Insight: The family office as private equity investor

By Mark S. Greenfield and Garry J. Padrta Jr. — September 4, 2020

Norton Rose Fulbright attorneys examine the pros and cons of taking the direct private equity plunge, including the potential for great rewards. They predict the trend among the largest family offices will continue toward actively-managed, direct private equity investing.

Private equity has integrated itself into the fabric of the global economy, riding a near decade long run of unprecedented performance. Although not immune from periodic economic slowdowns, one should expect private equity to remain resilient through present and future instability.

Family offices have bet big during private equity's ascent, allocating increasingly larger portions of their portfolios to PE. That bet has paid off, generating far superior returns relative to other asset classes. While returns may flatten somewhat, family offices expect to stay the course with PE for the foreseeable future.

While the trend of family offices migrating toward PE is noteworthy, the realignment in how many are doing it is compelling. With few exceptions family offices historically accessed private equity by investing passively in a fund controlled by a sponsor. Recently, however, many have detoured from this familiar route, actively managing investments in privately held enterprises directly. According to UBS/Campden Wealth's 2019 Family Office Report, family offices are allocating a greater aggregate percentage of their portfolios to direct investments than to traditional PE funds, while enjoying a material premium in ROI.

These results tell a story that's hard for family offices to ignore; actively managing investments in private enterprises is an option worthy of consideration. However, there remain pros and cons to direct versus fund PE investing.

Appeal of active private equity investing

The primary appeal of active private equity investing lies at the bottom line. Family offices must manage an ultra-wealthy family's entire investment portfolio, which requires prudent diversification. Because the private equity landscape is both specialized and competitive, sponsored funds offer a classic principal-agent solution, allowing family offices to invest in the private equity asset class by relying on experienced fund sponsors to manage invested capital. The price tag for that solution while steep—typically a 2% management fee, and a 20% performance fee—has been worth paying. Fund sponsors have access to deal flow, professional management, and, critically, a track record of delivering significant returns on investment.

With family offices managing unprecedented amounts of wealth and becoming more sophisticated and professionalized, some have found this solution less compelling. For family offices reaching critical mass, which Bloomberg News suggests amounts to approximately $500 million in capital under management, it can be more cost effective to manage investments directly. As UBS/Campden Wealth reports, family offices making such investments have done so paying an average total expenses of 1.17% of AUM, which can equate to millions of dollars in savings by forgoing the sponsor's fee, and without sacrificing performance.

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Fund investing may be better for many

But is it right for all? What are the challenges and the risks? Actively managed PE investing is not a one-size fits all solution as the private equity sandbox can be quicksand for the uninitiated or unprepared.

Success in direct private equity investing demands overcoming significant information asymmetries, e.g. identifying potential targets, evaluating their prospects, determining price and measuring risks. As the 2019 Family Office Exchange survey reports, the top barriers cited to direct PE investing are: (1) deal pricing, (2) due diligence, and (3) deal sourcing. Demand for attractive investments far exceeds supply, requiring investors to manage the aforementioned obstacles effectively while competing against myriad other sophisticated parties, including fund sponsors, chasing the same deals.

As such, the family office with the requisite financial capacity, yet remains deterred by these obstacles, may be wise to refrain from jumping in. For those investors, the familiar route of fund investing or the growing trend of co-investing may remain preferable alternatives.

Going the direct path

Notwithstanding these challenges, numerous reasons suggest the family office with the requisite capacity can be up for the task. For example, while family office heads who generated wealth through entrepreneurship may not have the same pedigree as a PE sponsor, they may have personal, specialized industry expertise or network that a professional PE manager may not. In the right circumstances, family offices can monetize such intellectual capital to grow investments or identify opportunities others miss.

Additionally, fund sponsors owe fiduciary duties to their limited partners and generally must obtain investment committee approval prior to investing. A sponsor may thus be more risk adverse or face additional investment restrictions as contrasted from the family office of a single ultra-high net worth family.

Finally, family offices can offer more flexible investment terms than their sponsor counterparts. Private equity funds generally deploy capital, increase value, and exit an investment during a three to five year time horizon that often necessitates acquisition of control. Family offices, in contrast, can employ longer-term investment objectives. Consequently, they can accommodate an entrepreneur's desire to avoid the pressure of a quick flip, or wishes to retain control. The family office thus may offer an attractive investment alternative that traditional PE funds often cannot.

The most critical first step to "going-direct" is assembling the right team. By acquiring the talent of experienced internal private equity managers, family offices can adopt many of the structures private equity sponsors utilize to successfully overcome the discussed barriers to entry. Further, a strong team of well-connected external advisers, including M&A legal counsel, can help source attractive deals, maximize returns, and identify and mitigate investment risk. With the right talent as a foundation, family offices with the requisite capacity can position themselves to compete in the private equity arena.

Given the aforementioned statistics, structural incentives and advantages, we anticipate the trend among family offices will continue toward actively-managed, direct private equity investing. Those family offices considering throwing their hat in the ring may wish to board the train before it leaves the station. As a recent McKinsey report notes, the private equity investors most likely to thrive in market cycles are those who strike early on available opportunities. While PE fund investing remains the viable approach for many family offices, those prepared to take the plunge likely will find direct investing, although not without additional risks, may yield greater rewards.

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