Home field advantage

Leveraging your family's strengths to maximize risk-adjusted returns in direct private equity investments

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While portfolio management dominates the conversation of most family office conferences, the reality is the majority of Latin families generated a significant amount of their wealth— and continue to maintain large ownership interests—in directly-owned, privately held companies. As the local capital markets often lack depth and transparency, direct ownership is frequently the only functional option for investing in the region. While family ownership structures provide other ancillary benefits, superior returns can be achieved relative to passive fund investments. However, success requires a structured approach to investing and a differing array of capabilities from the skillsets most traditional family offices cultivate.

Families choose to actively invest in operating businesses for a wide range of reasons, including:

- Maximizing financial returns
- Maintaining a greater sense of control
- Remaining active (i.e. desire not to "retire")
- Guaranteeing a source of employment for family members
- Achieving social impact

Assuming that achieving superior returns is the primary objective, the decision to invest in deals directly versus through institutional private equity funds should be based on which entity can generate the highest risk-adjusted returns. Ultimately, if the family's resources and capabilities provide a comparative advantage in finding targets at more attractive entry prices or better growing or operating those businesses, they should pursue these investments directly; otherwise, they would be better served in investing via a traditional fund vehicle. While fees are avoided in direct investments, this factor is generally rendered neutral when considering the opportunity cost of the family's time and resources.

Applying corporate strategy to your investments

Just as a company can devise a strategy for its operations, so can a family office—they can develop a "family enterprise strategy" across their cumulative portfolio of investments. Strategy is not created in a vacuum—it depends on the dynamic interaction between external factors and internal context. A good corporate strategy lies at the intersection of opportunities revealed via market landscape trends and analysis (outward looking), with an objective assessment of fit with your relevant capabilities (inward looking). There often exists synergy by combining the two approaches. For example, performing a diagnostic of internal growth and profitability by division may suggest future opportunities and can also assist in estimating or validating the profitability and margins of external market opportunities. Note that the range of strategic options should not be limited to acquisitions, as

opportunities may involve investing internally to accelerate organic growth.

While most are familiar with this first side of strategy through traditional frameworks such as Porter's five forces, the inward looking component is often misunderstood or misapplied. Formally known as capabilities-based strategy, this approach involves identifying an entity's unique resources, capabilities, and insights and then exploring adjacent markets and investment opportunities (gleaned from the external analyses) that could potentially benefit from them. While being an industry expert can provide advantages, many of these opportunities emerge from outside the sector, leveraging key commonalities (e.g., similar supply chains) or capabilities (e.g., access to specific segment of customers).

Leveraging your unique assets

For most families, comparative advantages often derive from the industry or sector where their money was initially made. Whether or not the family continues to have interests in these operating businesses, they should objectively assess their resources and capabilities in a structured, systematic manner. Begin by inventorying all active investments, any unique areas where value could be added, and your array of relationships and influence (across suppliers, customers, regulators, etc.). Your wealth of relationships and insights can be very valuable. As a function of their role or stature in the community, members will frequently have exclusive or early access to many "unadvertised" deals, which permit more attractive valuations.

The advantage is even greater for wholly-owned operating businesses, which can benefit from economies of scale or other synergies, such as the ability to cross-sell to previously inaccessible customers. As a practical matter, opportunities to vertically integrate (buying out one of your suppliers or customers) often result from being quietly approached during the course of business. The family's captive capital base and ability to move quickly allows it to react opportunistically to these commonly "sweetheart" deals. Ultimately, private equity investments can be viewed as an extended business development or M&A function of their portfolio companies.

Assessing relative capabilities and weaknesses in a fair and honest manner requires objectivity and candidness. A few sample questions include:

- In which industries do I have exclusive insights or access relative to outsiders? Can I obtain more favorable terms because of my relationships or status?
- What is the relationship between my various investments? Do these investments benefit from one another?

- Are there specific resources or exceptional skillsets that cannot be easily replicated or lost (i.e. if a key employee leaves)? Which other industries or segments along the value chain can benefit from these assets?

Beating institutional funds at their own game

A family's assets and resources are often supplemented by its unique investment structure and risk profile. Family offices benefit from a number of structural advantages relative to traditional institutional investors, which should be leveraged. If a family can focus on specific opportunities that are systematically less competitive, it will have a higher likelihood of achieving greater risk-adjusted returns. Common differences generally provide two key sources of advantage relative to institutional investors:

- Greater speed and flexibility
  - Ability to react opportunistically (nearly instant approval, with few formalities needed)
  - Lack of a definitive exit timeline, permitting longer-horizon investments
  - Willingness to entertain more creative investment categories and deal terms (e.g., earn-ins, asset swaps, long-term employment contracts, etc.)
  - Capacity to accept smaller deal sizes under the radar of larger institutional funds
- Better access & likelihood of deal consummation
  - Early access to proprietary deals, which avoid competitive auctions
  - Better ability to develop high-trust/empathy relationships with sellers (deeper, personalized connection than is usually developed with a foreign fund), which is often a precondition to a successful sale

Acquiring the right capabilities

Despite the unique structural advantages of family offices, they still need to evaluate opportunities with the same rigor and safeguards that a professional fund would use. History is littered with examples of failed investments due to poor due diligence or deal structuring. Particularly with smaller, private companies, fraud and other improprieties are prevalent. Unfortunately, family offices are also commonly viewed as unsophisticated investors who are willing to fund "pet projects" with sub-par risk-return profiles. Given the inherently high returns for well-performing private equity investments, the majority of returns are actually made by pre-emptively avoiding the bad deals.

Many of the traditional skillsets which family offices cultivate are not particularly well-suited for direct private investments. The capabilities and processes are fundamentally different from traditional portfolio investing. Given the pursuit of much higher returns, a greater tolerance for uncertainty is essential. While public market securities confront market and economic risks, these investments add an additional layer of complexity that require sophisticated analysis and due diligence. Applying due diligence and negotiation best practices can minimize the chances of surprises and can increase value. In particular, the legal and tax deal structure can have huge value implications, and dramatically reduce down-side risk if an investment underperforms. Finally, while valuation is consistent across both investment classes, the active role taken in private equity investments requires an operating skillset capable of identifying and unlocking latent value.

Choosing the right advisors

The investment banks and private equity funds that family offices confront have an entire stable of professionals to vigilantly represent their interests. While many family offices may not have the size or frequency of deals to warrant a dedicated in-house team, a wide array of alternative resources are generally available to supplement gaps. In particular, experienced professionals can help guide families through any

Aside from traditional requests for audited/reviewed financial statements, below are ten other key due diligence items to consider. While many of the items are subjective, the respondent's transparency and candidness (or lack thereof) can often speak volumes.

1. Distribution of revenues, gross margins, and cost by division and/or major product lines over the past 3 years
2. Ranked list of top ten customers & suppliers—willingness to arrange interviews with a few selected customers
3. Detailed summary of all liabilities (e.g., accounts payable, outstanding warranties, pension obligations, probable or pending litigation, contested ownership interests, etc.)
4. Aged breakdown of receivables & inventory
5. Copies of all major contracts (e.g., large customer agreements, key leases or patents, senior management employment contracts, etc.), including a mapping of legal structure
6. Organization chart broken down by function, indicating corresponding compensation and union status
7. Description of all major property, plant and equipment (PP&E) with historical and planned capital expenditure schedule
8. Pipeline of future products or services and their corresponding current status (i.e. expected time to market) and cumulative investment to-date
9. Management budget and projections with discussion of major assumptions (e.g., contracted backlog summary, breakdown of growth sources, etc.)
10. Management description of industry landscape (size, growth potential), key strategies, and its market share & competitiveness relative to key rivals

unfamiliar processes and recommend other qualified resources, as needed. Of utmost importance, specialized counsel (M&A and tax lawyers) with deep, relevant experience, rather than the family's personal generalist attorney, should lead all legal elements. Similarly, specialized transactional accountants are also vitally important.

Finally, an often overlooked resource is a financial analyst that can help analyze prospective deals and objectively represent the family's interest. By using a rigorous approach to analyze the industry landscape and to explicitly identify and validate underlying assumptions, analysts provide invaluable guidance regarding valuation. Clients generally find it useful to answer these key strategic and financial questions before incurring the cost of full-blown legal and accounting due diligence efforts. If the deal proceeds, this analyst can also play the lead project management role in quarterbacking these formal due diligence and execution tasks. Most large private equity firms will retain strategy consulting firms such as McKinsey & Company or Bain to assist with these efforts before consummating their transactions. Not coincidentally, the ideal background is generally former management consultants or investment bankers with extensive experience in executing private equity deals. Acting as the family's fiduciary, the advisor's compensation should be carefully structured as to not jeopardize their objectivity (success-based fees can incent the approval of questionable deals).

Innovative advisory firms such as McCombie Group, can efficiently play this supporting role. Various factors should be considered when selecting the right advisor:

- Proactive personality and approach, including the confidence and boldness to push back and to deliver the "uncomfortable truths" (as well as to admit when they do not know something)
- Relevant experience and track record in private equity
- Education and training across a wide array of skillsets (finance, strategy and corporate law are ideal)

Ultimately, choosing the right advisor is a question of fit based upon trust. The client should share similar values, communication styles, and risk tolerances and be comfortable with the individual's discretion. As it is generally most effective and efficient when the same person can continue to support the investment as it progresses through its lifecycle (aiding with monitoring and ongoing operations), this advisor's commitment as a long-term partner should also be carefully assessed. In general, experienced family offices prefer to continually retain the same highly capable and trusted financial analyst across their various deals, rather than finding and

hiring different industry experts for each specific investment.

Investing to your strengths equipped with the right resources allows you to maximize the likelihood of consistently achieving superior returns.

About the author:

David McCombie is Founder and President of McCombie Group, LLC—an innovative advisory firm providing family offices and investors with on-demand analytical/operational support across their direct private investments and operating businesses. As an outsourced analyst team, its professionals act as transparent fiduciaries objectively representing their clients' interests from A to Z (e.g., investment selection & analysis, due diligence support, portfolio company monitoring & consulting, etc.).

David is a former McKinsey & Company management consultant—as a specialist in corporate strategy, he managed multiple client teams across a variety of industries to quickly develop strategic recommendations within complex, uncertain environments. In 2009, David was selected as a McKinsey Global Institute Fellow to further develop the firm's regulatory capabilities (approximately 10 of 10,000 McKinsey consultants selected/year). Prior to joining McKinsey, he also worked within the financial institution group at Citigroup Global Banking in New York.

David graduated from Harvard Law School where he focused on corporate law & negotiation, and also studied corporate finance at the Harvard Business School. His thesis, "Hispanic Private Equity: A Cultural Approach to Achieving Superior Investment Returns" was published in the Harvard Latino Law Review. He graduated Phi Beta Kappa from the University of Miami with a degree in Economics/Finance, where he was a Cuban American National Foundation Mas Scholar. A committed member of the South Florida community, David mentors start-up companies at both the University of Miami and Florida International University entrepreneurship centers. He is a licensed Florida attorney.