

[3] Source: Harris White Paper: *Exploring Alternative Investments: Going Beyond Stocks, Bonds and Mutual Funds*, by Jack Ablin.

Please contact us for more information or for additional white paper titles or copies.

We look forward to the privilege of serving you.

For more information, visit us at harrismyCFO.com or call 1-877-692-3611.

HARRIS myCFO™

37062 (N 05/08)