Why direct investing into private equity is an attractive option for family office investors, notwithstanding the challenges

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By Rosalyn Breedy (pictured), Partner, Wedlake Bell LLP – Private equity is an important asset class for family office investors principally because of the potential to earn attractive returns in a low yield interest environment but also because as an alternative asset class the returns tend not to be correlated with the public markets.

According to The Global Family Office Campden Wealth Report 2019 which surveyed principals and executives in 360 family offices around the world, with an average of USD 917 million in assets under management: http://www.campdenwealth.com/article/global-family-office-report-2019

"Developed market equities produced an average return of 2.1 per cent for family offices; falling 5.2 percentage points below expectations.

Private equity fared the best of all asset classes for family offices, achieving an average return of 16 percent for direct investments and 11 percent for funds-based investing."

According to Prequin 2018 data out of an investor universe made up of 8,400+ investors, (up from 6,170 in 2015) fund of funds and public pension funds made up the largest groups of investors with 21 per cent and 14 per cent of the investor universe respectively but family offices are coming up fast behind making up 12 per cent of the investor universe.

Private equity investment by family offices faces a particular boost now because of the playing out of a global macro demographic trend with regard to wealth transfer. According to IQ;EQ White Paper "The Great Global Wealth Transfer" published July 2020: "Over half the wealth to be transferred by the entire population of those worth more than USD5m is to be transferred by those with more than USD100m in net worth (the 'family office' tier) and given the average age of transferors, a big chunk is likely to happen in the next five years, not the next ten."

Even though here are attractive return considerations which support the reason for inclusion of private equity into a family office investment portfolio. Family offices typically look to allocate only between 5-10 per cent of their strategic asset allocation to the private equity asset class. This is because of the negative factors private equity contributes to a strategic asset allocation. Namely, the need to rely on unverifiable valuation of underlying portfolio assets, the uncertainty of timing with regard to drawdowns and paybacks resulting in inefficient use of cash and the inability to rebalance easily the percentage allocation to the asset class if the allocation becomes overweight because of this.

These negative factors require a careful and limited approach to strategic asset allocation.

Furthermore, family offices other than the very largest, in practice struggle to deploy their allocations into private equity funds in a meaningful and repeatable fashion.

This is because family office individual allocations tend to be small within the overall size of the funds managed by the best performing managers which can mean that family office often struggle to get limited partner equivalent terms to institutional investors who can negotiate co-investment opportunities, cuts in fees and a share of the carry because of the sheer size of their allocation which of course means that the return the family office investor very often receives is less than the other investors.

However, on the positive side experienced family office investors who invest directly into private companies have found that they have an edge over the institutional investor.

Entrepreneurs, owner managers and family-owned businesses very often prefer to deal with family office investors. This is because family office investors are not constrained by the five- to seven-year life of the fund vehicle and are often willing to roll their sleeves up and add value to the business by serving on boards, introducing their network and in some circumstances providing useful business and sector experience and expertise gained from running their own businesses. Being an entrepreneur can also be a very lonely job and support from investors directors is often much more appreciated than investors realise.

"Campden's report shows that, 'In addition to capital, 72 per cent of family offices provide strategic guidance, 70 per cent participate on boards, and 70 per cent facilitate investment networking. Adding value in this way enhances value-alignment and can drive growth and returns for all involved as seasoned veterans guide entrepreneurs and their organisations through the turbulent start-up phases.'

Family office investors interested in private equity direct investment often look to take up opportunities to invest in business models that embrace digital transformation and innovative technologies such as robotics, automation blockchain and artificial intelligence as well as biosciences and clean energy. They are often prepared to invest very early stage and accordingly can seek to secure the edge on institutional investors this way and can in some cases generate outsize returns by moving up the risk curve.

However, direct investing is not without its challenges and family offices find that in addition to investing at the right price they have to hire in investment analysts to carry out the due diligence and financial modelling tasks in addition to developing sophisticated and robust risk management models to identify, monitor and mitigate the idiosyncratic risk associated with direct equity investing. Such risks are determined by the stage of the lifecycle, the appropriate incentivisation of the management team, ascertaining ownership of business-critical assets, the agreement between shareholders and debt providers and the performance of businesses in a pandemic.

Family offices looking to engage in direct investing need to ensure that they work with corporate lawyers and accountants who are efficient, effective and experienced in mitigating and dealing with private company issues from the beginning to the end of their lifecycle in addition to moments of change such as with joint ventures and mergers and acquisitions to ensure that they protect and secure the value of their investments.