Family Office Direct
Investments & Co-Investing

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Introduction

Family offices have a long history of direct investments, especially ultra-wealthy single family offices managing billions of dollars. Today, exceptionally affluent families frequently make direct investments in operating businesses, real estate properties, hard assets, and many other asset classes. In the aftermath of the financial crisis, many family offices were forced to reevaluate their allocations to third party investment firms.

Investment firms, from private equity funds to hedge funds, are coming to grips with this new reality: investors are increasingly looking for alternatives to the standard fund model. For decades, limited partners have willingly paid the industry standard expenses of two percent management and twenty percent performance fees (and even higher fees to invest in the top quartile funds). In recent years, however, many family offices have investigated alternatives to the standard investment fund structure such as direct investments outside of a fund, co-investment rights to invest alongside a fund, and club deals with other family offices and investors.

It would be wrong to suggest that family offices were not already interested in preserving capital, managing risk, and minimizing fees and expenses. However, the falling asset values and extraordinary volatility in the financial markets led almost all investors to question their investment strategies. There has always been a tension between LPs and GPs over fees and that tension hit a new high when losses piled up and investors continued to pay fees to outside managers. One of the consequences of the financial crisis is a heightened interest from investors, including family offices, in finding new ways to allocate capital while reducing fees and exercising greater control over their investments. Co-investments, club deals, and direct investments offer family offices a path toward lowering fees, gaining greater control on their investments, developing in-house investing capabilities, and diversifying their portfolios.

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Co-Investments

It is wise to first answer a common question: what is co-investing? Co-investing typically refers to when a limited partner invests directly with a general partner in a company or project, thereby allocating capital indirectly through the fund to the company but also directly to the company via the co-investment. This most often occurs with private equity funds, but there are also a number of real estate investment firms that offer co-investment rights to family offices. Co-investment rights may be offered to fund investors as a way to invest additional capital to a specific deal in which the investment fund is investing. The benefit to the investor is that this co-investment allows for a greater allocation to a specific company, often with minimal fees. In past years, that additional capital investment might have been part of the total capital commitment to the general investment fund. Institutional investors who have spent years developing their in-house investing expertise are now better positioned to invest confidently in deals that are particularly attractive. If a single family office has an experienced deal team, as many large single family offices do, the team might identify a specific company that makes sense for a co-investment allocation.

Speaking generally, there are two main types of co-investments: direct and indirect. In a direct co-investment, the co-investor will make an allocation directly into the portfolio company, manage that investment from the initiation to the exit, and negotiate terms of the investment with the company itself. Indirect co-investments are more likely to be structured differently, reflecting characteristics of the investor and the company. Indirect co-investment will most often occur under a Special Purpose Vehicle (SPV) where the co-investor allocates capital to the company via the SPV and then the investment is managed under that SPV, although co-investments may be made under different structures such as limited partnerships and LLC’s, depending on the tax treatment of the vehicle. Alternately, an indirect co-investment can be made through a fund, which could aggregate multiple co-investments, rather than a singular investment through the SPV. Of course, there are many different features of both indirect and direct co-investment structures and numerous considerations for co-investors, all of which should be evaluated with proper legal or investment counsel (Pepper Hamilton).

Thus, in a co-investment, a family office will typically make an allocation alongside the investment firm directly in a company, rather than simply making an allocation to the fund which may then be diversified across multiple portfolio investments. A common scenario that illustrates this distinction is when a private equity fund grants co-investment rights to a single family office. If that fund is investing in a company to take it private for $10 billion, then the fund may carve out a $500 million piece for the single family office to invest directly alongside the fund, rather than through the fund as a traditional LP. The benefit to the SFO is clear: the investor can invest directly, thus circumventing the typical fund structure and at least some of the fees that cut into its return on investment. But the investor still captures the benefit of having the private equity fund’s
management source, assess and monitor the investment and provide the majority of the capital on the investment. If the single family office were to try and invest independently without the private equity fund it would have to find the right company to invest in, come up with sufficient capital or financing to execute the deal, persuade ownership to accept the investment, perform due diligence on the firm, manage the investment and ultimately exit with a profit that justified the exceptional sweat equity and resources put into the deal. Thus, one can see why investors are pushing fund managers to allow these co-investments.

On the other hand, it is easy to understand why fund managers have been reluctant to allow co-investments. General partners have resisted the inclusion of co-investment rights for a number of reasons: the co-investment adds a layer of complexity to the fund; the general partner sacrifices capital that would have been invested under the standard fund vehicle and instead receives that capital through the co-investment structure; other limited partners in the fund are more likely to request similar arrangements; and by allowing co-investments, the general partner encourages future co-investments and direct investments by investors.

We recently recorded a webinar on Co-Investing for the Family Office Club and the Qualified Family Office Professional (QFOP) training program. Our featured guest Julia D. Corelli, a Partner at law firm Pepper Hamilton LLP, shared her insights on the co-investing trend. As Ms. Corelli explained, co-investments occur for a number of reasons. Co-investors may be brought in after the close for strategic reasons, for relationship reasons, or because the portfolio company needs the investment. For example, when a portfolio company requires additional capital, the private equity fund may approach family offices and other partners for an injection of capital in the form of a co-investment.

As we alluded to above, family offices are demanding co-investment rights for many of the same reasons that fund managers have historically opposed the model: LPs hope to use co-investments to reduce overall fees on investments, manage more investments internally, gain more control through investments in companies, and gradually establish an in-house investment platform. Family offices making co-investments may be able to avoid paying many of the fees associated with traditional fund allocations. While some of the costs specific to the co-investment may be shared with the family office, fund sponsors may be expected to forego management and performance fees on co-investments. This expectation is based on the understanding that the co-investment is piggy-backing the work already done by the firm in developing the strategy, sourcing and evaluating the company and therefore the same fees should not be charged to co-investors and this concession is often viewed as a reward for investors. The economics of co-investments will vary depending on the GP-LP relationship, the expenses incurred by the fund sponsor, the level of involvement by the LP, the structure of the investment, and many other factors (Pepper Hamilton).

One reason that private equity firms are starting to embrace co-investing is that it is a “necessary evil” for wooing some investors. In many capital raising campaigns, family offices will use
the recent fundraising dry spell as an opportunity to bargain for better terms from private equity firms. A family office that is approached by the investor relations or marketing team might see the chance to secure co-investment rights and set that precedent with the fund. This is an important concession to investors, and GPs are more likely to acquiesce if the investor is likely to make a substantial capital commitment in the fund, as well as the additional co-investment, and if the investor is unlikely to participate in the fund without the co-investment rights. Fund managers are increasingly forced to “pick their poison” as to whether they will allow the co-investment (or substitute other concessions like lowered fees, greater liquidity, more flexibility, etc.) or risk losing a large capital commitment and even the ending of the relationship with that investor. For those funds who have established a tremendous performance record of late, the decision is likely less difficult because meeting the fundraising target is a fairly easy task.

For one of the many funds that suffered significant losses during the crisis, co-investment rights can even be encouraged to sway wary investors burned by past allocations to the fund. Indeed, co-investment-focused funds have cropped up more as of late, with well-known private equity firms like Pantheon launching funds that encourage co-investments. In November, Pantheon filed documents with the SEC that showed the firm had raised $400 million from 11 investors in its Pantheon Global Co-Investment Opportunities Fund II (AltAssets). It is a difficult time to raise capital for new funds especially, so we have observed many private equity firms turning to co-investments to establish a unique value proposition for investors in hopes of luring away LPs from larger funds which often have less flexibility and stiffer fees. Our team spoke with one private equity firm CEO who was having trouble raising capital from investors and he noted that creating a co-investment vehicle for investors was an attractive option that his team was pursuing in order to draw in reticent LPs and compete for capital with the larger players who may be less likely to accommodate co-investment demand, especially if the investors making the request are smaller. At a recent Family Office Workshop hosted by the Family Offices Group, single and multi-family office executives cited co-investments as a very appealing component of any private equity investment, especially for those larger single family offices with an experienced investment team capable of handling the additional responsibilities.

Single and multi-family offices are increasingly looking to bypass traditional fund vehicles or at least lessen their investments through these structures. A co-investment is an attractive solution to family offices looking to invest directly without foregoing all of the benefits of the usual investment fund structure and without committing too much capital to a single investment. If a family office can utilize a fund’s deal sourcing, due diligence and operational capabilities while still making a sizable direct investment in the target company, then it is in some ways the best of both worlds for the family office.
Club Deals

The term “club deal” is often used interchangeably with co-investments but the two structures are very different. In some ways, a club deal resembles a co-investment and also a direct investment because club deals share characteristics of both types of investments. The practice of club investing has fallen out of favor in recent years among investment firms but club deals are gaining some popularity with single family offices like Michael Dell and his single family office MSD Capital or the Rothschild family in Europe.

As we did with co-investments previously, it is helpful to define a club deal. The definition of a club deal (as it relates to this white paper) is an investment made by multiple investors to buy a private business whole or at least acquire a substantial stake in the company. These investments are made directly in the company and each of the club “members” will contribute capital to the deal and typically receive a proportional share of the profits or losses on the investment. Investors might make the acquisition for strategic reasons, such as when a corporation collaborates with private investors to acquire a competitor or synergistic business. For other club deals, the transactions are essentially private equity deals where the investors identify an attractive buyout target and pool funds between a small number of other LPs to purchase a company with an eye toward selling it again for a profit after several years of improving or expanding the business. There are numerous examples of club deals where the partners are wealthy families buying a real estate property or an operating business and continuing to hold that acquisition for many years and harvesting the profits long-term.

Similar to co-investments, these deals may require a “lead” investor for the investor syndicate. The lead typically sources the deal and performs the necessary valuation, due diligence, and negotiations to complete the deal. In this case, other investors in the club deal are acting more like limited partners in a limited partnership fund where their primary role is providing capital and their reward is a share in the profits on the deal with a greater portion going to reward the lead investor, even if the deal is a single transaction outside a fund structure. Family offices are exploring club deals more and more as a way to lower investing expenses and assume greater control over deals. Club deals, like direct investments and co-investments, allow investors to allocate a specific amount of capital to an investment in a single company. This is an especially attractive feature for family offices that have been frustrated by a lack of discretion over their exposure to the various companies in a third party fund’s portfolio.

There are a numbers of differences between club deals and co-investments. While the structure often varies for co-investments based on a variety of factors, investors in a club deal generally come into the investment under the same structure. Club deals are more pre-mediated, with parties agreeing on terms and structures for the transactions in advance. A co-investment, on the other hand, is often an added feature on a deal and tends to be structured more opportunistically.
In private equity and real estate, multiple firms might team up for one club deal to acquire a massive set of rental properties or a large company. These club deals happen with multi-billion dollar acquisitions where several top buyout firms will bid for a company like Hertz, Freescale Semiconductor, ClearChannel, or Energy Future Holdings—to name a few big private equity club deals. In the years leading up to the financial crisis when billion-dollar buyouts were fairly common and financing was more readily available for these “mega deals,” private equity firms routinely teamed up to bid on large companies that would be difficult for any one firm to buy. As LPs, many family offices opposed GP-only club deals because many of these club deals resulted in extremely large deals and increased the fund’s exposure to a single large deal (especially when an LP had invested in multiple GPs in the deal), rather than diversifying the portfolio across several moderately sized, unique investments. Ironically, the club deal model has now been embraced by family offices in pursuit of lower fees, greater returns, and more control over investments.

Of course, when an LP is teaming up with a buyout firm on a club deal, there is an advantage for the investment firm in having a partner on a deal that is not a direct rival. The trend has allowed several large buyout firms to benefit from limited partners’ participation in club deals, such as when the Ontario Teachers’ Pension Plan and Chicago-based buyout firm Wind Point Partners teamed up for a buyout of Shearer’s Foods in 2012 or the 2006 mega-buyout of Hospital Corporation of America by a group of private equity firms and the Frist family clubbed together for a multi-billion dollar acquisition of the hospital company, resulting in the Frist family acquiring a 12 percent stake in the company (Wall Street Journal). Minority investments like the Frist’s HCA investment are common in the family office space, although they often involve less high profile acquisitions and more small to middle market operating businesses or properties.

Club deals are a frequent topic in the conversations our company has with family offices in recent years and many single family offices are still testing the waters, learning more about how club deals are structured, looking into the potential risks and conflicts that might arise, and evaluating the merits of the model. We expect increased club activity as family offices become more familiar with club deals and better understand when a club deal makes investing sense. At this point, the complexities and risks involved with club deals have made this structure less attractive to the majority of family offices compared to co-investments and direct investments, although it is important to monitor this trend as family offices develop stronger investor networks and continue their search for alternatives to traditional private equity allocations.

Direct Investments

After years of letting fees cut into the returns from private equity investments, some institutional investors are increasingly looking to direct investments. Direct investments allow the investor to exercise complete control over the investment and manage all of the deal processes.
internally while keeping all of the profits. For smaller deals, direct investing is an effective way to buy a stake in a middle market company, purchase real estate properties, and make allocations toward unique opportunities.

Of course, a direct investment is not exactly a revolutionary concept; family offices have been investing directly for centuries. But the financial crisis and the losses on many investments have led some institutional investors to look for returns internally, rather than relying on a third party manager and surrendering a fifth of the profits to that fund sponsor. Family offices, especially single family offices, are allocating more capital towards direct investing today than ever before. The ability to directly control real tangible assets, further influence an industry they already understand, and avoid fund management fees is driving interest in this area.

In the past, a family office might have relied on external fund managers for its equity holdings, real estate allocations, hedge fund investments, and other parts of the portfolio. Now, family offices are increasingly working to cut out external funds where doing so makes sense in order to keep investments in-house and rely on the family's own investment team. The mass layoffs in the financial services industry supplied ample talent to family offices looking to develop their in-house investing capabilities. Many $1 billion+ single and multi-family offices now employ investing professionals in multiple cities around the world with expertise that rivals that of professionals employed by leading banks and investment firms.

These direct investments do not only occur in the real estate and private equity spaces, but we have met many single family offices that have developed a custom hedge fund-like investing solution that is tailored to what that family wants in an investment product. Often these strategies resemble various common hedge fund strategies but the trading is done internally by an investment team that can take into account the family’s other allocations and the long-term goals of that investment portfolio. These trading operations can be expensive to manage and fees paid to brokers and consultants can certainly add up, but many family offices have been able to achieve impressive returns while keeping entirely for the family and to use as compensation for the in-house team. Not every family office has the team, the expertise, and the interest to justify the expenses, compliance headaches, and risks of running an in-house investment fund, but we expect those who do to continue to move away from the third-party model when it is possible to develop an internal team.

A direct investment, as opposed to co-investments (which are typically passive), requires substantial work by the investor. All of the functions that would be performed by a GP under a traditional investment must now be done by the LP. The family office is responsible for sourcing the deal, a tremendous challenge for any investment fund and more so for family office that lacks the fully-developed network and contacts that GPs have spent years cultivating. Our firm is often approached by single and multi-family offices that are looking for proprietary deal flow for direct investments. LPs are growing their deal channels but this remains an obstacle for many investors.
Another challenge for investors seeking to invest directly in companies or properties is the amount of due diligence work required to effectively make an investment. The valuation process alone can be exceptionally taxing and requires many weeks of high-level work. For smaller family offices, it makes little sense to retain expensive and skilled analysts and financial professionals when their deal expertise might only be needed a few months out of the year. Even at the larger pension funds and endowments the costs of retaining private equity professionals in-house can be too high and that work might be outsourced to expensive consulting firms (undermining the logic behind doing investments internally). The valuation and due diligence work are especially tough to swallow if the process does not ultimately lead to an investment, as is frequently the case when screening potential deals. Once an investment is made, the family office then has to take on the constant burden of monitoring the company, evaluating the investment, and working directly with the company’s management team to improve performance and make whatever changes are required to generate returns on the investment.

The Ontario Teachers’ Pension Plan is one of the most famous examples of a successful direct investment program, having made its first direct investment in 1991. But even this oft-heralded direct investor struck out on its very first deal when the company it invested in, White Rose, went bankrupt and the fund lost its whole investment. This was a harsh blow to a first-time direct investor and illustrates why many finance professionals warn against direct investing, even by large institutional investors. Fortunately for the Ontario Teachers’ Pension Plan, the pension’s board allowed the fund to continue its direct investment program and to learn from its first investment. As Jim Leech, President and CEO of the Ontario Teachers’ Pension Plan, told a CFA Institute audience in a speech this year, “Perhaps due to the White Rose lesson, we took our time – more than 10 years – in building the talent and infrastructure to prudently invest directly, first in Canada, then the US and now globally.” Now, the pension fund is a shining example of the success and rewards for those who manage to make direct investments effectively. The benefits of this program for the Ontario Teachers’ fund have been tremendous. The fund can exercise its own risk controls, manage the investments internally, and importantly, the fund achieves exceptional cost savings on its private equity investments. As Mr. Leech explained in his speech:

. . . One of the key benefits of “going direct” is lower cost. Think about it, a successful private equity investment via a fund will cost the investor 6% per annum. Our private equity costs are way below that and yet our net returns are in the top quartile.

Assuming that the differential is 5%, that means that our $20 billion Private Capital portfolio will, on average, earn an extra billion dollars per annum compared to investing through the best performing funds – enough to pay over 25,000 pensions each year.

Our Internal rate of return on our Teachers’ Private Capital direct investment department, for example, is nearly 20%. Why? Because we have our own internal
investment deal teams – we have about 50 investment professionals. This means we don’t have to rely on high cost, third party fund managers. (OTPP)

Family offices looking to develop internal direct investment programs should take note of the example set by Mr. Leech and his Ontario team in developing a private equity program. While it has a happy ending with a successful direct investment program, the story is also a cautionary tale, as you can see in the case of the White Rose deal, direct investing may require accepting some trial and error. If a family office is unwilling to invest the time, energy, and money into developing a competitive direct investment program then the investor is better off focusing on fund manager evaluation and due diligence and securing the best possible terms on its allocations.

Challenges to Family Offices

When presented with this “new era” scenario where co-investments, club deals, and direct investments are increasingly popular with family offices and other investors, many investment fund managers offer a number of reasons why this trend will not result in major changes. For one, co-investments and direct investments are not simple to execute. Private equity and hedge funds are paid exceptionally lucrative fees but those fees pay for very real expenses incurred from managing portfolio companies, developing proprietary trading strategies, structuring deals, compensating lawyers and service providers, paying highly-skilled professionals, managing risk, complying with many different regulations, and other costs. Investors may avoid paying some fees to third party managers, but ultimately those savings will be reduced by the cost of managing that alternative investment.

Another immense challenge to investors is simply identifying the deals or creating the strategy. A family office may simply not be invested in funds that offer co-investment rights or may not be interested in committing to a co-investment in the funds that do offer this feature. As any private equity executive will tell you, one of the toughest parts of private equity is finding an attractive deal and a willing seller. Our firm works with a number of family offices and they are consistently searching for qualified deal flow in specific sectors and revenue ranges. In many cases, these family offices do not have a consistent pipeline of deals and they often express frustration at their inability to source deals effectively and consistently. We have spent years developing relationships with investment bankers, business executives, industry professionals, and investment firms to help family offices better access proprietary deals. Co-investments offer investors some access to deals, but it takes many meetings and extensive research to identify attractive deals in the areas that investors really want to allocate capital. Private equity firms and established real estate investors continue to have a strong advantage over many investors who are just now developing in-house deal sourcing operations.

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On the hedge fund and trading side, most hedge fund professionals will tell you that a big challenge is finding a unique strategy that continues to outperform. A family office can develop a trading strategy or employ a good stock-picking team, but it might be the case that the ends do not justify the means. It might be too expensive for families if the internal unit fails to produce exceptional returns that justify the added complexity, the internal management challenges, the compliance costs and headaches, and all of the expenses incurred while running a hedge fund solution in-house.

**Conclusion**

There is certainly skepticism from investment professionals over whether many family offices can successfully develop direct investment programs. However, as we have seen over the years, many family offices can adapt to changing investment climates and develop new investing approaches to meet the day’s challenges. Direct investments, co-investments, and club deals are increasingly attractive solutions toward family offices’ goals of preserving capital and achieving consistent returns on investments.

In conclusion, these alternative investing structures can provide transparency and a potential upside rewards for taking control of a family’s investments without a layer of fund management fees, but it comes with risks and the responsibility of conducting deep due diligence and monitoring on that investment portfolio. The demand for co-investments, direct investment deals, and club deals shows no signs of slowing down and fund managers will learn to live with this new reality as more family offices become comfortable with these investments. Family offices will continue to investigate co-investments, club deals, and direct investments with an eye toward developing greater in-house investing capabilities and taking greater control over the portfolio.

I hope that you enjoyed this concise white paper. If you would like to learn more about the Family Office Club, please visit [FamilyOffices.com](http://FamilyOffices.com), download our free report at [FamilyOfficeReport.com](http://FamilyOfficeReport.com), or grab a copy of our book *The Single Family Office Book*. We are also hosting a full-day conference on this very topic in New York City on June 27th, 2016 with top family offices speaking: WilsonConferences.com/Deals

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