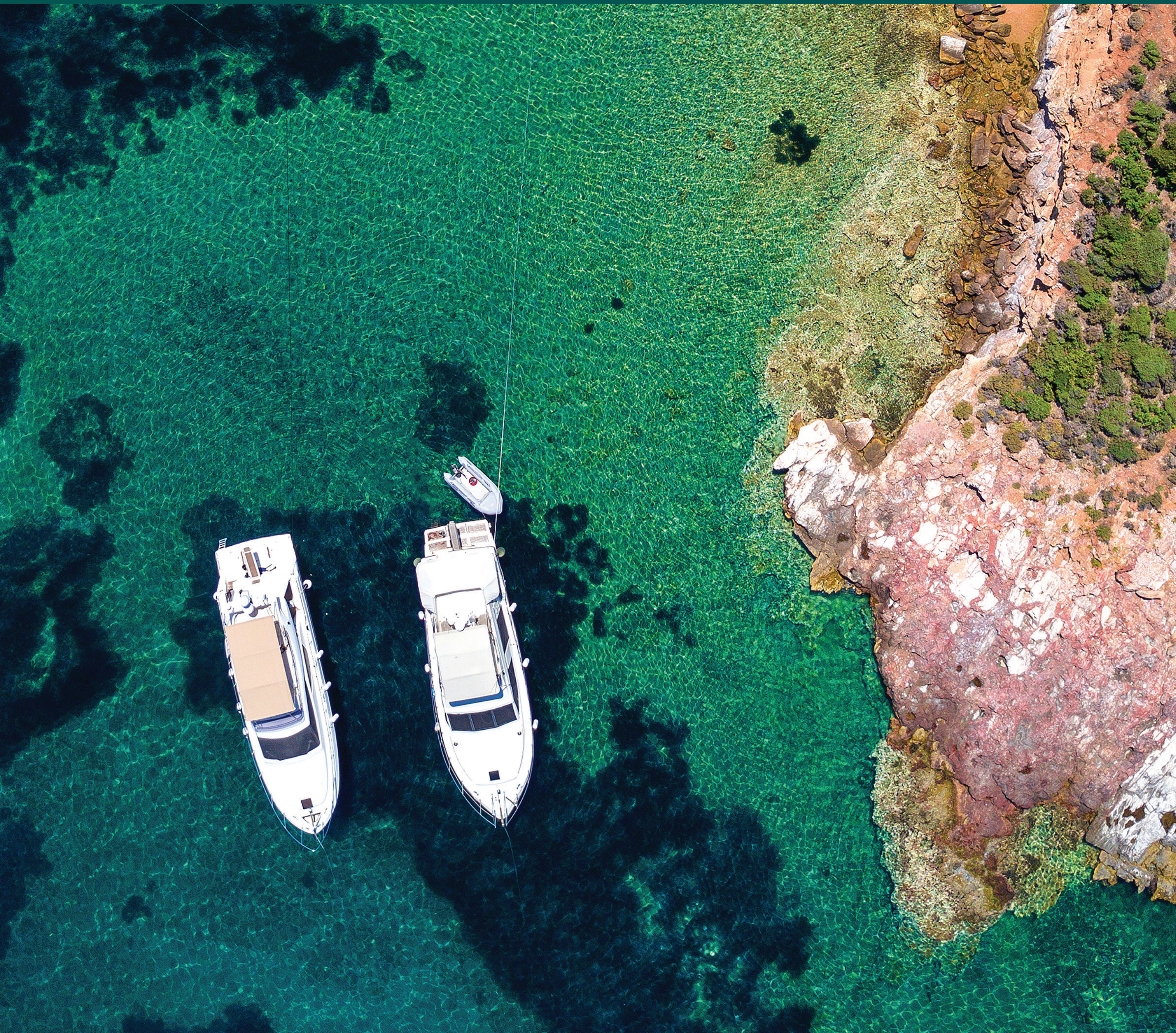
FamilyConnect

A Duane Morris LLP Publication for Single Family Offices



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*Welcome to the inaugural issue of **FamilyConnect**, our publication designed to provide meaningful content on issues encountered by single family offices engaging in direct investing.*

Family offices are increasing their roles as prominent providers of private capital. Duane Morris brings its deep experience to engage and support this community through in-person peer roundtables, content-rich vehicles, including this publication, and other impactful initiatives.

*Together with our strategic alliance partners **CohnReznick LLP** and **Quattuor Capital Partners of Raymond James**—whom we thank for their contributions to this initiative—we intend to strengthen a community in which family offices can exchange ideas, thoughts and opportunities.*

We invite your feedback and welcome your suggestions.

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SUMMER ROUNDTABLE: CO-INVESTING OPPORTUNITIES

This past summer, Duane Morris, CohnReznick and Quattuor Capital Partners of Raymond James welcomed approximately a dozen family office executives to the second peer roundtable of 2018. This roundtable focused on best practices in sourcing and structuring co-investing opportunities, the pros and cons of club deals, the use of independent sponsors and related topics. Below are four major takeaways from the discussion:

1. Family offices are investing like Private Equity and Venture Capital firms.

The role of family offices has expanded in recent years, including a shift from passive to controlled capital, as family offices compete with private equity and venture capital firms to provide private capital. Family offices have established themselves as major financial institutions and are better capitalized than ever before. Today, there is more capital in family offices than in hedge or private equity funds.

As family offices expand operations, their investment philosophies inevitably change and mature. Smaller, less sophisticated family offices are often undisciplined in their investment decisions and their strategies can change from generation to generation. This inconsistency is part of the institutional culture of many family offices, said Roger Arjoon, director of the Hinduja Merchant Bank family office. But with the recent shift toward disintermediation and direct investing, family offices are being forced to adopt investment philosophies and stick to them. Mature family offices will start to look and think like institutions, said Michael Felman of MSF Capital Advisors (who both advises other families and runs his own family office).

2. Co-investing creates opportunity, but there are risks.

Co-investment strategies—also known as "club" deals—are becoming increasingly popular with family offices. By working together and pooling cash, family offices can pursue investment opportunities that would otherwise be prohibitively expensive. Club deals also allow family offices to diversify their portfolios by leveraging their partners' varied expertise and connections and providing an avenue for the elusive proprietary deal flow. While bringing in partners can be costly, said Felman, family offices often pay less than they would in management fees to private equity funds. "There's no free lunch," he said.

As with all partnerships, however, club deals are not without risk. According to Mary D'Souza, CFO and director of Sentio BioSciences, partners may not realize that their interests are misaligned until it's too late. Capital calls, for example, often pose challenges, and partners need to agree about financing contingencies down the road. Similarly, investors need to be on the same page regarding liquidation rights, exit strategies and hold periods. Otherwise, Arjoon said, "things could get vitriolic."

3. Sourcing deals is a challenge—and exiting them can be just as hard.

A significant benefit of club deals is that they allow family offices to source a broader range of deals. But family offices originating these deals must be willing to compromise on terms. If the originator's terms are unattractive or unfair, it may lead to trust issues going forward. "In order to receive," said a few participants, "you need to share [your good deals]."

Knowing when to enter a deal is only half the challenge; determining the proper time horizon and exit strategy can be just as difficult, and family offices might not always agree. One person's view of a good exit isn't always the other person's view, and families need to have a framework in place in advance to work out any disagreements.

4. Family dynamics often come into play—and you cannot forget that.

Family offices must often contend with the complicated relationships of the family members. The worst disagreements are often between two relatives, and sometimes the controlling party needs to force a family member out of a deal—unless a disagreement can be mediated by a third-party professional. "A business is like a marriage," said Arjoon. It is important to make sure you are committed before you take the plunge. |||

ABOUT THE SINGLE FAMILY OFFICE PEER ROUNDTABLES

Family offices play an increasingly more prominent role as providers of private capital—both as investors in private equity funds and as direct investors in middle market companies.

To continue to engage and support this community, provide input, resources and value to participants, and foster a peer network of family offices, CohnReznick, Quattuor Capital Partners of Raymond James and Duane Morris host senior family office deal professionals for a continuing series of informal roundtable discussions.

We facilitate a peer group discussion of trends impacting the middle market and help you navigate the challenges and market risks that could impact your business as you execute your plans.

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FAMILY EQUITY: HOW FAMILY OFFICES ARE INVESTING DIRECTLY IN BUSINESSES

Family offices are employing their own spin on private equity by creating tailored portfolios comprising direct investments in private companies.

For decades, corporations, public market investors and private equity firms with deep pockets earned the attention of business owners seeking new investors or an influx of capital. But a new trend is proliferating. Over the past few years, family offices that traditionally have acted as limited partners have been investing directly in businesses, cutting out private equity firms, bypassing the associated management and performance fees, and buying larger pieces of companies. And that means family offices can now be considered a new class of potential investors or buyers for business owners reaching for the next level.

Direct Investment: The Family Office's New Frontier

A growing trend among some single family offices is setting up a consortium of two or more single family offices that combine resources to achieve a common goal. "A number of family offices think their experience as entrepreneurs, business leaders and growers puts them in a strong position to positively influence the companies," said Lawrence Calcano, iCapital's chief executive officer. Going direct is also "a means to lower the overall fees that they pay across their portfolio."

Here's what you need to know about the rise of family office investing:

- *A longer-term approach.* As patient capital providers, family offices are content holding investments that are performing well, while looking beyond short-term fluctuations. The tendency to hold companies for a longer period of time may be appealing to management teams who potentially own equity in the company and wish to stay in place after an acquisition.
- *A shot of support.* Family offices use their personal experiences and expertise to help support the companies in which they invest—typically attractive to founder-owned businesses.
- *Preferred middle-market options.* In terms of investment size, family offices can compete against other private equity firms within the middle market. According to a study conducted by the Family Office Exchange, 81 percent of the 118 family offices surveyed in 2017 have hired staff to invest directly in private firms. In fact, family offices did $100.6 billion in deals in 2016, compared with $25.1 billion in 2011, according to figures compiled by PitchBook data.

A Fruitful Framework

As companies consider moving away from private equity firms, the family office direct investing model is enjoying great success. Spearheading the trend is Pritzker Group, which has been investing family money directly into companies for 14 years and acquired four platform companies in 2015. Focusing on manufactured products, services and healthcare investments, Pritzker Group is best known for creating the Hyatt hotel chain and the Marmon Group, which was bought by Berkshire Hathaway for $4.5 billion in 2007.

"There's a network that's growing of the big family offices who do these kinds of deals," said Joseph Gleberman, managing director for The Pritzker Organization. "I was in the private equity business at Goldman for a long time, and it's not dissimilar to what it was like 20 years ago, when you started to see Blackstone do a deal with KKR or Goldman do a deal with Warburg Pincus." |||

> "Once you have met one family office, you have met one family office. By connecting family offices with investment opportunities either in their area of expertise or an adjacent area, there is an opportunity for them to add value while making investments that are not typically offered in a wealth management context."
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> > DAVID MANN, Managing Director and Head of Raymond James Private Institutional Client Desk

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DIRECT INVESTING IS A MARATHON, NOT A SPRINT

Once family offices build out their deal-sourcing capabilities, they need to shift emphasis to expanding operational components.

Sourcing opportunities and winning deals are, of course, vital pieces of any direct investment strategy. But family offices should understand that getting the deal done is only the first step. The heavy lifting happens in the weeks, months and years after the deal closes.

Yet, many family offices underestimate the importance of monitoring their direct investments on a continuing basis. They focus their energies on sourcing the deal and getting it done. Then, they open the champagne and move on, when they should be rolling up their sleeves and plotting a strategy to make the deal succeed in the long run.

"Most of the accidents in direct investing happen because the family office has taken its eye off the ball and isn't properly monitoring its portfolio," said Francois de Visscher, founder of de Visscher and Co., an independent financial advisor to single family offices.

He notes that family offices typically operate with a lengthier holding period compared to a traditional private equity investor. So, whether they pay six times or 6.5 times EBITDA (earnings before interest, tax, depreciation and amortization) for a particular business doesn't make a whole lot of difference. "The purchase price is never really the issue," de Visscher says. "Where family offices trip up is when they don't spend enough time with an investment or when they don't have the resources to properly monitor that business."

> Family offices are an increasingly formidable presence in the private equity universe and much of their success is attributed to the fact that they have done a great job of building up their deal-sourcing capabilities and partnering with professionals who have significant experience in making deals.

Family offices are an increasingly formidable presence in the private equity universe and much of their success is attributed to the fact that they have done a great job of building up their deal sourcing capabilities and partnering with professionals who have significant experience in making deals.

But, going forward, this may not be enough. The people who are really moving the needle in today's private equity industry are not only the dealmakers but the operating partners—the professionals who sit down with the management team on a regular basis to discuss strategy and address the challenges of the business. They make key contributions in areas from executive compensation to acquisition opportunities.

"The deal-making sophistication of family offices is growing stronger by the day," said Jeremy Swan, managing principal, Financial Sponsors & Financial Services Industry Practice at CohnReznick. "But when it comes to the post-transaction operations of these businesses, they have not built out those capabilities to the same extent. Direct investing is an ongoing journey for family offices and portfolio monitoring is clearly the next step on that journey."

In many ways, long-term portfolio monitoring is more important for family offices than for traditional financial sponsors. Why? Traditional sponsors are under pressure from their LPs to put money to work quickly and get a rapid return on investment, whereas family offices can operate at a more measured pace. Family offices are not under the gun to constantly deploy capital. Their goal is to grow their investments year over year as a way to compound their wealth.

The question then is: How can family offices best monitor their direct investments and work with management to grow value over the long term? Can they handle that task in-house or should they turn to an outside network of advisors to help them manage their portfolios?

The answer depends on how much direct investing the family office does. If a family office does an abundance of deals every year then, by all means, they should consider hiring a full-time staff to monitor those investments.

If, on the other hand, a family office makes only one or two investments per year, that may not be enough activity to justify maintaining a full-time staff to manage the portfolio. In this case, it probably makes more sense to partner with trusted advisors who are intimately familiar with operating issues and can help monitor those few deals.

"Family offices are starting to embrace this virtual model," said Swan. "They may have one or two people on staff for deal sourcing and then have a team of outside advisors working on everything from governance and operational issues to value creation and cybersecurity. With this virtual model approach, family offices can build out the necessary operating skills and really fill the talent gap."

It's also important for family offices to keep in mind that, as a practice, monitoring can be shaped differently depending on what the family wants to accomplish with its portfolio. For instance, one family office may look at direct investing as an efficient vehicle for compounding wealth. Another office may be making investments as a way to provide employment opportunities for future generations.

"The way you monitor your investments will depend on your objectives," said de Visscher. "If your goal is to open up opportunities for family members, you will want to work with management to groom family members to serve as the next generation of executives in the business. But, if your strategy is pure wealth-building, that's very different. Maybe you are not looking for an exit but, if you see the right offer, you may pursue it. Then, there has to be constant communication and a strong alignment of interests between the management team and the family office."

Whatever their investment goals, it's vital for family offices to keep in mind that portfolios, like families themselves, do best when given the care and attention they need. |||

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FAMILY OFFICE EXECUTIVE PROFILE: KATHERINE HILL RITCHIE

Interview with Katherine Hill Ritchie, Director of Strategic Development, Nottingham Spirk

Katherine Hill Ritchie has 16 years of family office and investments experience working internally or as an advisor to prominent family offices, including Simon Group Holdings, Eden Capital, the private equity arm of a single-family office, and PEX Global, an investment platform for family offices.

Q: How did you get started in this business and why do you stay?

I went to business school at Fordham, graduating in 2003, and wanted to pursue alternative investments, media and marketing; hedge funds were the cool thing then. I had no interest in investment banking or working for a bank. I didn't know what a family office was; the term was usually "high net worth."

My first job after business school was a startup—hedgefund.net—a fascinating coalescence of hedge funds, data and the internet. Pension funds, funds of funds, endowments and family offices used our data—and I could see the marketing possibilities. Through our research, a family in Buenos Aires could learn about a hedge fund in London—there was otherwise no good way to connect back then.

Later, I heard that a family office in London wanted someone in New York with hedge fund experience; I applied and got the job. After that, networking would lead me to relocate to Geneva, Switzerland, for a family office that was expanding. I joined and saw the investment portfolio triple in size. I traveled all over the world conducting due diligence on managers and was part of a team that managed $3.5 billion in hedge funds.

The family office world is truly fascinating, and I have learned so much about how family and legacy impact investing. I meet interesting people and hear great stories of both boom and bust. I am lucky that today I am an advisor and work for two great family offices. Once you dip your toe in it, you want to stay.

Q: How did you find Nottingham Spirk and how would you describe its investment philosophy?

I was introduced to Nottingham Spirk several times in my career. When I was considering leaving my last position, they asked me "Why don't you work for us?"

Some family offices still have operating businesses; Nottingham Spirk does. John Nottingham and John Spirk—the founders—will see a gap in the marketplace or something they could improve upon. Example: The $5 SpinBrush competed with the $100 Sonicare electric toothbrush. SpinBrush was sold to Crest for $475 million. Nottingham Spirk holds over 1,200 commercial patents. The company has engineers and designers on staff.

We are connected to many universities and review thousands of patents, ideas and business plans each year. We find the ones to invest in and we work on it together: do the prototyping, testing, develop the product, put in management, build a board. At first, we are usually one of a few investors, or the only investor. We will usually take that through to a Series A and then introduce it to our network for them to invest in the company as well. We will do a club investment, where we say to our network "We have done the prototype and have a functioning product." Then, NS is off to work on the next project or go and invent something else. We can also see return on our money through exits, licensing or a revenue share. We don't want to stock products, however.

Our focus is two-fold: (1) medical devices outside the body (*e.g.*, diagnostics, MRI machines, ear thermometers) and (2) consumer products of any type (from automotive to AXE body spray for men).

We may do later stage investments with products and companies that have been around for a while that need innovation. We work with Fortune 100 companies and are looking to team up with private equity firms for leveraged buyouts.

Few family offices make things, and it is a fun environment to be a part of. NS hires more engineers than, say, investment analysts. We have a biomimicrist on staff who studies processes in nature and applies them to materials and systems to create/engineer medical devices and consumer products. For example, did you know that Velcro came from looking at tumbleweed/burrs under a microscope?

Not all families want to be passive investors and outsource everything to third-party money managers. Many still do that, but a kind of hybrid investing model—directs, co-investing—will continue and grow for those interested in spending the time and resources.

Q: What kinds of investing trends you are seeing?

I came from the fund world at the start of my career, moved into secondaries and then directs and co-investing, so I have seen the whole spectrum from passive to active.

Not all families want to be passive investors and outsource everything to third-party money managers. Many still do that, but a kind of hybrid investing model—directs, co-investing—will continue and grow for those interested in spending the time and resources. It requires more of a hands-on approach and you have to hire the right team to execute and manage the investments. Smart family offices can have incredible flexibility, and they should be nimble and leverage these opportunities. The world constantly evolves and so does the investment world. Direct investing/co-investing allows you to be more interested in the opportunity than in holding fast to a particular profile of investing. |||

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