

Family Office Insights

Direct Investing: A Continuing Trend Among Family Offices

Over the last several years, more and more family offices have been pursuing a direct investment or co-investment strategy for all or a portion of their alternative investment asset allocations, instead of making those investments through private equity funds. This trend is expected to continue across the family office spectrum. Recent surveys report that the majority of sizeable US-based family offices are currently engaged in direct investing and, increasingly, many family offices report that they prefer direct investments or co-investments to investments made through private equity funds.

This investment trend reflects the growing recognition of the potential benefits to family office investors from direct investments or co-investments. Direct investments and co-investments can allow a family office to reduce management fees and carried interest expenses payable to fund managers, thus providing the potential for higher returns, and can provide the family office with increased control of and transparency regarding the investments themselves.

That being said, direct investments can still pose challenges for a family office, particularly one that does not have its own internal investment team to provide the resources, expertise and analytical capabilities necessary to properly develop an investment strategy, source potential investments, negotiate the terms of those investments and monitor the investments once completed. Before engaging in direct investing, it is important that a family office take into consideration its understanding of the target industry, its ability to conduct thorough due diligence, its underwriting ability, and whether or not it has the expertise to properly evaluate potential acquisition opportunities and deal pricing. A co-investment strategy, in which a family office partners with a private equity fund sponsor and invests in a specific opportunity alongside the fund, is an increasingly popular alternative, as it can mitigate some of those challenges by allowing the family office to leverage the investment sourcing, structuring and negotiating expertise of the fund sponsor, often at an all-in cost to the family office (through structuring fees, management fees and the like) lower than the cost of participating in the investment through the fund as a limited partner.

Even in light of these challenges, many family offices are engaging in direct investments and co-investments and we expect that these strategies will continue to be a focus for family offices in the future. As the family office sector continues to develop and mature, market studies indicate that family offices are now much more likely to engage internal investment professionals to assist them in sourcing and vetting alternative investment opportunities. In addition, as the sector continues to become increasingly visible in the deal community, we are finding an increasing acceptance of – and often a preference for – family office buyers among potential sellers of privately-held businesses and their advisors, as family offices are often seen as a hybrid between the traditional categories of “strategic” and “financial” buyers.

In many cases, this is because family offices are viewed as combining the ability to bring their own industry expertise to the target company in the way that a strategic buyer would, but with the potential for flexible transaction structures and the ability to retain ownership and maintain management participation that are features of “traditional” private equity transactions. Family office investors are also often seen by potential sellers of privately-held businesses as attractive acquirers as they typically do not have the same investment timeline as private equity funds do, and thus can position themselves as being “long-term” investors, which can be an appealing alternative for business owners who are concerned about the future prospects for their management, employees and communities.

Family office investment professionals considering a direct investment or co-investment strategy need to have a clear understanding of the family's financial return goals, risk tolerance and how those investments will fit within the family's current portfolio. Family decision-making dynamics can be significantly more complex when evaluating this class of alternative investments, compared with the pursuit of a traditional asset allocation strategy and the allocation of capital to investment fund sponsors, as a family office's engagement with a direct investment or co-investment will typically require significantly more on-going participation by family members or the family office investment professionals.

As direct investment activity is on the rise for family offices, it is creating opportunities for investment professionals and opening up a new universe of potential buyers for sellers and their advisors to pursue and evaluate. While not without challenges, a successful direct investment or co-investment strategy can be a profitable component of a family office's overall investment portfolio.

Please contact your principal Squire Patton Boggs lawyer or either of the lawyers listed in this publication for additional information or for help on these matters from our global Family Office Services team.

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