CHAPTER 1

Introduction to Direct Investing

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Investors have more and more options than ever before for methods to deploy capital in the aim of generating financial returns. Today many family offices, high-net-worth individuals, and institutional private equity investors have amassed wealth through private company ownership.

Many of these successful business-building investors are looking for more avenues to deploy large investments in private equity–oriented investments. Today, for many investors, from early stage *angel* investors who deploy tens of thousands of dollars through mega funds with billions of dollars under management, the strategy is the same: Invest in the ownership *directly* of a privately held company or illiquid asset like real estate, and sell your ownership interest for a profit at some point in the future.

Where historically extraordinary wealth has been created through building and owning equity in privately held enterprises, options range from public securities to esoteric hedge fund strategies. Investors can typically access any type of investment that meets their objectives defined in a risk-versus-return profile. As investment risk increases, the opportunity to generate outsized returns also increases. With innumerable choice for investors, from

longstanding established asset classes through newly formed financial instruments, there continues to be a sustained interest in a form of investing referred to as *direct investing*.

Direct investing may be defined as investments that meet the following criteria:

- The investor is making the decision to participate in a specific investment that is closely held (not publicly traded).
- The investment capital is funded directly by the investor (from a balance sheet under their control).
- The investor will own an operating asset through a direct investment that has unique and specific operating requirements.

Investment strategies designed to capture the value created through private company ownership have typically been the domain of private equity (PE) and venture capital (VC) funds. "The MoneyTree™ Report by PricewaterhouseCoopers LLP (PwC) and the National Venture Capital Association (NVCA) based on Data from Thomson Reuters" revealed that "venture capitalists invested $48.3 billion in 4,356 deals in 2014, an increase of 61 percent in dollars and a 4 percent increase in deals over the prior year. In Q4 2014, $14.8 billion went into 1,109 deals."[1] To gain exposure to the outsized returns offered by these funds, family offices and ultra-high-net-worth individuals have invested as limited partners in a blind portfolio of fund investments. These funds, on one hand, may offer exceptional return expectations but also require large capital commitments that are illiquid for the long term with little visibility into the underlying companies for the investor. These funds also charged investors management fees and carried interest. In 2014, there were 33,429 Regulation D offerings reported on Form D filings, accounting for more than $1.3 trillion, with approximately 301,000 investors participating in these offerings.[2] To achieve high returns in the PE market as a limited partner, investors must gain access to the top-performing funds that are rarely open to new investors. This leaves family offices struggling to generate returns by investing with mid-tier fund managers, in turn making direct investing into specific deals more and more attractive.

Direct investing is not a strategy that is one-size-fits-all or for that matter appropriate for all investors to consider. At the end of any investment process, investors have an illiquid investment in an operating company and "own" the business, including the operational and execution risk associated that all companies are subject to regardless of size, sector, or stage.

This is, however, an attractive investment strategy for investors who:

- Have meaningful capital to deploy relative to the market in which they intend to build a portfolio
- Have the ability to sustain significant losses and are allocating a percentage of their overall portfolio that reflects the reality that some of these types of investments do not work out
- Are operationally minded and prepared to participate in active company investments as opposed to passive investments
- Have a unique advantage as an investor in terms of a track record of success in certain industries or markets, and can be defined as a "value-added investor"

Many investors can generate very attractive returns and outcomes through deploying capital into growth-oriented private companies. One aim of this book is to help investors identify the various approaches for participating in direct investments. There are countless examples of investments in private companies that fail. There are also examples of extraordinary successes although statistically rarer in occurrence. Through the book's research, interviews, and case studies we strive to better understand the dynamics of the direct investment risk/return profile, provide a framework for how to scrutinize opportunities, and feature perspectives from industry experts and showcase some current trends and strategies.

With the growing investment options that are available to investors, direct investing is not just a trend, but historically is a fundamental economic engine for growth, innovation, and monetizing the rewards of entrepreneurship. An important intention of this book is to be a comprehensive resource on the topic of direct investing that is beneficial to the seasoned practitioner and the less experienced investor alike.

2008: A Wakeup Call for Investors

With the contractions on the private equity markets in 2008 came an increased scrutiny by investors into their holdings and an investor mind-shift about public markets. What were some of the lessons learned from one of the most catastrophic market crashes in history? A *Wall Street Journal* article chronicling the lessons learned post-2008 identifies six key lessons learned: (1) Ignore Wall Street's optimistic projections. (2) People in charge may not

know much more than you. (3) Debt is dangerous. (4) We are more risk adverse than we think. (5) Simple is beautiful. (6) Cash isn't trash.[3] There are a few more that the private investor and family office gleaned. When it came to investing in PE funds, the crash of 2008 triggered a host of liquidity issues for PE firms as the direct investing marketplace virtually dried up overnight. In particular, limited partners were unable to control the timing of divesting of assets and although many would be inclined to hold, or even reinvest, in an operating company during an economic downturn, they could not drive the timing of an exit as a limited partner in a fund.[4] This meant their capital was "benched" or locked up under the provisions of the fund, inhibiting them from exiting and deploying capital at the bottom of the market.

Some of the lessons learned from 2008 highlighted previously, coupled with the frustrations of lockups for funds, certainly contribute to an increased interest by investors to make a direct investment into a privately held operating company or real estate asset where there may be increased control, visibility into company operations, transparency into reporting, and niche, off-market opportunities for growth and appreciation.

Does the current focus and attention by investors on direct investing indicate that this is a new category of investing or a temporary trend? I believe that this is *not* a trend, but rather that building wealth through business ownership is the most fundamental basis for how great wealth has been amassed throughout modern history. From early industrialists, such as Ford, Du Pont, Getty, Carnegie, Rockefeller, and Firestone, building and investing into operating companies has been the backbone of the U.S. economy. And advancing from the industrial revolution, business owners like Pritzkers, Gates, Jobs, Bezos, Branson, Schultz, and Page still seek new innovations, process, technologies, products, and services that drive economic growth. Great fortunes have been amassed through building and growing business and the wealth realized through owning privately held equity.

Role of the Family Office and Private Investors

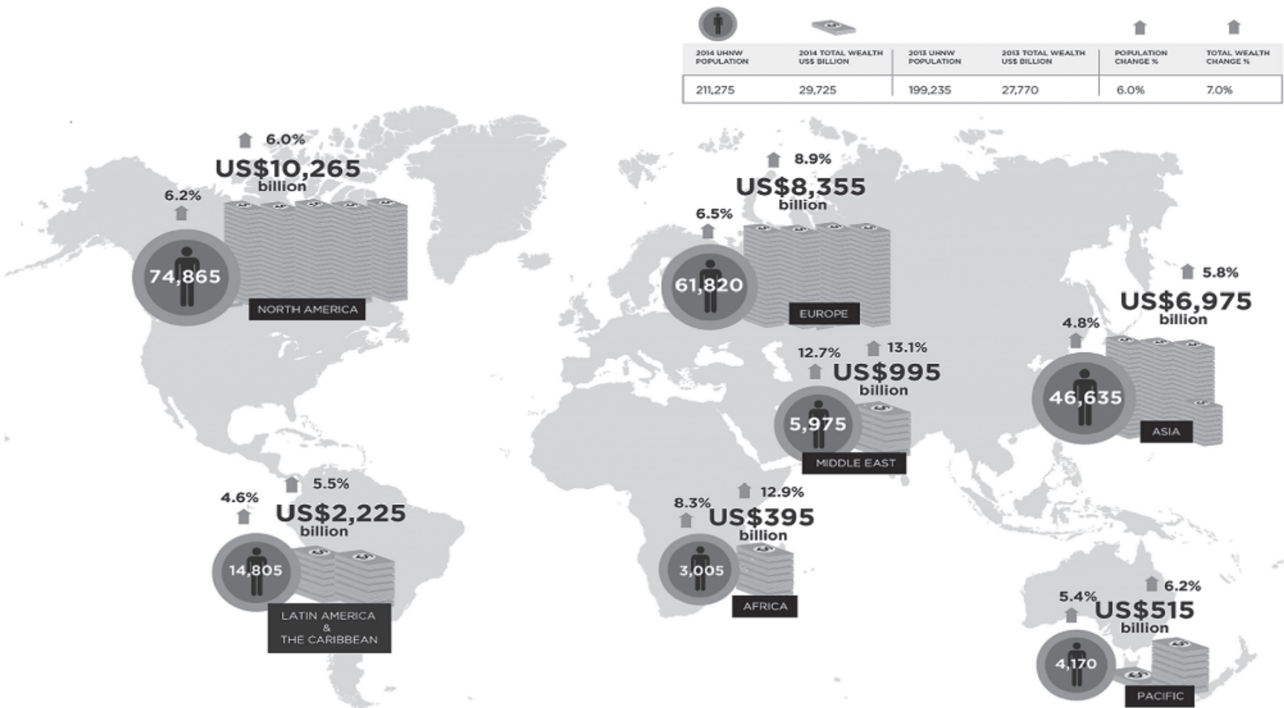
The private investor most focused on in this book is the family office. The definition of *family office* varies widely and often depends on whom you ask; however, the general rule of thumb is that they are entities to manage wealth for multiple generations. Some are more investment focused, while others may be designed to prepare family members to collectively manage, sustain, and grow their wealth. Family offices are the first line of defense to manage the various risks that wealth exposes families to. In addition to offering potentially a

wide array of services such as tax, fiduciary, and compliance needs; investment management, risk management, estate planning, and trust administration; philanthropic advisement and financial education programs for family members; and family governance and wealth transfer planning, the family office typically has a higher purpose to create continuity and cohesion for families around their wealth. Those who may be familiar with the concept of the family office may not know how to identify whether it is right for their families or their client families, and those questions are expanded in *The Complete Family Office Handbook* (Hoboken: Wiley, 2014).

In the United States, the Securities and Exchange Commission has increased oversight of the family office and enacted the Family Office Rule, which defines a single-family office as "any type of qualifying entity that provides investment advice to a single-family including traditional family offices and private trust companies."[5] The definition is still fairly broad, but the reality is regulatory bodies are also closing in on putting more definition around these organizations in order to monitor and track their advisory practices. What does this really mean? The increased scrutiny on Wall Street post-2008 has shredded the proverbial kimono from many family office outfits, requiring them to make a determination of the need to register. Although the exact number of family offices is not known, Family Office Exchange estimates that more than 5,000 families in the United States have family offices, and that there are at least twice that number embedded inside private operating companies.[6] This number is an estimate and no grounded research on family office has occurred in earnest due the fact that the definition tends to vary. Consequently, it is difficult to put too much weight on it, but data points on the ultra-affluent are available and Wealth-X studies indicate that there are approximately 211,275 ultra-high-net-worth individuals (UHNWIs) with $30 million or more in net worth.[7] (See Figure 1.1.)

In the family office market, a notable legacy of wealth has been spawned through entrepreneurship and business ownership. From the inception of wealth to generate significant returns in a privately held company to warrant the setup and creation of a family office to the evolution of the family office and its investments to hold onto or deploy additional capital into privately held investments—the role of the family office can vary dramatically. So what is the appetite of family offices and private investors in the direct investing marketplace? With the increase in the deployment of capital across the investment landscape, research for this book reveals that private investors, family offices, ultra-high-net-worth individuals, and qualified buyers have an increased interest and capacity to make sizeable investments across multiple sectors when it comes to directs. J.P. Morgan and the World Economic Forum

FIGURE 1.1 Wealth-X's World Map of Wealth



Source: Wealth-X *World Ultra Wealth Report* 2015–2016

in 2016 surveyed 81 families, of which three-quarters had a net worth of at least $1 billion. Collectively this group of family offices represented over $200 billion in global wealth. They learned that we asked how family offices put assets to work; 65 percent noted investing in direct private equity and real estate.[8] Yet, the question remains: Is the direct investment space a prudent space to invest?

The direct investment space is not a panacea for all family offices and private investors. It is fraught with pitfalls and unforeseeable risks; yet for many family offices whose time horizons will certainly outlive one or more generation's lifetime, these possible downside risks can be qualified and managed, as these investors have distinct characteristics that broaden the overall opportunity set. For example, family office investors may be able to generate adequate returns to cover lifestyle needs and expenses on more traditional investment strategies that afford them the opportunity to take high risk that can yield high-return capital into direct investments. In other words, they have a much longer-term perspective for an investment than a traditional strategy or fund might have, which allows them to invest at both ends of the spectrum.

Key to this investment model is that the investor will participate as an owner of the investment for the life of the investment. Many times the focus is spent on the upfront activities and little attention is given to the operating needs that will be required for many years. The questions to focus on are:

- Why are family offices more focused on direct investing? (The answer to this we discussed earlier.)
- What are the opportunities and risks?
- What are the key drivers?

The Opportunity

There is no doubt that the intrigue and interest in direct investing is perhaps at an all-time high. In fact, a *Forbes* article notes that individual private investors and family offices are the "rising power in the private equity," as private investors and family offices are increasing their commitment to private equity at a time of record low interest rates, attracted by the private equity opportunity for double-digit returns that are not correlated to their public stock portfolio. In fact, Palico research, the online private equity fund marketplace, found in 2012 that family offices "account for 8% of the world's $4 trillion in private equity assets under management. That family office

share is double that of just five years ago."[9] Virtually no investment or wealth management conference can refrain from discussing direct investments. The interest for investors, both private and institutional, is top of mind. The direct investment opportunity is attractive for many reasons. First, it may provide uncorrelated returns to traditional public market investments. Second, these investments have the ability to generate vastly larger returns than traditional publicly traded equities or bonds. Third, they tend to align with building and growing one or more businesses, particularly within founder family offices where the source of wealth was a function of starting. Direct investing for entrepreneurially minded investors becomes a logical outlet for deploying capital. And the opportunity of direct investing has several best practices learned and key considerations to assess its viability for each investor.

Best Practices

Over the many years of private investors engaging in direct investing, several best practices and lessons learned have been identified. Family Office Exchange (FOX) has captured their own list of best practices that they have gleaned from the Direct Investing Network (DIN) that they run for their active investor members. First, they found that investors lean to investing in deals where their capital gives them a strategic advantage. Perhaps they have first hand knowledge of a sector from prior business ownership and experience, or geographical or cultural experience, say, investing abroad, or perhaps they have an important peer group of investors or network that can bring a demonstrable edge to the investment. These advantages can be major considerations for where and how to put the family office capital to work.

Second, FOX identifies the importance to stay in "Circles of Competence," leveraging one's ability to be flexible. In other words, FOX sees a best practice to take advantage of their flexibility. From the check size to the deal size, the investor preference to the time horizon or sector, family offices, unlike PE funds or pension funds, are not governed with the same strict investment mandates. Third, FOX finds that family office investors have to make direct investment strategically and diversify them as their assets deployed in this area scale. FOX finds their family office investors have a strategic rationale for investing in the direct investment, but as the broader wealth of the family expands, so too should the diversity of the direct investment mandate and even the investment size.

Fourth, funds can play an important role particularly where the family office investor does not have expertise or access to market information. Although not all family offices will invest in private equity funds, for segments where due diligence, access to information, or direct experience in the sector is meager, PE funds can be a valuable tool in the investment toolbox. In conjunction with a broader asset allocation, PE funds can play a productive role for some family offices. Sara Hamilton shares, "For example, U.S. families often use funds for exposure to international or emerging market countries. Healthcare, pharma, or high technology sectors, where industry information tends to be highly specialized and barriers to entry are high, are other examples of areas where families emphasize their use of funds (or experienced co-investors). In addition, being an LP in a fund not only can provide you with valuable market information about where companies are transacting, industry trends, and market cycles, but can open up investment opportunities in an industry where relationships and information can be your most important assets."[10]

Further, FOX found that family offices should seek strong growth opportunities with high returns to the invested capital by the family office. They provide certain retail chains or franchises as an example of a model with highly positive unit-level economics and marginal returns for each new location opened. Family offices may find these investment opportunities attractive due to their asset intensiveness, stable cash flow, and replicable growth model. Another best practice FOX found is to utilize tax-advantaged structures whenever possible and preferable. Employing top tax counsel, family offices can own assets and manage them in a highly tax-advantaged manner relative to their overall portfolio of assets.

Another best practice FOX revealed is that there is an opportunity to capitalize on the changing demographics of wealth and business ownership. It is well documented that there is a sea change of wealth transitioning from one generation to the next; however, where has the most wealth in recent decades been created? Research from Wealth-X determined that 46 percent of wealth created in the last 20 years came from three primary sectors in the United States: financial services, real estate, and food service. Among these top three industries, 60 percent of business owners are over 65.[11] As family firms and business transition, there are great opportunities for direct investors into these domains.

Finally, FOX identifies co-investment with peers and partners with solid domain expertise as a best practice. A means to an end, co-investment is an important outgrowth of the interest in the direct investing space. Nate Hamilton notes, "For some families, it is a way to leverage capital, due

diligence, and sourcing capabilities within areas where they already have existing core competencies. However, several of the most sophisticated investors cited co-investment deals as opportunities to partner with families that know more than they do in a particular sector or industry."[12] The FOX report indicates that the industries where families seek to partner with co-investors include healthcare, technology, real estate, and energy. More on co-investment strategies is covered in Chapter 3.

Key Considerations

The best practices from Family Office Exchange highlight some invaluable lessons learned and align with several key considerations gleaned from the research for this book. The following section provides further considerations for deploying capital into directs. Because there is no crystal ball to forecast the future when it comes to directs, it is important for the investor to analyze and form an independent view as to why an investment will perform well before deploying capital. The most successful investors profiled in this book are able to create a tempered view of the potential positive outcomes of an investment and be very disciplined in forming a view as to why an investment will not perform as expected. Assessing, managing, and pricing risk is a daily function for direct investors. To follow are several key considerations for investors considering or deploying capital into direct investments.

Recognize that direct investing is not a cost efficiency for PE fund investments. Making a direct investment outside of a VC or PE fund many times will be costlier to the investor up front. Most independent investors decide between hiring full-time resources internally to lead their investments or hiring outside consultants or experts. Yet the rationale to invest in direct investments in order to reduce fees as justification to invest in this manner is fraught with folly. Chapter 2 explores further the direct investing landscape and specifically the family office's role in this domain. Chapter 3 provides a broader understanding of co-investment strategies and club deals and the strategic opportunities of collaboration with co-investors.

Be a learning investor and look to trusted, strategic advisors and co-investment opportunities for greater intelligence. Another important consideration attractive to certain family offices and private investors is that they often provide a unique insight and operational support for an investment. Following the theme that these investors have created wealth through successfully building companies in the past, direct investors tend to be very operationally minded

and active in a portfolio of operating companies. The term *value-added investor* applies to this approach where successful investors likely have cultivated a network of experts that can bring knowledge, advice, or step into an operating role or that provide a segment of the expertise that gives them deeper insights from operating experience than the lay investor. Many times we talk about the direct investors' "unfair advantage," or the fact that they have a leg up or superior intelligence of how to navigate a specific sector or strategy. What makes the investors' contribution of capital more attractive to a company or management team is the likelihood that the investors bring industry, market, product, people, investors, or lender relationships that the management team would not have access to on their own. When deployed effectively these value-added characteristics of the direct investor provide for a distinct advantage for a privately held company. Chapter 4 discusses the various private equity strategies and walks through the private equity life cycle.

Have a clear investment process and thesis. Where investors are planning to execute on a handful of deals in any given period, it is recommended for the investor to have a disciplined investment rigor where they seek input from internal and external experts and not bear the investment decision alone. In this situation the upfront work to get into an investment is significant and many times will drive up costs to hire industry experts to assist with due diligence. This is, however, money well spent if part of a process is designed to mitigate risk by picking the right investments, valuing them correctly, structuring the appropriate terms, and backing the right management team. Chapters 5 and 6 introduce the process of direct investing and how to develop an investment thesis.

Bet on the jockey, not the horse. This phrase denotes the importance of valuing the leadership and management above all else when considering any direct investing opportunity. This brings up the final point that the process of direct investing has two sides, the investor and the management team. There is a reason that the private equity market rallies around the cry of "bet the jockey, not the horse"—the "jockey" being management and the "horse" being the business or the sector. The operational risks for these types of investments are a major factor that may lead to a failed investment. But the management team also desires to have a quality investor the same way an investor requires a quality management team. Often the means to deploy capital may not be enough of a strategic advantage. Do their values, ethics, business acumen, leadership style, and experience match their role and the opportunity? There are incredible business opportunities all around us, but they may be all for naught if the key leadership is not the proverbial right jockey for the job.

In Chapter 7, the book investigates further sourcing, vetting, and analysis of a direct deal, and the due diligence on the leadership is also a key component of this analysis.

Pay attention to the terms and structure of the deal. No matter how much you may know about the deal and its opportunity, the key terms and structural considerations are where the rubber meets the road. Understanding which provisions are most important to you and why, where you fall in the cap table, and what your upside and downside risks are is critical when it comes to the deal terms and structure. Chapter 8 explores in more detail the "art of the deal" when it comes to structuring, terms, and portfolio construction.

Be prepared that direct investments are operationally intensive. There are a variety of considerations the family office and private investors need to take into account when considering direct investing. The single greatest risk to owning an operating company is execution risk. Execution risk is the risk that a company's business plans and thus the investor's associate capital will not be successful when they are put into action. The dynamic in the direct investing marketplace is one of collaborating with management teams who will be driving the day-to-day management of an operating business. These are investments that ultimately require significant care and feeding and it is very common that investors underestimate the scope of involvement required in making an investment a success. Despite going into an investment with the best intentions, there may be situations where a president or CEO needs to be terminated and, in particular with a smaller company, the investors many times will be the most likely candidate to fill the operational void when a decision like this must be made. Chapter 9 covers the operational oversight considerations, exit strategies, and how best to harvest returns.

Hire slow and fire fast. The difficult truth in the direct investing universe is that bringing on new employees in any business is not a sure thing. Take time to properly vet and conduct due diligence, background checks, and probe deeply into references before moving forward. Consider a first 90-day plan so that new hires are clear about alignment, goals, and metrics for evaluation. Conversely, when problems arise and there is a demonstrated pattern of infractions, do not fool yourself that somehow the employee will be turning over a new leaf. This is not the time to make excuses but rather to gather a plan for consequences and perhaps an exit. Personnel issues in direct investments can make all the difference with achieving intended growth plans. Chapter 10 provides some key insights on this front through the lens of the direct investing CIO.

Direct Investing means different things to different generations. Millennials are keen on direct investing; however, research indicates that theirs goals are not just about profits, but about progress. The desire to leave the world better than what they were born into is a common theme among the Millennial research, and they are finding opportunities through impact or socially responsible investing into directs a means. Chapters 11 and 12 explore the Millennials' role in direct investing, specifically impact investing and the SCIE model as a means to deploy impact-related investments into directs.

Direct investors are thinking globally, not just locally. Direct investing is more commonly done in your "geographical backyard"; however, increasingly investors are exploring more opportunities abroad to take advantage of dislocations in the marketplace. Yet, global direct investors beware—the bounty that exists is often connected to regulatory, cultural, legal, and international business standards unique to each geography. What applies for a direct investment at home likely does not apply when investing in emerging markets. Chapter 13 closes the book with insights, examples, and lessons learned from investing in directs abroad.

Direct Investing is not for everyone. Direct investing can be a roller coaster; from increases in operational intensity and oversight to disappointments with meeting milestones or requirements for additional follow-on capital. Despite writing a book about direct investing, we are keenly aware that direct investing is a niche, not the norm, and certainly not appropriate for most UHNWIs or family offices. Conversely, the majority of family offices should assess several considerations from risk to time horizon, to diversification, to appetite for volatility in a closed environment, to having to step into an active leadership role should the investment veer south. Thus, think long and hard before committing capital to this segment of private equity. A best practice is for family offices to ask the questions, "Does the direct investment strategy complement or play to the family office's strengths?" and "What ultimately are we attempting to achieve and for whose benefit?"

Conclusion

This chapter provides the basic tenets of direct investing, including the definition of direct investing for the purposes of this book and the background of direct investing. This chapter discusses the important wakeup call that 2008 provided and the ramifications it had on the direct investing marketplace. Further, this chapter more broadly defines the primary audience for

this book, the family office, and the role of the family office and private investors in direct investing. Finally, the chapter discusses the opportunity direct investing presents and some of the best practices when it comes to deploying capital into direct investments. The chapter closes with some key considerations for deploying capital into direct investments. Now that a foundation for direct investing has been formulated, Chapter 2 will expand on the opportunity, attractiveness, and broader investor considerations for the nuances of direct investing.

Notes

1. "The MoneyTree™ Report by PricewaterhouseCoopers and the National Venture Capital Association based on Data from Thomson Reuters" or "PwC/NVCA MoneyTree™ Report based on Data from Thomson Reuters," National Venture Capital Association 2015, nvca.org/pressreleases/annual-venture-capital-investment-tops-48-billion-2014-reaching-highest-level-decade-according-moneytree-report/.
2. Scott Bauguess, Rachita Gullapalli, and Vladimir Ivanov, "Capital Raising in the U.S.: An Analysis of the Market for Unregistered Securities Offerings, 2009–2014" (October 2015), www.sec.gov/dera/staff-papers/white-papers/unregistered-offering10–2015.pdf.
3. Brett Arends, "Six Lessons You Should Have Learned from the Financial Crisis: Are We Any Wiser Than We Were Five Years Ago?" (September 22, 2013), www.wsj.com/articles/SB10001424127887324665604579081223815849080.
4. Limited partners are limited to the extent of the partner's share of ownership, but also limited partners generally do not have management responsibility in the partnership in which they invest and are not responsible for its debt obligations.
5. www.natlawreview.com/article/sec-adopts-final-definition-family-offices-exempt-investment-advisers-act.
6. Barbara R. Hauser, "The Family Office: Insights into Their Development in the US, a Proposed Prototype, and Advice for Adaption in Other Countries," The Journal of Wealth Management 4 (2001): 15–22; M. Rankin, "Wealth Management: A Brief History and Evolution of Family Offices," unpublished white paper, presented at the Family Firm Institute Pre-Conference Wealth Advising Seminar, October 5, 2004.
7. *Wealth-X World Ultra Wealth Report 2015–2016.*

8. *Inside the Single Family Office Today*, an in-depth look at how some of the world's wealthiest families are managing their fortunes and legacies, conducted by J. P. Morgan and the World Economic Forum, 2016, p. 8.
9. Forbes 2015, www.forbes.com/sites/antoinedrean/2015/07/28/individual-investors-and-family-offices-are-the-rising-power-in-private-equity/2/#14bd1d363aaf.
10. Nate Hamilton and Sara Hamilton, Family Office Exchange 2016 whitepaper, "Private Capital Perspectives: The Emerging Presence of Private Capital in Direct Investing."
11. Fox Wealth Advisors Forum, 2013.
12. Nate Hamilton and Sara Hamilton, Family Office Exchange 2016 whitepaper, "Private Capital Perspectives: The Emerging Presence of Private Capital in Direct Investing."