DIRECT INVESTING (PART III): TIPS FOR SETTING A PROGRAM UP FOR SUCCESS

May 2019

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NEPC Private Wealth

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Direct investments—a strategy popular with institutional investors—are also appealing to high-net-worth clients because they not only eliminate the fees associated with commingled fund investments, but can provide better alignment with the values and mindset of the investor.

However, it is challenging for wealthy individuals and family offices to compete with the experience, intellectual capital and the deep network of relationships forged by a private equity firm. As a result, there is little evidence to show that they outperform corresponding private equity fund benchmarks. The performance of direct investments is further diminished when the estimated costs of running such a program are factored in. The good news is that the thoughtful structuring and the focused implementation of direct investment programs can help in setting private clients up for success.

For a family office, a direct investment represents an investment in a company or asset which is a standalone investment or a co-investment (an investment made alongside a lead investor). This compares to an indirect investment where the family office is relying on the expertise of an intermediary—commonly known as a general partner (GP)—to make an investment in a diversified fund structure, typically charging management and performance fees.

In this final installment of a three-part series, we discuss some factors to keep in mind while developing a direct-investment strategy. This follows our paper last month, where we examined the performance of direct investments relative to both private fund structures and the public markets; and part one of the series, which focused on trends in direct investing and the motivations driving private clients. When developing a strategy, consider the following:

- **Direct versus GP-led fund investments:**
  These should be considered complementary rather than mutually exclusive. Chances are the expertise a family office brings to the investing process does not cover the universe of opportunities; investments in GP-sponsored fund investments can enhance diversification.

- **Active versus passive direct investing:**
  Being a board member or an active investor involved in the business will likely provide more control at the expense of a more concentrated portfolio; this may be worthwhile if it aligns with the family office's investment skill set and organizational structure. Passive direct investments, where involvement is limited once the investment is funded, offer some implementation ease at the expense of loss of control.

- **Buyout versus venture capital:** A study[1], published in 2014, showed that the likelihood of direct investments falling short of their private equity counterparts is greatest when a unique skill is required, for instance, in the case of venture capital funds when there is a premium on access to information. Direct investing in venture capital seems to be particularly challenging given the required domain expertise and the high failure rate of companies in this space. To this end, buyout-focused investments will likely be a better area for most family offices.

- **Co-investments versus standalone:** Co-investments seem like a natural first step when developing a direct-investment program. The advantage of co-investing is leveraging the underwriting work of the GP. The challenge is to avoid the potential anti-selection bias and the risks tied to too much capital being allocated to a specific deal or sector. These situations are typically associated with accelerated timelines and the co-investor is usually passive.

- **Sector-focused versus generalist:** Certain transactions, such as those involving life sciences and technology, require both business acumen and technical expertise, and may be better suited for family offices with a strategic focus and domain expertise. Other industries may be less specialized, and the broad perspective of skilled generalists may provide an adequately strong foundation.

- **Internally-resourced versus using external resources:** Family offices can resource a direct investment internally or utilize third-parties to assist in a variety of functions, including market analysis, valuation support, legal and tax reviews. The key is to have a keen understanding of your own strengths and weaknesses.

- **Investing alone versus with others:** Investing with others may offer additional insights into the due diligence process and provide the opportunity to share resources and expenses. However, you may need to come to an understanding with your fellow investors on key issues, including the sharing or division of costs and resources, the level of involvement of each party, and how each will deal with success or failure.

It is vital to hone in on the competitive edge or differentiated approach that you will bring to each investment.

For family offices contemplating a direct-investment program, we offer the following suggestions that we believe can help set you up for success:

1. **Don't skimp on the due diligence:** At NEPC, when we evaluate investments, we develop a thesis that supports the sustainability of a manager's long-term performance. A family office should hold itself to the same standard. To this end, a focus on the potential fee savings is not enough; it is vital to hone in on the competitive edge or differentiated approach that you will bring to each investment. The nature of direct investments–individual investments in companies compared to an investment in a fund–magnifies the importance of risk management tied to idiosyncratic risks that create the potential for asymmetrical results. If you lack domain expertise or find yourself at a competitive disadvantage, seek the help of skilled third-parties or avoid investments in that space.

[1] *The Disintermediation of Financial Markets: Direct Investing in Private Equity*. Lily Fang (INSEAD), Victoria Ivashina (Harvard University and NBER), Josh Lerner (Harvard University and NBER, September 3, 2014).

2. **Sound governance:**
   Put systems in place to ensure you avoid chasing deals and that support a thorough due diligence process. These include establishing and monitoring milestones and streamlining decision-making around the potential deployment of additional capital into a company when another round of financing is needed. At the time of the initial investment, it is important to know the capital needed to achieve the exit milestone as not participating in additional rounds of financing could lead to dilution of intended returns.

A sound governance structure is a key element of success to help evaluate opportunities, deploy capital, and establish and monitor milestones.

3. **Watch out for blind spots:**
   Understand your own bias and weakness, and avoid operating in a vacuum where they can impair the decision-making process. To avoid regret down the road, make sure the size of the investment is appropriate, the organization is equipped to deal with challenges associated with the investments, and the investment program is designed to complement your other portfolio holdings.

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