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CO-INVESTMENT FOR FAMILY OFFICE AND HIGH NET WORTH INVESTORS: LOOKING AT THE REALITIES

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Data now shows that over the long-term, a good private equity portfolio outperforms public equities, and for most wealthy families there is no substitute for a well selected group of private equity funds as an entry point to this asset class. In addition, wealthy families with entrepreneurial backgrounds are increasingly seeking direct private equity investments and looking for co-investment opportunities with other families or institutions. However, the risks can be very high and the practical obstacles much more substantial than is often appreciated. This paper explores some alternative approaches.

BACKGROUND

Over the last five years - effectively in the aftermath of the "credit crunch" – the market has seen a significant growth in the appetite of wealthy families and high net worth investors for directly held private equity investment. In some cases this is driven by an underlying entrepreneurial confidence and experience in a family's background, and the prospect of a more exciting return than from portfolio investing. It can complement, or be instead of, investing through funds.

There are a number of factors behind this increased, but in many cases quite generalised, desire to access direct private equity investments. They include the growth in numbers of 'super wealthy' families globally, driven by entrepreneurial activity and some mistrust in the investment community in general and in fund structures in particular. Many believe their direct business experience gives them an advantage over the professional investment community and that they can take a longer term view, working with other families to share 'off-market' opportunities.

Hence many wealthy families and family offices are attracted to the concept that they can bypass the investment community and do their own thing, investing directly in private businesses and new ventures, often with a controlling interest.

However in many cases the appetite is just that - and has not been satisfied due to the myriad of difficulties in accessing opportunities and finding the correct structures and relationships to invest successfully. Families looking to make such investments face a number of real hurdles:

High entry levels per investment

For all but the very richest families, the amount they can commit to a single investment is limited and this may restrict them to relatively small, early stage companies, unless they can work with a number of co-investors.

High risk and earlier stage investments

The need to make smaller investments can cause too much concentration at the high risk end of the market, especially relatively young companies and even start-ups. Investors are often excited by the prospects of early stage businesses; in many cases this is in stark contrast to the experience and expertise of that family and the way they made their original wealth. Such investments may start as a relatively small exposure but they invariably require several further rounds of financing, often without shareholder rigour to make the difficult decisions and management changes that are so often required.

Inadequate resource

Professional private equity managers normally employ a team of at least 6 professionals to identify and appraise opportunities, negotiate deals and manage the portfolio. Typically a private equity fund would look at around 100 projects or companies for each one it invests in and that is just the beginning of the work. Negotiating the deals requires an immense amount of time, experience and expertise and, in any portfolio, at least 30% of the investments are likely to have problems which require significant attention, with the possibility of further funds being required and / or terms being renegotiated. Even successful investments require significant time and attention to ensure management teams remain on track and exit returns are maximised.

Most family offices do not have a team of sufficient size or specific experience to manage a portfolio on that basis and hence operate a more opportunistic model, often selecting their investments from a far smaller sample.

They may feel that they can operate on this basis because they have greater business and / or sector expertise or better contacts than a private equity house and hence are introduced to better quality opportunities from which to choose. This, however, is highly debateable in most cases. Perhaps more credibly, they may have specialist expertise and contacts in areas related to their core business, which may give them significant competitive advantage. This is probably the most persuasive argument for direct investment by families, but this has the obvious downside of increasing sector concentration.

Narrow focus leads to lack of diversification

Most wealthy individuals or families thus tend to concentrate investments quite narrowly rather than building a well-diversified portfolio. In one sense they are managing their risks by investing in areas which they fully understand, but on the other hand they are exposing themselves to a downturn which hits one or two sectors as a whole.

Unfavourable ratio between the return and costs

The costs and risks of running a sub scale private equity operation can be very substantial and seriously erode returns. While investors often decry the ‘2+20’ fee model of most private equity funds, the real cost - even before the investment performance - may be just as high or higher within a family office if it is sub scale.

Lack of suitable structure, governance and administration

For cost and other reasons, families tend not to have the formal structures, processes and disciplines employed by commercial private equity firms. This can lead to short cuts, inadequate due diligence, monitoring and decisions which reflect the interests of the decision makers (often one or more family members), rather than the interests of all beneficiaries. We have seen several cases of poor decisions being made by existing family office shareholders, especially to maintain a past valuation that is patently too high, perhaps to save face. Taking a long-term view is one thing - ignoring the reality of a problem situation can cause losses to increase.

Poor quality monitoring and reporting

For similar reasons, monitoring and reporting is often inadequate such that problems are often identified and therefore addressed too late.

Family conflict

Unsuccessful private equity investments are one of the most common causes of family conflict between those directly involved and the more passive family members, especially where governance and reporting are lacking.

THE CASE FOR CO-INVESTMENT

Co-investment with other 'like-minded' family offices is increasingly seen as the solution to many of the problems listed above. Some of the benefits of co-investing:

- Gives critical mass by pooling resources and enabling participation in larger transactions.
- Pooling of sector and geographic expertise, with one family for instance being the lead investor in Africa and another in South America, one in Health Care and another in Luxury Brands.
- Larger investment pools enabling employment of greater expertise whilst reducing costs as a percentage of returns.
- More formalised structures, governance disciplines and reporting to satisfy needs of external investors and regulatory authorities, will also benefit the family.
- Wider diversification and better risk management.

However, the reality is that far more families talk about such co-investment opportunities than actually participate. The reason that theory is not always converted into practice is down to the significant levels of trust required to enter into these type of deals.

BUILDING AND MAINTAINING CO-INVESTMENT RELATIONSHIPS

Building sufficient trust and mutual respect to invest in each other's deals can take many years to achieve. Indeed it is far more likely that such relationships exist between families operating in the same business sector, where they have direct experience of each other, whether as partners or competitors.

Those who seriously want to consider co-investment thus need to focus on how to build and maintain that trust, which not only gives them the confidence to invest in a deal outside their own area of expertise, but in an investment which is led by a family of which they have no previous business relationship. Furthermore, as is the case with all private equity, it must be understood that some investments will go wrong, however expertly conceived and implemented, and the relationship of trust must be able to survive some early mishaps and some difficult decision making discussions.

It is thus not sufficient to simply build the trust required to make the first investment. It is critical to ensure that properly defined structures are in place, with clearly defined responsibilities and accountability to resolve amicably and professionally any problems which may arise after the investment is made. The issue of fees is likely to cause friction too - few families will feel it is reasonable for them to be the lead investor on a deal and receive no remuneration for that role. We have seen this left imprecise at the outset of a co-investment and then develop into a more toxic issue among the investors. Perversely we have even seen some family investment "clubs" reinvent a similar structure and fee basis as the institutional private equity industry, even if from a different perspective.

The keys to maintaining trust, even when things go wrong, are often more formal and accountable structures. However, the problem is that, as the process becomes more formalised, so a family office or high net worth individual can tend to see this as just another form of restriction and structure they would prefer to avoid.

ALTERNATIVE APPROACHES TO FINDING CO-INVESTMENT PARTNERS

There is a variety of ways of finding and maintaining co-investment partners, from using a family's own contacts and networks to find partners for individual transactions on a case by case basis, to the more structured and formal approach of joining a 'club' or participating in a fund.

Case by case from own network

This will depend on informal relationships with other families, probably built up over many years. The advantage of this approach is that it is very flexible and no substantial costs are incurred until a specific transaction is under consideration.

The disadvantages include:

1. the co-investor has little control over the deal flow, except those which are sourced through it itself;
2. the co-investor's most trusted contacts are likely to be biased towards the sector it knows, making it more difficult to achieve diversification;
3. it is unlikely that a clear policy and other parameters are agreed in advance, so every transaction has to be started from scratch, with no investment guidelines and no preferred structuring arrangements.

The investment club

Some families are attracted to the concept of a co-investment 'club', which has been established to bring together a number of families for the purpose of co-investment. At one end of the spectrum, some clubs are entirely informal with no rules or obligations, where the object is purely to provide a forum for families to meet and show each other their deals. Other clubs do have rules and often carry a clear obligation to participate in some if not all the deals undertaken by the club as a whole.

The dilemma for a club is that it does not want members who are there primarily for market intelligence purposes, but are unlikely to invest in practice. On the other hand, it would be extremely difficult to form a club where each member was required to participate in every investment.

Those clubs which require more commitment tend to be for property investment rather than trading companies. Some, for example, require each member to participate in at least one deal in every three, or their membership will be revoked. In another case Sure Investments run a property club where, rather ingeniously, each member must participate in every deal but has the opportunity either to double or to halve their allocation, the result being that if more members wish to scale back than scale up, the investment cannot proceed.

There is one stark disadvantage to investing in these structures. In the competitive and dynamic private equity market globally, the ability to speak for the entire investment funding "cheque" is perhaps one of the most powerful advantages an investor can have. Many of the discretionary investment clubs have struggled to overcome this handicap - they are often seen by savvy sell side advisers and management teams and vendors as second class buyers. To secure investments they are thus faced with either paying materially more than the funded buyers, or investing in opportunities that hang around the market long enough to enable the club to raise money from its members. The bigger the 'club' in terms of numbers of members, the worse the issue. A small club of 3-5 investors can get close to overcoming this issue - the larger clubs usually cannot. The smaller 'clubs' may even be able to get one of the investors to underwrite an investment, which obviously solves the problem.

Creating a fund

In one sense this is the tidiest solution with several family offices joining together to create their own private equity fund, with its own purpose built management structure. Such a fund would obviously be set up within an appropriate structure and governance framework. For many families, however, this does not give them the independence and control they require, and feels like they are back into the fee and control issues they are trying to avoid.

Building a co-investment programme through institutional channels

This is a topical and interesting route, and one that is developing fast at present. It involves family office accessing co-investment led by an institutional private equity manager (commonly referred to as GPs or General Partners). Why would GPs offer out co-investment opportunities? GPs do this to access more capital for larger deals, but more often they are forced to offer this as "bait" to attract the investor into a fund structure. Increasingly GPs see they must offer investors this top-up facility where the investor puts an amount into the fund structure, at full fees, but expects to be offered co-investments allowing them to invest an additional 25-50% of this commitment as a co-investment at no fee. This way the investor averages down fees and gets the opportunity to "bespoke" an element of its portfolio.

We are aware of a few large and sophisticated family offices which have used this route as the entry point to co-investment. As all deals are managed by a GP, there is little / no risk of an orphan asset (without a GP to manage it), they have all been through the normal rigorous due diligence process and the GP will almost certainly have had sufficient capital to underwrite the deal - so avoiding being the "second class buyer". It does not get close to scratching that entrepreneurial "itch" some family offices have, but it is a good way to build expertise and contacts. For a family with little experience of private equity investing, such co-investing can be a good low risk "training course".

The key downside here is that the investors need to have a significant programme of fund commitments to build such relationships with GPs. And very small investors in funds will by implication have less favoured status in the fight for co-investment, unless the investor can convince the GP that it brings special knowledge to the situation.

The "fundless sponsor"

This esoteric term refers to private equity firms/ teams that do not have a fund from which to invest. The credit crunch and its aftermath has produced a number of these, and they raise money for each investment on a case by case basis. To be clear they only do this because they cannot raise a fund - but they make a virtue of the co-investment process to attract precisely the family office investors that we are discussing here. They have had some success doing this, and will have more professional processes than most families or "clubs", but they will remain subject to the second class buyer problem, as most advisers will know they do not have discretionary funding. The better fundless sponsors will move as rapidly as they can to raise a fund, so the remaining ones could be seen as managers that are not successful enough to do so.

Fees for these deals are lower than on fund terms, but will probably be somewhere around the 1% pa management fee, with a carried interest charge of somewhere from 5-20%. Carried interest structures can be more creative and ratcheted than in a fund, often to the benefit of both GP and investor, although it can have the effect of focussing the GP on taking excess risk to achieve an outperformance ratchet. One of the bigger risks is that the fundless sponsor collapses and the team breaks up as it doesn't have sufficient income (without a fund) to hold together. The investments may then become "orphans" without clear direction and the investors may have to find a new manager.

The adviser route

The alternative, for those who wish to invest directly, is to seek an adviser who has the experience, resources, infrastructure, network and deal flow to address many of the problems mentioned above. The challenge here – and it is a considerable one – is for the adviser to have a business model which brings reasonable alignment of interest with the client, rather than being incentivised primarily to 'sell' the deal. The key to this is a long term, more broadly based relationship of trust and a remuneration structure which ensures the adviser is not tempted to endanger the relationship for the sake of a single transaction. He or she can also be relied upon to advise throughout the investment period if required.

Few corporate financiers are well placed to do this and few have the experience and skill set which includes portfolio management. However, a well-positioned adviser can add considerable value and is sometimes able to bring together co-investors in a way that suits the objectives of both the investors and the investee company.

SUMMARY

The private equity class is high risk - seductively attractive from afar but difficult to access and even more difficult to do well in practice. The, maybe understandable, emotional backlash to funds and fees post the credit crunch has in our view bred a rush to direct investment, in most cases by families without the expertise, contacts and structures to manage a meaningful private equity portfolio. There is no asset class with quite such a variance between the top quartile and bottom quartile funds - when private equity goes wrong it can go very wrong. For this reason we believe families need to think very hard about their real motivation for trying to do direct deals, and to rationalise their strengths and weaknesses before making any steps to source such deals. Of course there will always be some families that can do this well - either with such critical mass, or expertise, or with a talented in house team or a trusted adviser - but the experience of the evolution of the private equity sector suggests there will be some serious casualties along the way.

Encouragingly, we are starting to see some larger families taking a much more thoughtful approach and not rushing straight into direct investing. This includes realising that the family needs to develop its network and expertise first, in many cases by making a small number of "fund" commitments to create strong relationships with established players in the favoured market and accessing lower risk co-investment opportunities as a first step. Over time that can be extended to backing "one off" deals and even taking a lead investor role, if confidence and experience is sufficient.

Each family also needs to think very hard about its internal governance. It is often highly desirable for an experienced outsider to chair an investment committee and create a firebreak between any family members that have excessive power over new investments, and multiple beneficiaries. In one instance we have seen one very wealthy family move to institute a policy of excluding any investment sourced through the family members (one of the supposed benefits of this direct investing route) due to the internal controversy and waste of executive time these ideas were creating.

The good news is the relatively immature private equity sector is maturing to see families as an important and interesting investor base that can in many cases bring more than just money to the table - and therefore the prospects are good that over the next 5-10 years there will be the opportunity for sophisticated and patient families to create routes to direct investing that minimise risk and create real long term value for their family members. It might look less interesting than investing in an exciting looking start up - but it will almost certainly produce better returns and cause a lot less disruption within the family office.

On the 15th January 2015 Stonehage Group Holdings Limited completed a merger with Fleming Family & Partners Limited ('FF&P'), a London-based Multi-Family Office. The combined company is called Stonehage Fleming Family & Partners Limited ('Stonehage Fleming') and is the leading independently-owned multi-family office in Europe, Middle East and Africa. Its advisory division provides corporate finance and direct investment advisory services as part of a holistic approach to advising wealthy families.

FOR MORE INFORMATION

Niall McCallum
Partner - Head of Corporate Services

Niall is Head of our Corporate Services Divisions in Jersey and Luxembourg. He joined the Stonehage Fleming Group in 2007 to develop the corporate services and mutual fund business and is a Director of numerous mutual funds, corporate and other structures.

Prior to joining the Group, Niall worked with Deutsche Bank International in their Corporate Trust division where he was responsible for corporate services provided from Amsterdam, Delaware and Jersey. He has over thirty years' experience in the offshore finance industry. Niall has a BSc (Hons) in Pharmacology from the University of Liverpool and is also an ICSA Associate.

David Barbour
Co Head - Private Equity

David is Co Head of the Stonehage Fleming Private Equity team. He has led a number of private equity investments and exits and sits on the Board of RFIB Holdings.

David joined the Group in 2003, became a full time Executive in 2006 and Co Head of the Equity team in 2008. He started a career in the broadcast media, became a Lawyer then Investment Banker at Robert Fleming and JP Morgan Chase. He joined Robert Fleming in 1995 after spending a year with UK cable company NTL. He qualified as a Corporate Lawyer with London firm Ashurst Morris Crisp.

Richard Hill
Partner

Richard heads Stonehage Fleming Advisory, he advises clients on a wide range of advisory, investment and capital raising mandates in various sectors, including financial services, real estate, technology and natural resources.

Prior to joining the Group in 2002 where he helped establish the advisory business, Richard worked at JP Morgan, he previously qualified as a Chartered Accountant with PwC and then joined the investment banking business of Robert Fleming.

Richard Clarke-Jervoise
Asset Management

Richard graduated from the University of Leeds and completed an MSc (Econ) in Development Economics from the School of Oriental and African Studies in 1996. Following graduation, he joined Barclays Capital where he worked as an analyst in the Investment Banking team. He left Barclays in 2001 to join PROPARCO, where he was part of the team leading the firm's private equity investments in frontier markets including Africa and Asia. He then joined Access Capital Partners as an Investment Director before moving to Quartilium, a Paris-based Private Equity fund of funds in 2007.

Richard was co-head of the firm which managed €1.4bn and invested in private equity, infrastructure, mezzanine and venture funds globally. He joined FF&P Asset Management in 2014 to head up the private equity team.

enquiries@stonehagefleming.com
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