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ACCESSING PRIVATE CAPITAL - A GUIDE FOR FAMILY INVESTORS

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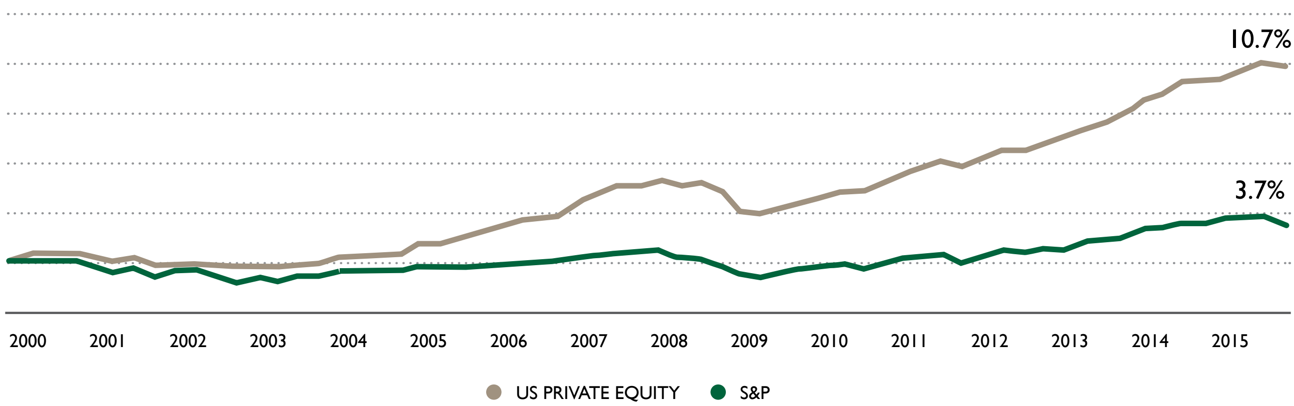
With the backdrop of continuing low interest rates and periodic bouts of extreme market volatility, private capital has attracted increasing attention and investor demand in recent years. The key attraction of the asset class has been its returns, with the industry consistently out-performing public markets by a meaningful margin as shown by Chart 1.

CHART 1: PRIVATE EQUITY RETURNS VS PUBLIC MARKETS 2000-2015[1]



Past performance is not a reliable indicator of future returns.

Within the asset class, there are of course a multitude of segments, some showing returns substantially above the average and some substantially below.

Another attraction has been the ability to invest in high quality private companies. This feature has had particular resonance for entrepreneurs and families whose own wealth typically originated in a successful private business.

1 Source: Cambridge Associates LLC U.S. Private Equity Index is compiled from 1,231 U.S. private equity funds (buyout, growth equity, private equity energy and mezzanine funds). Returns are net of fees, expenses, and carried interest. Bloomberg: S&P 500 Total Return Index. All data as at 30.09.2015. **Past performance is not a reliable indicator of future returns.**

The two principal options for investing in private capital are investing directly in companies or investing via funds:

INVESTING DIRECTLY IN COMPANIES

Whilst highly attractive in theory, investing directly in companies is frequently much more of a challenge than it might initially appear. The key consideration is the extent of a family's available resources, both financial and human.

Many families in business believe they can harness their business knowledge, skills and contacts to generate higher quality deal flow and opportunities than a typical private equity house, but most of them have found it challenging to convert this theoretical advantage into practical reality. They also come to realise that the portfolio management skills required for investing in businesses which they do not manage or control are not the same as the business skills required to run their own company.

Building a portfolio of direct investments requires not only a significant amount of capital, typically $50-100m as a minimum, but also requires one or more family members or a third-party professional, plus a supporting team, consuming significant time and/or cost.

Typically, a private equity team will look at about one hundred proposals for every investment it undertakes and the amount of work required to progress and monitor these transactions is substantial.

The reality therefore is that among business-owning families there are many who have:

- Failed to find or convert the opportunities they seek
- Invested but found that managing the portfolio is more demanding than anticipated
- Built a very concentrated portfolio not giving sector diversification.

For these reasons, many families conclude that while they rightly wish to utilise their own skills in the sectors they know best, they also frequently seek exposure through funds or other professional channels designed to:

- Give them greater diversification
- Give them experience in private equity which gives them a 'feel' for the market
- Gain privileged access to deals led by private equity houses
- Expand their networks

INVESTING IN FUNDS

Where investing directly in companies is not a viable option, the best route is to invest via private capital funds. In some cases, families may choose to combine these routes, investing in particular private opportunities directly but accessing other opportunities via funds.

Families have two main options for building a portfolio of funds: they can invest directly in funds or they can invest via an access vehicle such as a fund of funds[2]. Similarly to investing directly in companies, a family's choice is likely to be driven principally by the extent of their human resources and the amount of capital they have to deploy.

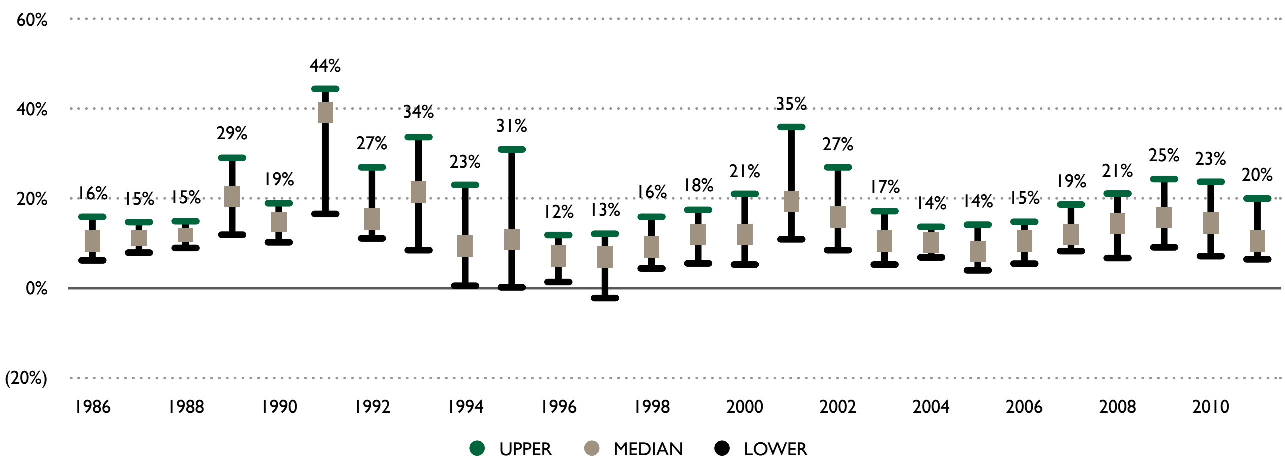
The key to success is a disciplined approach. There are four golden rules of fund-investing outlined below:

A. ONLY INVEST WITH TOP TIER MANAGERS

It should be understood that selecting the right managers is even more important in private capital than it is in public quoted investments. The reasons for this are that performance records of private capital managers are much more widely dispersed and because the best performing managers establish a competitive advantage in accessing deals, they tend to sustain their advantage over a lengthy period.

2 For Professional and HNW investors subject to suitability

CHART 2: THE DISPERSION OF RETURNS FOR PRIVATE EQUITY MANAGERS[3]



Past performance is not a reliable indicator of future returns.

B. ENSURE TIMING OF INVESTMENT IS STAGED OVER THE CYCLE

There is significant dispersion of returns from one year to another and we therefore recommend that clients phase their fund investments over a number of years, thereby achieving diversification over the entire economic cycle. The objective is that, having built up an initial portfolio spanning three to four years, a family's private capital portfolio will become self-sustaining and they can use the distributions generated to fund future commitments and capital calls.

C. DEVISE A FOCUSED INVESTMENT STRATEGY

The extraordinary post-crisis economic conditions have led to an erosion of returns in private capital, whilst continuing to out-perform public markets. However, this has not affected the whole asset class equally. As may be seen in Chart 3, falling returns have disproportionately hit the largest end of the market where returns for top quartile managers have fallen closer to 15%, reflecting intense competition among managers for the largest, high profile transactions. This is not the case for mid-market managers or smaller managers where returns have remained, on average, well above 20%.

In part, these higher returns reflect a degree of additional risk associated with smaller businesses, but also reflect the fact that private equity managers can add greater value to smaller and mid-sized investee companies. In addition, the returns in these segments are less driven by financial engineering since leverage is less prevalent than at the large end of the market.

As a result, families wishing to invest directly in private equity funds should be careful to consider a broader range than the large-cap funds which frequently market directly to them. In particular, accessing smaller funds will allow them greater scope to capture the higher returns available.

D. ENSURE THE FAMILY'S TIME HORIZON IS ADEQUATE

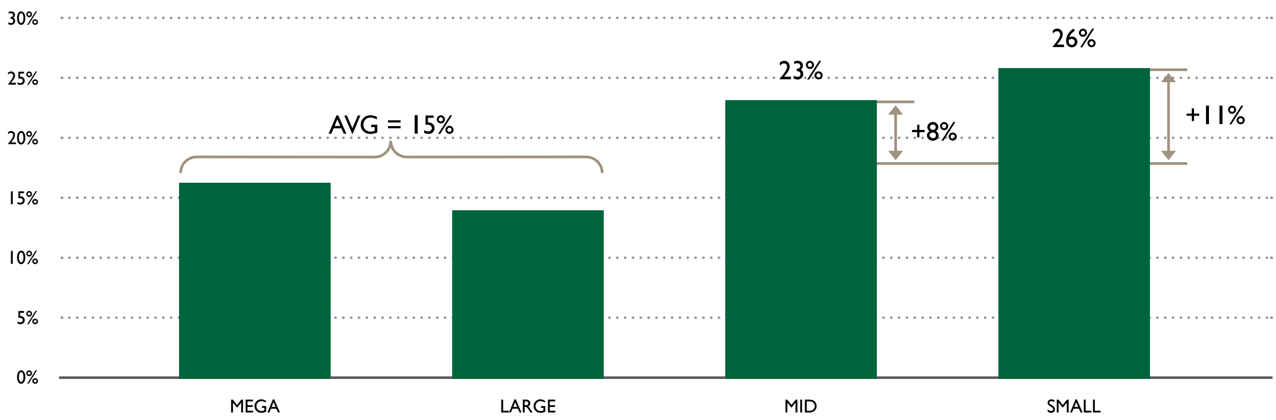
The life of an average private equity fund is ten years and may, in some cases, be longer. For many wealthy families, this kind of time horizon does not pose any problems. However, it should be pointed out that recent studies highlight a mismatch of liquidity horizons as being the single largest risk in private capital funds[4].

Families and their advisers should therefore make absolutely sure that they will not need to access the money they are committing before the end of the fund-life.

3 Source: Cambridge Associates US Private Equity Index & Selected Benchmark Statistics 30.6.15. Data label refers to the difference between upper and lower quartile performance. **Past performance is not a reliable indicator of future returns.**

4 British Venture Capital Associate study, *Risk in Private Equity - new insights into the risk of a portfolio of private equity funds* – (BVCA October 2015).

CHART 3: PRIVATE EQUITY RETURNS BY TRANSACTION SIZE[5]



So, what are the options for families seeking to access the asset class via investing in funds?

OPTION 1
DIRECT INVESTMENTS IN FUNDS

The most obvious route is to invest directly in those funds. This avoids an additional layer of fees and gives the family direct access to the managers. For families looking to follow this route, we would recommend they consider the following:

FINANCIAL REQUIREMENTS: Whilst the minimum investment allocation for building a portfolio of funds is less than for building a portfolio of direct private equity investments, it remains high. The minimum investment that most leading private equity managers will consider is $5m or higher. If a family is to build a portfolio of ten funds, this will require an allocation of $50m.

HUMAN RESOURCES: Whilst not as intensive as for direct investing, the execution of a strategy focused on private equity funds requires one or more family members to dedicate all or a significant part of their time to researching and accessing such managers or to hire a dedicated resource. Given the estimated 5,000+ private equity managers, this is not a task to take on lightly.

ADMINISTRATIVE BURDEN: The administration of such a portfolio is also relatively labour-intensive, which should not be overlooked.

One option is to use the feeder funds put in place by many of the larger private banks. These routinely offer their clients the ability to invest in several of the largest 'brand name' private capital managers. This has the advantage of being a relatively easy way to access some of the higher quality managers with a significantly lower minimum investment amount.

The principal disadvantage of this route is that such offerings are typically very expensive (in some cases, prohibitively). Furthermore, in addition to charging higher fees to their investors, the banks also charge as much as 4% to the underlying manager for all money raised. Many of the best private equity managers view this as exorbitant and therefore refuse to work with the banks. This tends to mean that the managers who do work with the Banks are the large, frequently listed private capital managers – the very managers for whom returns are falling, as mentioned above.

Families should therefore examine the potential fee drag carefully in order to determine its impact on returns.

OPTION 2
INVESTING VIA AN ACCESS VEHICLE

For families who do not have sufficient available capital to invest directly in funds, the best route is to use an access vehicle such as a fund of funds or similar. These vehicles will typically build a portfolio for a group of investors, thereby reducing the minimum capital requirement per investor.

5 Source: Preqin . Benchmark data as at 04/01/2016. Data relates to average performance of first quartile buy-out funds globally for period 1999-2015. **Past performance is not a reliable indicator of future returns.**

Fund of funds managers offer a number of advantages. They are typically highly professional groups with good experience of constructing portfolios and therefore significantly reduce the risk for their investors. Most importantly, they normally have good access to the top tier private capital funds, an important consideration as we have seen above.

When examining this route, there are a number of considerations:

COSTS: Access vehicles and fund of funds will charge an additional layer of fees. These may be more or less significant and in all cases, investors should try and minimise the drag from these additional fees. For funds of funds in particular, fees are commonly charged on the basis of an investor's total commitments rather than on the value actually invested at any given time. As with bank feeder funds, this will have a significant drag on the ultimate performance.

DIVERSIFICATION LEVELS: A criticism that is frequently made of funds of funds is that they are over-diversified. A typical fund of funds will frequently contain 30 or as many as 50 underlying funds. As a result, it will have exposure to 500-1,000 companies. We believe that this is over-diversified and that, as a result, the returns will rapidly mean-revert rather than capturing the fullest potential of the top-performing managers. One way around this is to select a vehicle with a more focused portfolio.

INVESTMENT STRATEGY: Whilst there are a growing number of niche fund of funds focusing on specific niches or sub-segments of the private capital market, many of the largest fund of funds are having to deploy several billion dollars annually. In these cases, their ultimate investments are likely to be with the largest brand-name private equity funds and subject to the lower expected returns we referred to above. Families should therefore look carefully at the investment strategy and expected portfolios of funds of funds to ensure that they will be gaining exposure to some of the higher returning segments.

FLEXIBILITY: Fund of funds are frequently like oil-tankers, it takes them a long time to get moving (capital is typically drawn over a 7-yr+ period) and when they do, they are difficult to stop! The challenge for a family is therefore that they are required to make a firm commitment to invest over a number of years. A number of fund of funds now offer annual programmes which we believe offer a structural advantage to investors, enabling them to have greater flexibility in adapting their commitment levels to their own changing circumstances.

CONCLUSION

We believe that private capital returns have justified the recent attention that the asset class has received in recent years. For investors with a sufficiently long time horizon, private capital can play an important role in achieving their overall return target. However, given the illiquidity associated with the asset class, it is important to give thought up-front to the most appropriate route for an investor's individual circumstances. The most important factor here will be a sensible evaluation of the resources that a family can realistically dedicate to this sector.

For some families, especially those with relevant business expertise, direct investment may be the preferred route. However, this often proves more difficult than anticipated and the option of investing at least partially through funds should always be considered.

Where families do choose to invest in the asset class via funds, there are a number of options as well as golden rules which should be respected in order to avoid disappointment and to achieve the best returns from their investment.

For those who choose a combination of direct, funds and funds of funds it is obviously important that the investment strategy and implementation is properly coordinated to avoid excessive concentration of risk.

FOR MORE INFORMATION

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Richard is Head of the Stonehage Fleming Private Capital Investment team. He has over 15 years' experience investing in private capital as a lender, a direct investor and a fund investor.

He joined the Group in 2014, prior to this he worked for a number of private equity fund of funds. Richard began his career at Barclays Capital where he worked in the Investment Banking team. He graduated from the University of Leeds and holds an MSc (Econ) from the School of Oriental and African Studies. Richard is a member of the British Venture Capital Association's Limited Partner Committee.

Scott Oliphant
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Scott is a Partner within Stonehage Fleming Investment Management and is responsible for a number of key clients of the firm. He joined the Group in 2011 with a special focus on client engagement and developing client services.

Scott studied Politics and History at the University of Glasgow before moving into private client wealth management in 1999. After two years at Goldman Sachs in London, he moved to UBS Wealth Management, where he helped develop the business and advised individuals and families on their affairs.

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