



# Direct Investing

## A pathway to family stewardship



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## Direct Investing: A Pathway to Family Stewardship

This whitepaper is intended for the family steward. It is meant for the investor who seeks to actively manage their wealth with the aspiration of providing future generations with not only continued economic success, but also a framework for personal and professional development. If that is you, then whether your holdings survive your grandchildren has less to do with finding the right firm to manage the family trust and more to do with your family's personal involvement in investment practices and their overarching life values and attitudes. Though seemingly obvious, this is a point worth emphasizing and unpacking. Too often families depart from the core business practices and fundamental life outlook that their forbearers relied on to generate the family wealth in the first place, giving way to the proverbial maxim “shirtsleeves to shirtsleeves in three [or four] generations”<sup>1</sup>. This paper advises families on how to avoid this outcome. Specifically, it:

- Illustrates that passive investments alone are not enough to sustainably secure family wealth;
- Assesses why it pays to be a creator, rather than just a funder, of value in an enterprise;
- Identifies direct investing as a dominant strategy for not only for adding and capturing enterprise value, but also conveying cost conservatism and business savvy to the family's ethos and lifestyle;
- Lays out options for investing directly, describing corresponding tradeoffs; and
- Outlines the skills and mindset necessary to develop future generations of value creators.

## Challenges facing family wealth sustainability

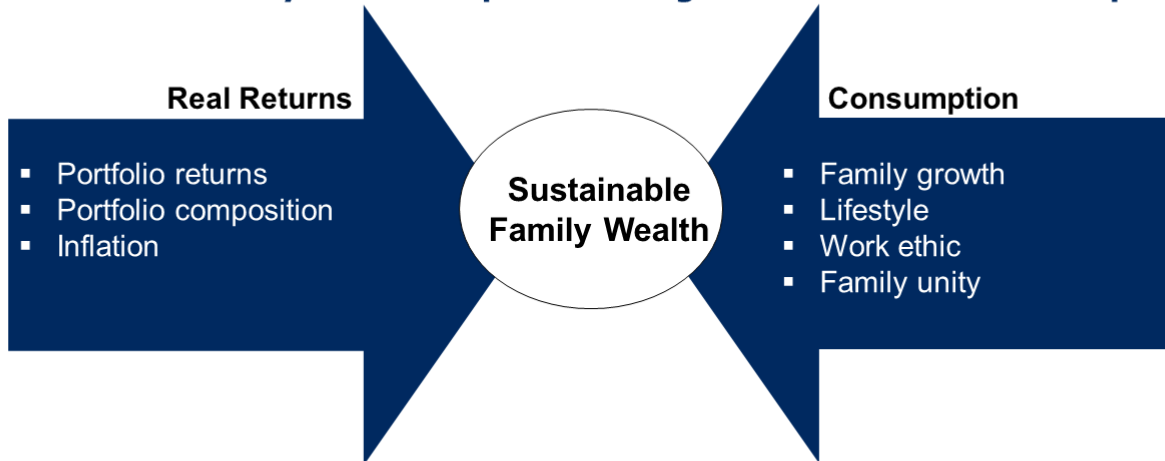
While it is easy (and in the most extreme cases, rightly justified) to fault later generations for failing to “mind the register”, the inflection point in the rise and fall of family wealth typically occurs when the founding generation transitions away from their original operations. The established norm of selling the family business and shifting to portfolio investments is a critical juncture. All too often, accomplished business operators hand over the “keys” to the financial professionals, trusting them to maintain the family's wealth. Conventional passive investments, however, are primarily intended to preserve, rather than accumulate capital, and are normally insufficient to stem the triple threat against family wealth sustainability: (1) inflation—a latent risk in the current economy; (2) growth in family size; and (3) expanding

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<sup>1</sup> This adage is curiously repeated in many cultures all across the world—i.e. *Brazil* (Rich father; noble

lifestyles. Simply put, strong real financial returns and cost discipline are required — *if you are not growing your wealth, you are losing it.*

Figure 1  
**Sustainable family wealth requires strong real returns & cost discipline**



Consider the following simple, though illustrative, scenario:

Let's say a successful operator sells their enterprise for \$100 million and invests the proceeds in a typical diversified portfolio, believing, not unreasonably, that their future progeny should be well taken care of indefinitely. Well-performing portfolio investments typically average a nominal annual return of about 6.5 percent— as a benchmark, consider that the ten-year average annual return for all U.S. college endowments is 4.9 percent, with endowments over \$1 billion under management, earning 6.9 percent.<sup>2</sup> With this in mind, our operator's family will earn a real annual return of 4 percent, once we account for inflation, which historically has remained around 2.5 percent.<sup>3</sup> Note that this inflation rate is pegged to a typical basket of mass-market household items, and therefore assumes that our family does not often indulge in luxury items. The cost of living extremely well<sup>4</sup>, as measured by Forbes, has over the past decade regularly outpaced mainstream inflation as measured by the Consumer Price Index (CPI) by approximately 2.5 percent annually. This gap appears to be widening as a consequence of increased demand for luxury goods, driven by the surging number of wealthy individuals worldwide and the size of their net worth.

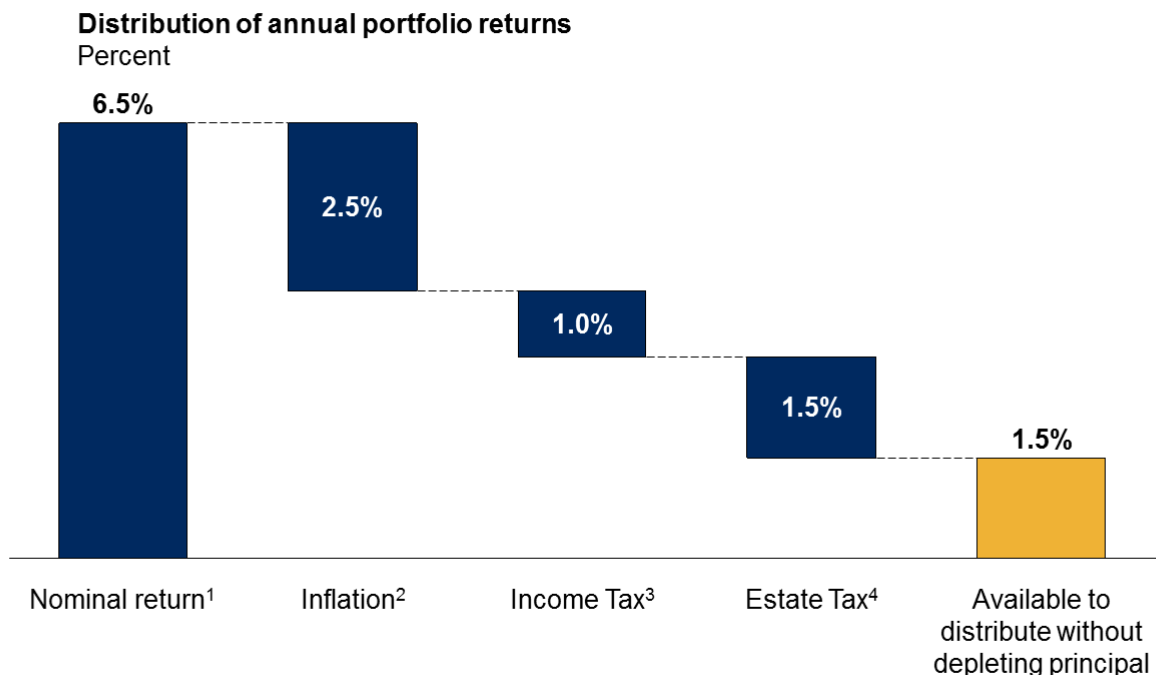
<sup>2</sup> Another yardstick, CALPers, the nation's largest pension fund at \$233 billion and typically viewed as the "gold standard", has earned a 10-year average of 6.8 percent.

<sup>3</sup> Over the past 20 years inflation has averaged 2.5 percent. It reached 3.2 percent in 2011.

<sup>4</sup> The basket of goods used in this index includes exotic travel, sable fur coats, yachts, caviar, and other niceties.

Our scenario up to now has ignored the reality of taxes, which can be substantial. Capital gains are taxed at a rate of 15 percent, reducing total annual returns by approximately 1 percentage point to 3 percent. Then there is the estate tax, which we assume our family will pay every 30 years, on average as the estate passes on to the next generation. Further assuming that our family does not want the estate tax to cut into their initial principal and that they spread the cost of the tax evenly over the intervening 30 years, they would, effectively, “pay” a levy of 1.5 percent annually even with tax efficient planning. Taken altogether, as summarized in Figure 2, this analysis implies that, annually, our family can only draw down the remaining 1.5 percent generated from their returns without reducing the current purchasing power of their \$100 million principal.

Figure 2  
**Conventional portfolio returns barely surpass inflation & taxes**



1 Benchmarked against average 10-year return of leading college endowments and pension funds

2 Inflation benchmarked to 20 year average

3 Income tax assumed at capital gains tax rate of 15%

4 Estate tax is smoothed over ~30 years and assumed to be 35% of all assets above \$10mm exemption

While \$1.5 million per year in investment earnings is a significant family income, as Figure 3 describes, *the per person allotment quickly falls in later generations simply as a consequence of growth in family size alone*. For example, assume that each heir has two children, on average, and that no more than two generations can draw from the



wealth at any time.<sup>5</sup> This would suggest that by the fourth generation, a successor could only draw \$125,000 per year (in today's dollars) in investment income— *1/6 as much as a family founder*<sup>6</sup> —in order to not deplete the family's principal. (Note that, while we used \$100 million as the initial principal for this illustration, the results proportionately hold true for any given starting level of wealth.)

Figure 3  
**Moderate family growth requires down-sizing of lifestyles across generations, if relying on conventional portfolio returns to preserve family principal**  
 Assuming wealth is passed down evenly to two children each generation suggests...

Generation	No. of people supported <sup>1</sup>	Annual amount available per capita based on \$1.5mm return on principal (today's USD)
1 <sup>st</sup> (Family founders)	2	\$750k
2 <sup>nd</sup> (Two children)	4	\$375k
3 <sup>rd</sup> (Four grandchildren)	6	\$250k
4 <sup>th</sup> (Eight great-grand children)	12	\$125k

**...4<sup>th</sup> generation heir can only draw 1/6 as much as a family founder to preserve family purchasing power of initial principal— relationship holds independent of wealth size**

1 Determined by summing new heirs that have come of age and heirs born in previous generation; calculation further assumes no spousal claims, except for spouse of founding generation

Although striking in its results, this hypothetical scenario is still wildly optimistic in its assumptions. Aside from ignoring potential investment gaffes and costly divorces, it takes for granted that future generations are capable of adjusting their lifestyles so they can live off of the proportionally smaller investment income. Herein lies the most pernicious and subtle threat to wealth sustainability that has ruined great families and nations, alike: prolonged deficit spending. The inconvenient irony is that lifestyles typically expand with each generation just as more “mouths to feed” emerge, although the consequences of these actions will not be fully appreciated by the family until years later. *Yet, as Figure 4 demonstrates, conventional portfolio returns afford no room for later generations in our example to maintain, let alone, exceed past family lifestyles without “raiding the piggy bank”, that is to say, cutting into the initial principal.* Over time, such consumption further stresses family wealth, as the smaller principal generates less returns annually.

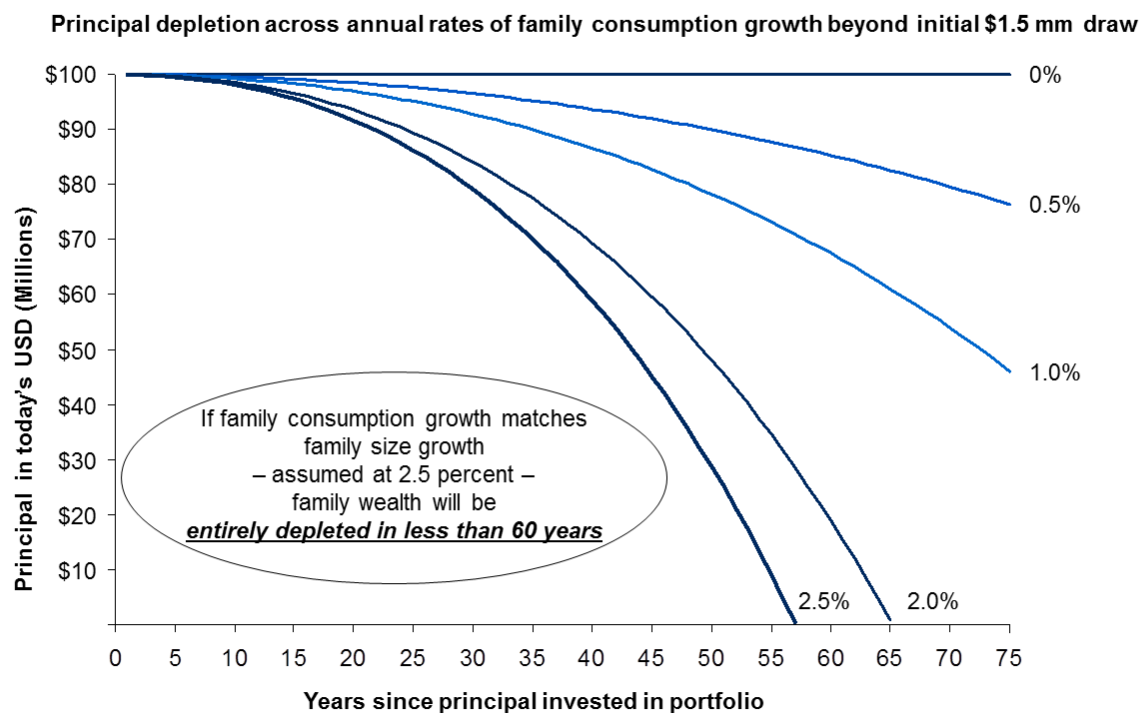
<sup>5</sup> This implies that when the grandchildren receive their inheritance their grandparents have passed away. Analysis further assumes wealth is split evenly among all heirs.

<sup>6</sup> Analysis assumes no spousal claims except in the founding generation.

To see this result from our scenario more clearly, consider that, all other things equal, the real investment income drawn down in each year by the family increases by 2.5 percent— meaning that if the family draws \$1.5 million in the first year, it would draw \$1.54 million the next year and so on. This would imply that total family wealth would be entirely exhausted in less than 60 years. We highlight 2.5 percent annual consumption growth because it corresponds to the annualized rate of growth in family size in our example, which is based on each heir having two children, on average. (This rate would go up to 3.9 percent if heirs averaged three children each.) Applying this annual consumption growth rate to our analysis is, therefore, effectively equivalent to assuming that future heirs are each able to maintain the same lifestyle as a family founder.

Figure 4

### **“Raiding” principal to maintain lifestyles quickly depletes family wealth**



In sum, our analysis concludes that passive portfolio investments, while necessary for diversification, are not enough to achieve family wealth sustainability. Instead, we must consider a complementary approach that promotes “strong balance sheets” that can generate wealth, while also ingraining cost conservatism across generations.

### **Value creation: Key to long-term wealth sustainability**

Every business opportunity requires a “founder” who takes the initiative and risk of putting a deal together. Your willingness to assume this role and directly create value

for an enterprise determines your ability to consistently earn outsized financial returns. Such earning potential is readily apparent when you consider that pure financial investors implicitly “pay” a lot for entrepreneurial talent through equity dilution. In this context, money and “sweat equity” are considered fungible and, therefore, entrepreneurs can command extremely favorable terms and economics for their involvement in generating value. This is best exemplified by looking at the handsome premium paid to entrepreneurs and founding managers in venture capital raises. To see this, consider the experience of Gabriel Baldinucci, former Managing Director of Palm Ventures, a major family office:

By the time angel investors purchase equity in a pre-revenue company, the typical pre-money valuation is between \$1 and \$2 million. An investment of \$100k in a company with a \$1.5 million pre-money valuation will result in the SFO [single family office] receiving 6.25% ownership in the company (.1m/1.5m+.1m). Startup companies will typically raise enough to give away only 30-35% in their first round of financing. However, many of these companies (not only internet) will have spent less than \$100k to get to this point. Their \$100k has earned them 65-70%, while yours will earn you 6.25%. You would have to invest \$100k in ten more companies to achieve the same level of ownership as the founders, risking 10x more capital.<sup>7</sup>

Moreover, by the time a company IPOs, more than 50 percent of the offering generally remains with management who is credited with generating most of the enterprise value.<sup>8</sup> *In short, it pays to be a creator, rather than just a funder, of value.*

Increasingly opportunities for major value creation— such as starting a new venture from scratch or a significant restructuring/scaling up of a company at a critical juncture— are concentrated within privately owned operating businesses, which typically have much greater upside (as well as risk) than their public market brethren. As shown in Figure 5, private operating businesses are normally valued at a lower multiple of their earnings than larger public companies. As a result, all other things equal, privately held firms are comparatively “cheaper” and yield a correspondingly higher rate of return.<sup>9</sup>

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<sup>7</sup> Baldinucci, Gabriel et al. “Entrepreneurship in the Family Office.” Family Office Association. 2011

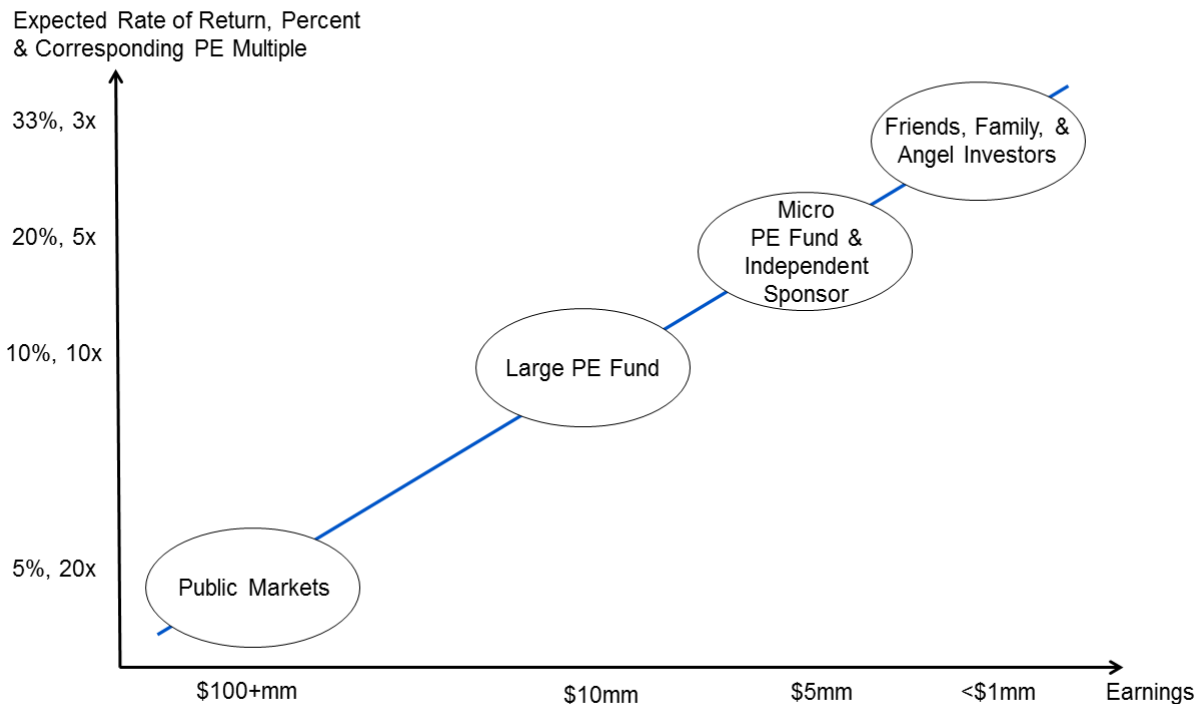
<sup>8</sup> Historically, the median ownership stake of officers and directors decreases from 68 percent before the IPO to about 44 percent immediately afterward – Mikkelsen, W. et al. “Ownership and operation performance of companies that go public” Journal of Financial Economics, October 1996

<sup>9</sup> There is a direct mathematical inverse relationship (reciprocal) between the PE ratio and the expected rate of return.



Figure 5  
**Opportunities for outsized returns concentrated in private investments**

Illustrative progression of enterprise returns & valuation multiples, across growth scenarios



This variance derives from a number of factors, some intrinsic and others from market inefficiencies. First, smaller, private enterprises with nominal market shares generally experience more risk than larger, more established incumbents. Additionally, private companies are illiquid by definition and, therefore, experience a further discount. The market structure of private equity firms further perpetuates this as investments become smaller and competition subsides. Consider that, as a general rule, funds invest in 5 to 10 deals, each typically worth \$50 million.<sup>10</sup> Given the increased competition for these larger deals, returns decline accordingly. As deals become progressively smaller, the high overhead of needed professional staff to run investments makes it increasingly difficult to substantiate their opportunity cost. As a result, these investments are generally not made through funds, but through independent sponsors on a deal-by-deal basis or through more “hands-on” fundraising mechanisms.

### Private investment deal structures

Within the universe of direct private investments, deal structures vary in their degree of separation from the ultimate source of value creation, which are the enterprises receiving capital. The further away from the initial value creation you go, the greater

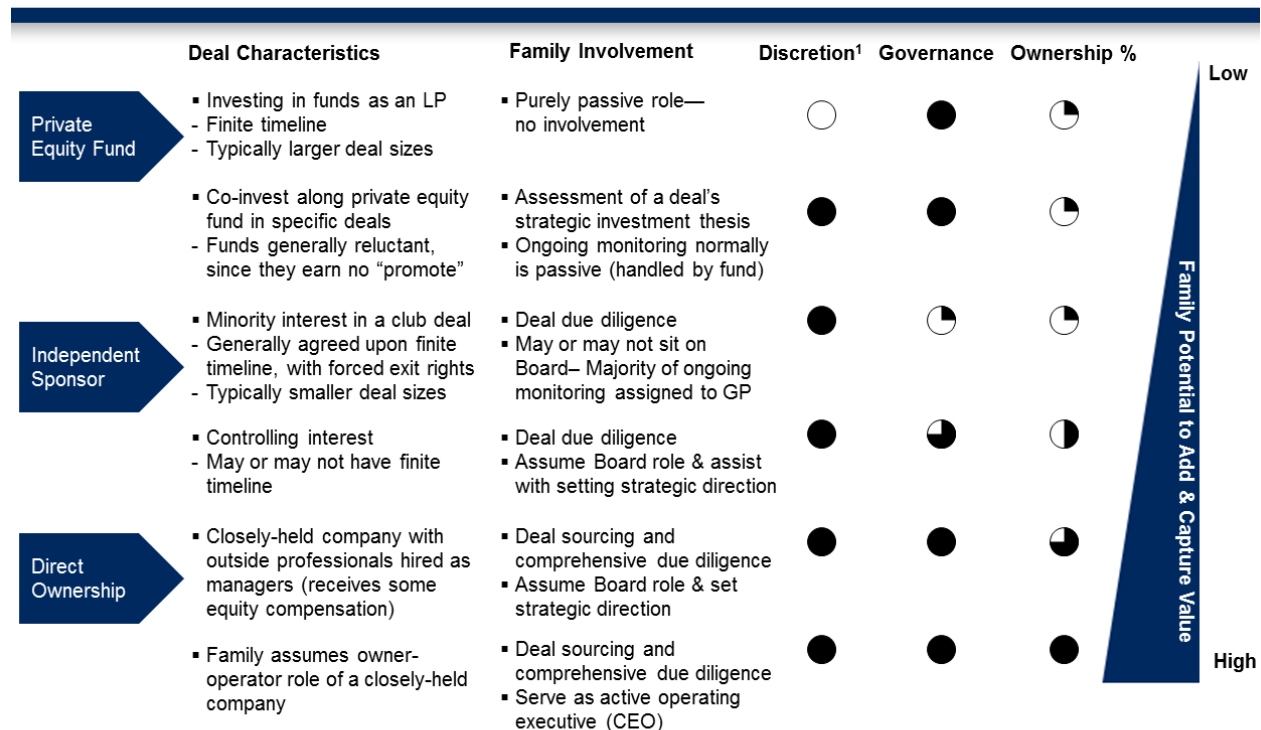
<sup>10</sup> In their 2012 report on sizing global private equity markets, BCG & DealMarket note that the median private equity deal size between 2007 and 2011 was approximately \$50 million, with the top 7 percent of deals worth at least \$1 billion.

the propensity for intermediaries to claim a “piece of the pie.” Conversely, the closer you are to running the business, typically, the greater your share of returns. To see this, three alternative deal structures and their variants are discussed below.

Investors can gain exposure to private investments by: (1) investing as a limited partner (LP) in a conventional private equity fund, (2) investing in a direct club deal (i.e. independent sponsor), and (3) owning enterprises directly. Each vary across a number of factors and require differing levels of personal time and commitment. Specifically, these structures differ with regards to level of discretion in deal selection, quality of governance, and size of the ownership stake, all features that influence the potential value that can be added and captured as an investor. Nevertheless, as described below and summarized in Figure 6, *direct ownership is the superior approach — it not only is the sole structure that allows the scope to create and capture value, but it also conveys a number of intangible benefits to the family's ethos and lifestyle*, as will be covered in later sections.

Figure 6

### Value creation is maximized & best captured by direct ownership



<sup>1</sup> Refers to ability to affirmatively choose participation within specific deals

In the first approach, participating as an LP in a private equity fund, you are confined to a purely passive role. The General Partner (GP), which tends to be comprised of highly specialized professionals who are experts at selecting and overseeing investments,

assumes total discretion. Thus, you are precluded from influencing the selection of particular deals taken or the timing of capital calls and exits. While the finite timeline of funds can create distortions regarding when to exit, funds typically excel at keeping a pulse on the market. They are typically adept at quickly executing a deal when the timing is right, which is an important driver of value in private equity. Overall, given their professionalized, institutional nature and centralized authority to set and execute strategy, GPs generally facilitate strong governance.

Nevertheless, many wealth holders dislike the incentives of discretionary funds because without a commensurate downside, GPs do not invest as owners, tending to deploy capital no matter what. Although most funds are typically reluctant to permit it (particularly without sizeable capital commitments in the underlying fund, as the GP receives less favorable economics), co-investment opportunities provide the benefit of greater discretion as they enable you to selectively deploy additional capital in specific deals. Additionally, funds do not provide investors with the opportunity to directly add value, let alone capture it. This role is “outsourced” to the GP and the management of portfolio companies, leaving you only able to capitalize on your financial interest in the fund—historically, private equity funds as an asset class have averaged between 12 and 17 percent returns over the past twenty-plus years.<sup>11</sup>

Moving across the value continuum is the direct club deal, which is comprised of a group of like-minded investors that unite to fund individual opportunities directly on a discretionary basis. Unlike funds, this structure provides you with the comfort of proactively agreeing with an investment and the opportunity to directly add value to an enterprise through sitting on the Board or making critical introductions, for example. Nevertheless, this structure is vulnerable to three main weaknesses. First, your ability to capture any added value largely depends on whether you own a minority or controlling stake. If you own a minority interest, a large portion of your value creation accretes to the other shareholders, who free-ride on your expertise and connections. Second, to the extent later rounds of financing are eventually needed (as typically is the case in venture capital), you are disadvantaged as an outsider since you will have to invest at increasingly higher valuations, diluting your overall returns. And, third, the decentralized structure of a club deal is vulnerable to having too many “chefs in the kitchen”. As many club deal investors can attest to, being a minority investor whose view or interest is misaligned with the other shareholders can be a recipe for headaches or worse disasters. In particular, the timing of the exit can be a significant source of contention. Controlling interests in club deals are uncommon, but, if achieved, can

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<sup>11</sup> Kaplan, Steven, et al. “Private Equity Performance: What do we know?” University of Chicago, working paper. Feb 2012

mitigate the structure's disadvantages, replicating many of the benefits of direct-ownership.

Finally, at the highest end of the value continuum is the direct-ownership and operations of closely-held businesses. Here you directly build or buy a business venture. You maintain total deal discretion, have the authority to lead company governance, and, most importantly, have the opportunity to capture 100 percent of the value that you create. Of course, this description downplays the difficulty and dedication required to successfully run a company. Still, the direct ownership option enables you to determine the extent to which you participate and contribute to day-to-day operations. You can choose to “drive the bus” yourself as an operating executive or to limit your role to setting high-level strategy through sitting on the Board and rely on professional management to lead operations. The use of equity-based compensation as an incentive for hired executives enables additional degrees of flexibility and risk management within the direct ownership option (generally 10 to 20 percent of shares outstanding). Ultimately, given the alignment of incentives it achieves, management pools generally have a nominal impact on net returns.

Recall that this discussion is predicated upon the family's willingness to be actively involved in managing its direct investments. An important corollary to the above recommendations is that to the extent you desire to be completely passive or future generations do not have the interest or capabilities to participate, your family would probably be better served by gaining exposure to the asset class by investing through a fund or other “curated” investment structure. Simply put, to achieve the benefits of direct investments—namely, improved chances for family wealth sustainability—you and your family should be prepared to get “your hands dirty.”

### **What is the manifestation of these direct investments?**

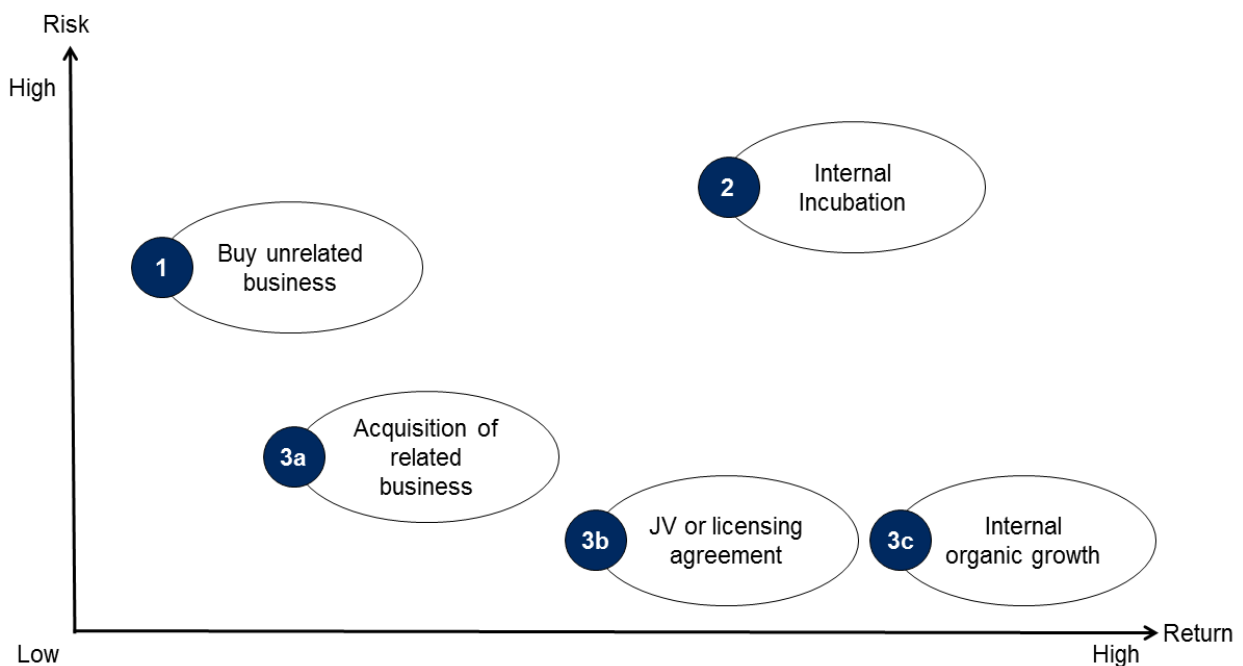
Direct investments can take many different forms; three principal strategies stand out. First, the investment can be a pure “financial play” in which you acquire a pre-existing business outside your industry of expertise. Second, direct-ownership can involve incubating companies within a broader holding company that leverages pre-existing overhead and infrastructure to internally launch new ventures. Third, a direct-ownership investment can be part of a more conventional play along the corporate development continuum, where capital expenditures or acquisitions are effectively used to “build or buy” growth for your pre-existing operating businesses. Specifically, you can: (a) “bolt-on” acquisitions onto a holding company to gain economies of scale and other related synergies; (b) enter into a joint venture or licensing agreement that scales up existing operations; or (c) build an internal business case for organic growth and fund it.

While each manifestation has a unique risk-return profile, as summarized in Figure 7 and detailed below, here again the magnitude to which returns are outsized in direct ownership is by far determined by whether you founded or bought into the business. All else equal, you ultimately end up with a far greater share when you start with 100 percent “sweat” equity in a venture and give away a few points here and there to incentivize productivity than when you buy into a pre-existing venture starting with an initial 0 percent stake. Given this dynamic, we can conclude that, just as a function of the level of ownership interest, founding a mediocre business can potentially generate superior returns to alternative investment arrangements.

Figure 7

**Direct investment opportunities are typically most attractive where you have pre-existing expertise and/or capabilities**

Risk-Return profiles across direct investment options



Acquiring a going concern in an unfamiliar industry presents high risks since it is difficult to leverage any pre-existing assets, institutional knowledge, or access to markets, each of which have the potential to materially impact the risk equation. Moreover, the expected return is lower since much of the upside is typically already embedded in the premium paid in the acquisition price.<sup>12</sup> In contrast, incubating enterprises internally, while offering a much more binary payout, can capture

<sup>12</sup> Boston Consulting Group research confirms that about two-thirds of all takeovers destroy value for the acquirer in the long run. See recent publication *Plant & Prune: How M&A can grow portfolio value*, Sept 2012



significant value for the owner/founder. Moreover, it often provides an excellent avenue to incorporate other entrepreneurial family members whose passions may lie outside of the core family business. Normally, this strategy is only actionable for “simpler” more execution oriented startups, where the archetypal “genius founder” is less important. *(Please look out for a future whitepaper regarding successfully incubating companies.)*

Corporate development options to opportunistically expand ongoing operations hinge upon a “build or buy” decision, with the prospect of a joint venture or licensing agreement representing a hybrid approach with characteristics of each. Overall, options along this continuum are less risky than the two strategies previously discussed because they involve a pre-existing enterprise with relevant expertise. Nevertheless, they too vary across risk and returns, generally improving as you transition from acquiring to building internally. For example, the acquisition of a pre-existing business comes with the typical caveats related to absorbing an outside enterprise — i.e. premium paid to the seller, structural barriers to realizing synergies, cultural incompatibility, etc. These potential pitfalls can be mitigated by entering into a joint venture or licensing agreement that shares the risk with a suitable partner; though, this also requires sharing the returns. Alternatively, the risk-return “sweet spot” can be best achieved if you can invest in growing organically, expanding into promising geographic or product line adjacencies that leverage your pre-existing infrastructure and capabilities to generate incremental revenue.

*In more concrete terms, the risk-return profile of a direct deal for a “widget-maker” typically improves as they move from acquiring an existing widget factory, to partnering with another factory, to buying a new widget press that will operate within their own factory.*

Overall, it is clear that direct investments are most attractive when you stick to opportunities in which you have direct knowledge and resources that provide a comparative advantage relative to “competitors.” This can be achieved by carefully inventorying your array of assets, relationships, and distinctive capabilities and then identifying investments that can best capitalize from it. For example, within the context of making the investment, operators can leverage relationships to gain early access to proprietary deals, which avoid competitive auctions, allowing for lower purchase prices. The advantage is also especially relevant on the operational front. A strategically coherent investment allows for economies of scale and other synergies, such as the ability to cross-sell to previously inaccessible customers. (For a fuller treatment of this point and to learn how to make the most of your comparative advantage see the November 2011 McCombie Group whitepaper *Leveraging your family’s strengths to maximize risk-adjusted returns in direct private equity investments.*)

## **Are direct investments riskier than portfolio investments?**

There are two principal types of investment risk: market risk and execution risk. Market risk relates to the systematic macroeconomic tide that impacts entire industries and lifts or sinks all boats. Within them, all companies whether public or private must confront these systemic trends. Thus, in this regard, passive investments can be viewed as just as susceptible to market risk as direct investments. Where the manifestation of risk diverges between these two approaches is in execution, which is idiosyncratic to the enterprise.

Execution is not easy; otherwise, everyone would be wildly successful investing directly. But, to the extent that a direct investment increases execution risk in your overall portfolio, it can be mitigated, as highlighted earlier, by investing in a strategically coherent manner where opportunities are pursued only when you have a comparative advantage. Such prudence is critical as the majority of returns in direct investing are actually made not by routinely hitting “homeruns,” but by tying together a string of hits and preemptively avoiding bad deals. Yet even when investing within your core competencies, the danger always looms that you are less rigorous when vetting your own projects. You can mitigate this by inviting other disciplined early stage investors into your deals as minority partners, allowing their research and insights to complement your due diligence efforts.

The risk management matrix you apply to new operating ventures should also not forget many of the business practices and tactics that made your family initially successful. Specifically, a growing body of evidence indicates that the long-term perspective and lower levels of leverage traditionally associated with family businesses can increase their chances of surviving periods of market turmoil, ultimately permitting higher returns over time. As a McKinsey & Company study notes, despite the unique challenges faced by family enterprises, “from 1997 to 2009 a broad index of publicly traded [family controlled firms] in the United States and Western Europe achieved returns to shareholders two to three percentage points higher than their comparable peers.”<sup>13</sup>

That said, a focus on superior execution does not necessarily mean that a specific business should be run indefinitely. Industries mature and become obsolete, and valuations experience cycles of boom and bust. While the intent should be to build an enterprise as if it had to be held indefinitely, you should maintain a close pulse of your

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<sup>13</sup> Total shareholder return measured against the S&P 500, MSCI World, and MSCI Europe indexes; Christian Caspar, Ana Karina Dias, & Heinz-Peter Elstrodt. “The five attributes of enduring family businesses.” McKinsey Quarterly. Jan 2010

respective industries to continually consider an opportunistic sale or exit. However, once you do experience a liquidity event, we maintain that you should continue to invest directly to generate the necessary returns and to preserve the values, ultimately associated with family wealth sustainability.

A common rebuttal to investing directly in operating businesses is that it requires placing too many eggs in one basket, a context where one bad decision or the poor execution of a good decision can prove costly. This is a valid consideration and, therefore, we reaffirm the importance of asset diversification. We do not endorse the elimination of portfolio management, but, instead, caution investors from becoming completely passive. *Direct investing should be a component of your portfolio strategy, not a substitute.*

We recommend that you work closely with your portfolio managers to avoid double exposure to industries where you are investing directly. Further, the highly illiquid nature of these investments must be taken into consideration. While planning to ensure adequate cash for upcoming needs and unanticipated risks is important, liquidity is a double-edged sword. From our experience, we find that tapping into the principal itself becomes progressively likely the more accessible the portfolio. An often overlooked benefit of holding wealth in operating businesses is that it “locks the cookie jar,” minimizing the amount of idle capital and ultimately discouraging unnecessary spending.

### **Skill and mindset: Implications for value creation**

In order to successfully generate sustainable value from direct investments, a variety of skills and attitudes are prerequisite. Three key elements are crucial: a calibrated risk appetite, a comprehensive entrepreneurial skillset, and an ownership mindset.

First off, direct investments require a calibrated sense of risk taking that initially makes an educated bet and preserves the ability to identify and “kill” losers. This is a delicate line to walk. Direct investments often require vision and by their nature are long-term commitments. Whatever their manifestation – be it a startup venture or corporate development acquisition – it typically takes time to develop and fully exploit value-creating strategies. Nevertheless, direct investment should not be a euphemism for a “pet project” that drains rather than adds value. Projects, especially those pitched by family members, should be viewed objectively. They should be given a hard, emotionally detached look before and after the investment, if consummated. Pre-investment, robust deal screening and deep analysis of the strategic landscape is necessary to avoid poor deals. Post-investment, clear operational milestones or hurdles that unequivocally define success are vital to protecting against underperforming

investments, as they help determine if/when the “plug” should be pulled. Independent third-party advisors can be valuable in managing this process.

Second, direct investments require a wide-ranging entrepreneurial skillset. Simply put, you have to be a “jack of all trades,” competent across strategy, finance, sales, marketing, and operations, among others. This broad skillset allows you to launch a lean-enterprise, particularly during critical start-up phases, and allows you to better judge professional management’s performance when you eventually bring them on.<sup>14</sup>

Finally, successful operators are set apart by a distinct “ownership mentality” that unleashes a virtuous cycle of commitment and reward within a company. They do not view themselves or their core team as 9-to-5 employees. Instead, they are driven by an intangible resolve that promotes dedication, resourcefulness, and prudent stewardship-based thinking. One example of this behavior is drawing a standard, market-rate salary, particularly when operations are small and high overhead cannot be supported. While readily apparent, this point is worth emphasizing within the context of family investments. Family dynamics can be irrational in some cases, but they should not run afoul of fundamental business discipline. The mindset of an owner balances current family needs with respect for an enterprise that is meant to generate above average returns on a risk-adjusted basis.

### **Cultivating future generations of “founders”**

Families often pursue direct investments not because they are necessarily aiming to blow industry incumbents out of the water — though, that would be welcome — but, because of an overriding interest that supports value creation: a desire to cultivate a consecutive string of “first generation founders” that can independently contribute to wealth generation. As previously underscored, superior returns are not enough to sustain family wealth. An ingrained sense of cost conservatism is also required across generations and there is no better teacher of this discipline than exposure to running a business. Fundamentally, direct-ownership helps you appreciate how money is earned and grounds you by requiring empathy with staff of all levels. Moreover, core business skills such as budgeting are directly applicable to personal management.

Turning this aspiration into a reality, however, requires developing and executing a succession plan and a genuine commitment by heirs. Family leaders must take concrete actions to cultivate the needed capabilities within the family. Specifically, they should

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<sup>14</sup> We recommend reading *Lean Startup* by Eric Reis. This book emphasizes the importance of creating and assessing a minimally viable product, which effectively validates a business plan’s key uncertainties prior to allocating a comprehensive budget.

create space for future leaders to develop the ability to thrive in the unstructured, ambiguous environments that typically define new investment opportunities. This can be achieved by a formal or informal management training program that rotates heirs through different positions (or requiring comparable work experience in other leading firms, where best practices can be learned) and bolstered by formal academic studies in a broad range of relevant disciplines. Line positions that ultimately lead to taking responsibility for one or more profit centers are generally most beneficial in developing general management skills. Assigning responsibility for more autonomous efforts, such as opening up a new territory, or launching a new store also help to foster entrepreneurship within a safe, supportive environment. Staff positions, such as “Assistant to the President,” are typically less effective, as they seldom offer clear responsibility and accountability.<sup>15</sup>

It could be that future generations may have no interest in leading day-to-day operations in the “bread and butter” family business. While the introduction of professional management is often a suitable response to this challenge, heirs should still develop a minimal skillset to oversee the business and influence overall strategy in order for the family to continue to accrete the benefits of ownership. And to the extent that future generations demonstrate a capacity to pursue passions in other areas, identifying and cultivating these areas of interest — still within the framework of rigor previously addressed — is another means by which families perpetuate a culture of ownership necessary for value creation across generations. This ethos, above all else, is the fundamental value offered by direct investments that family stewardship rests upon.

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<sup>15</sup> Carlock, Randel & Ward, John. *Strategic Planning for the Family Business*, Palgrave. 2001



*About the author:*

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David McCombie is Founder and President of McCombie Group, LLC— an innovative advisory firm supporting family offices and ultra- high net worth individuals across their direct private investments and operating businesses. Its professionals serve as transparent fiduciaries, objectively representing clients’ interests from A to Z—from initially selecting, analyzing, and consummating an investment, all the way through continued monitoring and performance improvements.

David is a former McKinsey & Company management consultant— 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, he 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 briefly worked as an associate 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 strategy, and also did extensive coursework in 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 start-up community, David serves as a venture mentor at both the University of Miami and Florida International University entrepreneurship centers. He is a licensed Florida attorney.

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