Playing to Your Strengths:

Strategic Deal Sourcing for Family Offices

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Playing to Your Strengths—Strategic Deal Sources for Family Offices

As we have discussed in previous white papers, direct investments are deployed with the intention of allowing the investor to directly contribute to the future value of the asset. Developing an investment framework— a so-called "investment policy"— helps investors focus on direct investment opportunities (e.g. industry, asset class, etc.) best suited for them. While our prior white paper discussed the benefits of developing your investment policy, this one emphasizes the importance of effectively sourcing high quality deals in order to maximize return potential. While quality of fit is extremely important, returns are amplified when combined with securing deal flow in a proprietary manner (i.e. deals with lower levels of competition).

In order to find investment opportunities that match these criteria, proactive ownership of the deal sourcing and structuring process is crucial:

- Focus on opportunities that institutional investors (i.e. private equity firms) cannot pursue—either due to smaller deal size or unique terms which they are structurally unable to offer, and leverage on your more personal and flexible nature
- Establish your investor "brand" across a strategic network of relationship builders that provide the opportunity for you to review a deal before other potential acquirers, a process that requires a significant amount of time, money, and resource allocation

The Importance of High-Quality Deal Flow

While various individuals may describe it somewhat differently, every private equity investor essentially seeks the opportunity to invest in a promising company at a reasonable (i.e. low) price. Finding deals before other interested parties have an opportunity to bid up the target's value enhances their attractiveness. Howard Marks, the legendary Chairman of Oaktree Capital Management, articulated in one of his famous investor letters that "the easiest way to win at investing is by sticking to inefficient markets[1]." Similarly, the "holy grail" of direct investing lies at the intersection between 'proprietary deal flow'— meaning a steady stream of investment opportunities with a low level of competitive intensity—and a high degree of fit for a particular family's unique strengths and context. Investors covet proprietary deal flow because of three distinct advantages:

(1) It increases the probability of deals closing due to lack of competition, thereby improving efficiency of execution and minimizing failed deal costs;
(2) It increases the likelihood of closing at a lower price point since you are competing against fewer bidders that can drive up the price. This will ultimately increase your return multiples and decrease risk by providing a cushion against unanticipated cost overruns and other unfortunate occurrences not accounted for in the pro forma projections. As Benjamin Graham described almost a century ago, having a 'margin of

[1] Marks, Howard, "Getting Lucky" Oaktree Capital Management Memo From Our Chairman"

safety' (i.e. buying cheap relative to an asset's intrinsic value) is the most reliable approach for achieving investment returns[2];

(3) It provides space for creative deal making where you can redefine deal structures to be tailored to your unique strengths. Bypassing the traditional process, in which business owners sell based on the highest asking price, will provide you the opportunity to leverage your strengths and present an offer that draws on your unique value-add; and contributions as a strategic partner, thereby reducing the overall cash outlay; and

(4) It grants you the advantage of time—you can control the process at your pace rather than being pressured to meet the business owner's deadlines. You can utilize the luxury of time to get to know them more personally and to see how their performance over time reconciles with their original projections.

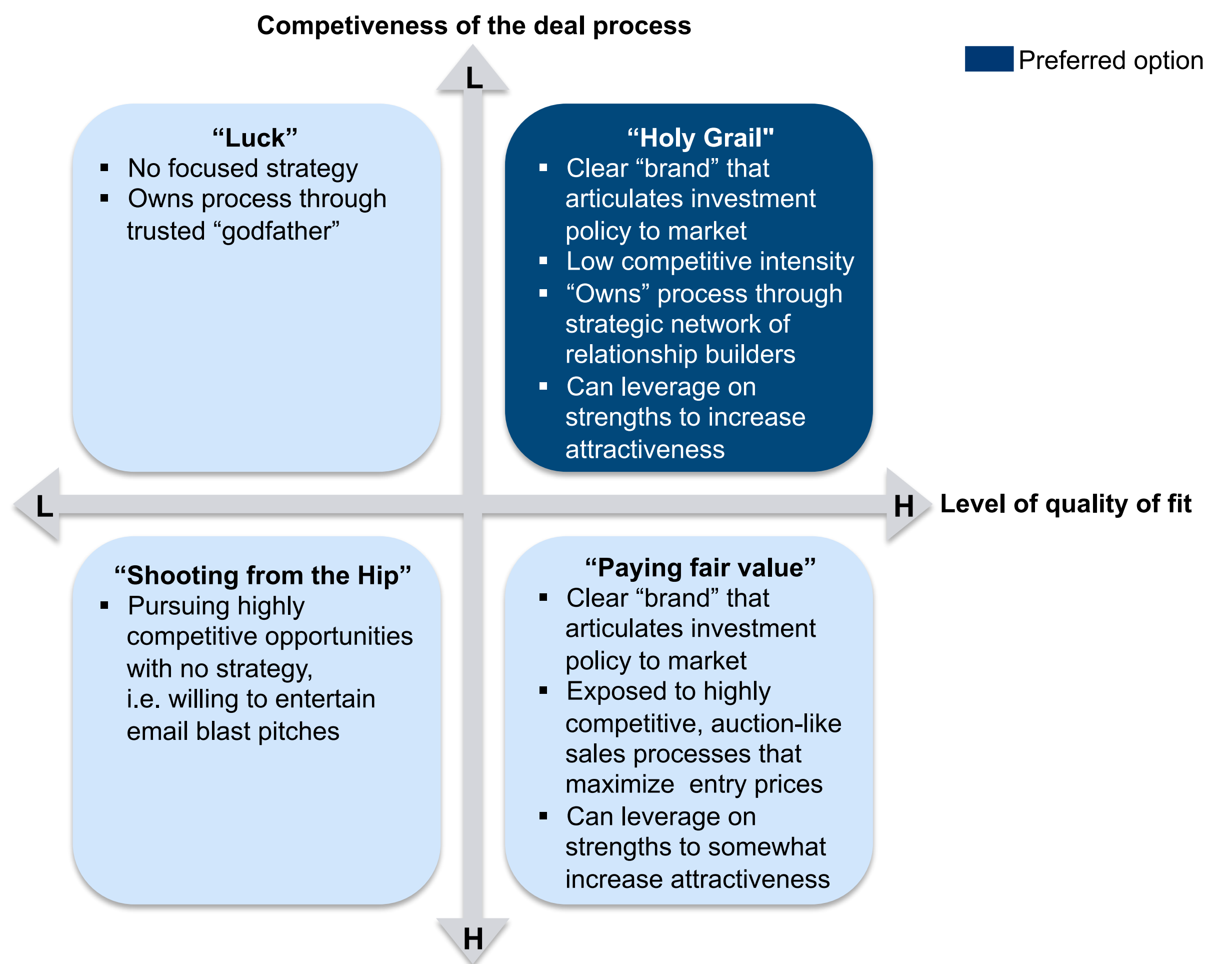

Figure 1. Intangible Contributions

[2] Graham, Benjamin, "The Intelligent Investor: Revised Edition" First Collins Business Essentials (2006)

In Figure 1, we can see how the favorability of a deal changes with respect to the quality of fit (how well your cultural and operational strengths align with the business) and the competitive intensity of the deal process. The lower the competition experienced in the deal process and the greater the quality of fit and alignment, the better the potential returns will be. The "Holy Grail" scenario occurs when you proactively identify off-market opportunities that fit well with your family's investment policy, resulting in maximized return potential. On the other hand, engaging in structured processes, such as auctions, which are designed to maximize the sales price of any given entity normally results in lower returns. The poster child for this are deals that come through an investment banker, whose job it is to generate as much widespread interest in order to boost the sales price.

Investors Understand the Importance of Deal Sourcing

If you were to analyze where value is generated within the private equity value chain (see Figure 2 below), a disproportionately high amount would come from sourcing attractive opportunities at a low price. It is such a valuable component that sophisticated private equity firms spend significant money on deal sourcing. Given the more attractive entry prices obtained, most incur the cost to maintain in-house professionals tasked with identifying prospective off-market deals. In fact, according to an analysis by David Teten[3], 86% of US funds have at least one person tasked primarily with deal sourcing; on average, private equity and venture capital firms dedicate approximately 15% of its full time staff just to new deal origination. Additionally, firms will gladly pay handsome "finder's fees" to outside referrers for deals that are successfully closed upon—these up-front cash payments average between 1.5 and 2% of the total purchase price[4]. Even though this approach is more common amongst institutional funds, family offices could theoretically source deals by incentivizing others through a similar arrangement.

Figure 2. Private Equity value chain (lifecycle)

[3] Teten, David, "Where Are the Deals?! Best Practices of Private Equity Funds in Originating Investments," July 12, 2011 presentation

[4] The standard industry compensation structure is called the Lehman formula: 5% on the first million dollars of purchase price, 4% on the second, 3% on the third, 2% on the forth, and 1% thereafter

Play to Your Strengths

During the Revolutionary War, the informal American militia was able to defeat the much larger, better equipped and better trained British Army by using guerrilla tactics that played to their strengths (e.g. superior knowledge of the region's geography). Had they confronted the opposition head-on in a traditional volley, a victory would have been impossible. Similarly, family offices must leverage their unique comparative advantages, avoiding head-on competition with larger, better-equipped institutional investors (i.e. private equity funds). As has been discussed in our prior white papers, these funds have a lower cost of capital and an incentive structure that enables them to pay marginally higher prices for any given asset. To the extent that you do outbid these savvy professionals, it's likely to be a Pyrrhic victory (i.e. the dreaded "winner's curse" of overpaying). Nevertheless, as will be discussed, families have the ability to gain the upper hand through unique deal structures and other intangibles that cannot be replicated. By maintaining the objectivity and emotional discipline to avoid competing on unbalanced playing fields, you have the ability to successfully generate outsized returns.

Treating Business Owners as Your "Customers"

An owner of a good, strong business is in a coveted position and is frequently being contacted by various potential service providers and intermediaries who are eager to transact with him or her. Just as family offices are magnets for unsolicited investment pitches, the constant bombardment can result in a defensive wall of skepticism. Ultimately, a business with positive, stable cash flows has the luxury of saying "no" to any given offer it may receive, since it does not need to concern itself with selling or obtaining outside capital to remain operative. Given the inherent leverage/bargaining power that owners of attractive businesses have, it's in the best interest of family offices to treat them as if they were valued "customers." In any industry, good customer service is fundamentally about developing an ongoing trust-based relationship formulated upon mutual understanding, respect, and the desire to add value.

It is important to differentiate yourself from the rest of the "noise" by showing your willingness to patiently invest the time to build a relationship that could eventually develop into a mutually advantageous opportunity. One of the strongest assets a family has is that it is not a large, faceless firm. Therefore, it is critical to ensure that you humanize yourself: leverage your common backgrounds and values as a means of building rapport. Throughout these interactions, it is important to show, rather than simply tell, about your unique value-add and the additional intangibles (such as relationships, collaborative working style, etc.) that you can bring. Ultimately, people want to conduct business with people that they like and respect.

Applying Proven Sales Techniques to Deal Sourcing

The most successful salespeople within B2B (Business-to-Business) businesses utilize a technique called "consultative selling." Rather than simply promoting an existing product or service (e.g., "I'm calling because I want to buy your company"), this methodology focuses primarily on the experience that the potential customer feels during their interactions with you, with the intent of trying to create a collaborative approach that yields a relevant solution. This necessarily requires that you take the time and interest to truly learn about their circumstances, needs, and goals (requires more listening and less speaking). It is often valuable to place yourself in a target owner's shoes and consider the following empathetic questions:

- Why are they considering this transaction?
- What is most important to this individual?
- Who are the other vested parties that may be influencing this person?

Since selling a business is a once in a lifetime event for most business owners, it usually is their first experience doing a major transaction. Consequently, its important to help them become educated regarding the process and to acknowledge and address any concerns or fears that they may have (oftentimes, it can be valuable to introduce them to knowledgeable professionals, such as M&A attorneys, who can provide objective validation). Frequently, investors need to educate owners of the value of transacting in the first place. For example, while an owner who accepts growth capital will experience dilution, he has the opportunity to significantly accelerate his growth trajectory—sharing a portion of a larger pie ultimately should result in more value than owning 100% of something smaller. Another significant hurdle is that most owners are often not educated about the differences between the various kinds of investors. The reputation of private equity has not always been favorable due to a great amount of misinformation. Additionally, Main Street continues to harbor a distrust of "New York suits," as they fear that they may use tricks to commandeer the business and let management go. While they may have received cold calls from private equity funds, the more secretive nature of family offices makes them less likely to have any awareness of them and their relative potential benefits. Therefore, educating sellers of the differences between institutional investors and family offices is crucial.

Selling and the Flexible Nature of Family Offices

An outright sale of a business is a blunt tool to achieve a nuanced range of (often conflicting) objectives that a business owner may have. A few of the many objectives business owners may seek to achieve include:

- Capital to expand or to make acquisitions
- Liquidity for retirement
- Ensuring the firm remains within the family for generations
- Succession planning that ensures an orderly transition to the next generation
- Maintaining a continued business legacy and commitment to valued constituencies, such as its employees and the community, etc.

From countless conversations of business owners who have sold their organization, the near universal refrain is that this is the "hardest decision of [their] life—like selling [their] own son."[5] Unfortunately, most owners of smaller companies currently have few alternatives other than selling a business outright via a traditional sale. If truly provided with the full range of options, it is our experience that many, if not most business owners would prefer alternative deal structures. By thinking of a business owner as a "customer," we can strive to identify their unique needs and to develop a more customized offering, rather than proposing a cookie-cutter transaction. Given their inherent flexibility, this provides family offices with an excellent differentiator and a unique opportunity. Additionally, by being open to these untraditional deal structures, you dramatically increase the subset of potential investment opportunities—Many owners who would not have considered selling may consider these more relevant options.

Avoiding Commoditization

From cell phones manufacturers to IT services, every brand tries to avoid having to compete based upon price. Similarly, private equity investors must remain vigilant against becoming commoditized, and competing to pay the highest price. Owners have a natural tendency to try and maximize their payout on salient points when confronted with commodity-like choices. Just as brands attempt to de-commoditize themselves by introducing into the equation attributes such as quality, service, customization, and convenience, so should you. As a smart investor, you want to present a unique proposition that is incomparable on an apples-to-apples basis to other offers. Reframing this discussion to focus on the elements that are most important to a buyer is valuable for all involved parties.

Even if other financial institutions did manage to present the same exact terms, which is unlikely, it would still be difficult to compare their offerings to those of family offices because of the "human element." In deals involving ongoing involvement, compatibility is of paramount importance. When deciding whom to choose as partners, business owners are not comparing based solely on the highest valuation—they must make a number of subjective judgments regarding questions, such as:

- Who do I feel has the ability to add the most value over the long-term?
- Who do I enjoy working with the most?
- Who shares my core values?
- Who do I trust the most?

It is oftentimes advantageous to explicitly mention early in the process that you are unlikely to be the highest bidder for a deal, but that you can still add significant value through other means. In order to differentiate yourself, position yourself as an innovator who is willing to be creative and pursue win-win approaches. Make the case that you will provide a custom solution for their unique needs, and over the long run can often provide them with superior long-term value. Since the investment will fit with your Rules-based Investment Framework, your family can likely add significant strategic and operational value. Additionally, selling to family offices can be advantageous to business owners due to several systematic reasons:

[5] Interview with large family office executive

- Long-term committed capital that doesn't need a quick exit
  - When raising additional capital, owners seek a sense of control and often are highly dissatisfied with the traditional private equity forced exit in 5 years.
  - Many families invest as cash flow investors—while they would consider attractive opportunistic offers, they own businesses with the intent of owning them perpetually for generations, providing stability and continuity
  - "When we own portions of outstanding businesses with outstanding management teams, our favorite holding period is forever."[6] –Warren Buffett
- Flexible deal terms and working arrangements
  - Family offices are advantageous in the sense that they can pursue structures which private equity funds structurally cannot or will not pursue; they could be willing to:
    - Take small minority positions to buy out family members desiring liquidity
    - Provide sellers the ability to eventually buy back full control
    - Eliminate or dilute "forced sale" provisions
- Compatible, family values
  - Families are likely to share important values and traditions, which helps build rapport and trust with business owners
  - One family we have worked with flies out all of the brothers to have a "family dinner" with a potential seller, emphasizing their trustworthiness and approachability that a "suit" flying in from NY simply cannot provide
- Ability to be less disruptive, with the desire to not "gut" businesses in order to marginally increase short-term returns
  - After building a company from the ground up, a seller remains a member of the firm and its community forever; it is in the best interest of sellers to engage with buyers who will carefully manage and be more engaged with the business over the long term, enforcing rational business decisions that will not taint their reputation
  - Willingness to take longer-term views and not destroy a firm's established culture for a short-term improvement in profitability; these tactics are often short-sighted and counterproductive as low morale often leads to low productivity and errors
  - Families can and often will pledge continued support for other valued constituencies, such as long-time employees, the local community, etc.
  - Because of their more flexible nature, they are more likely to allow sellers and/or their families to still remain active in the business in some capacity

To conclude, the most valuable currency with a prospective business owner is a trusting relationship, based on mutual respect and common values. Despite this relationship, many business owners may still want to turn to an outside advisor or intermediary to validate the adequacy and fairness of the offering, through a formal process. However, if you can help

[6] Buffett, Warren, Berkshire Hathaway Shareholder's Letter (1988)

shape the scope of the expected deal terms (i.e. convincing the owner to favor deal structures where you are strongest), you can significantly tilt the odds of success in your favor. As articulated in a recent Harvard Business Review article regarding effective sales, "To win a deal, you've got to get ahead of the RFP (Request for Proposal)."[7]

Focus on Opportunities that Institutional Investors are Structurally Disadvantaged to Pursue

As discussed in our most recent white paper[8], families exhibit their greatest strengths when they invest as a strategic rather than a financial investor. Unlike private equity funds, a strategic investor brings a pre-existing platform, which is capable of partnering and adding value at an operational level with prospective targets (not just writing checks). Ultimately, the goal is to achieve strategic coherence (i.e. synergies) across the portfolio, where the whole is greater than the sum of the parts.

Fundamentally, all of the various points negotiated in a deal can be categorized into two fundamental components: economics and structure (primarily governance/control). Given the limitations of a finite-life fund, financial investors tend to be extremely conservative regarding this latter element—deal structures are all relatively standardized. However, if you, as a family office, can flexibly/creatively customize deal structures to accommodate a business owner's unique needs, you can maximize your strengths and value proposition relative to the weaknesses of professional financial investors. Ultimately, family offices are likely to perform best with two kinds of deals that private equity funds and other financial institutions are structurally disadvantaged to pursue:

1) Deals of a smaller size that are uneconomical for larger firms to chase
2) Deals utilizing atypical deal structures, which funds are structurally limited from matching

Institutional funds will not invest in smaller opportunities because their opportunity cost requires them to focus their efforts on a limited number of larger, more capital-intensive deals. While the specific threshold depends on a particular fund's size and strategy, most require a minimum equity check size of $20mm[9]. Similarly, the nature of private equity funds biases them towards investment structures that provide them with control (i.e. acquiring more than 50% of the stock) and an easily achievable exit. As illustrated in Figure 3 below, deal structures can be viewed along a continuum—funds show a strong preference for outright purchases and have a progressively lower appetite for each structure as you move rightward. Interestingly, this spectrum also negatively correlates with the comparability of offers. In other words, the

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[7] Adamson, Brent; Dixon, Matthew; Toman, Nicholas; "The End of Solution Sales," Harvard Business Review (June-August 2012)

[8] For fuller treatment of this topic see: "Rules-Based Investing: A 'how to' guide for targeting and assessing direct investment opportunities." McCombie Group Whitepaper Series. June 2013 <http://www.mccombiegroup.com/rules-based-investing/>

[9] These thresholds are significantly lower for venture capital investments.

right-hand deals are progressively less likely to be commoditized because of the increasing importance of the investor's involvement and strategic role.

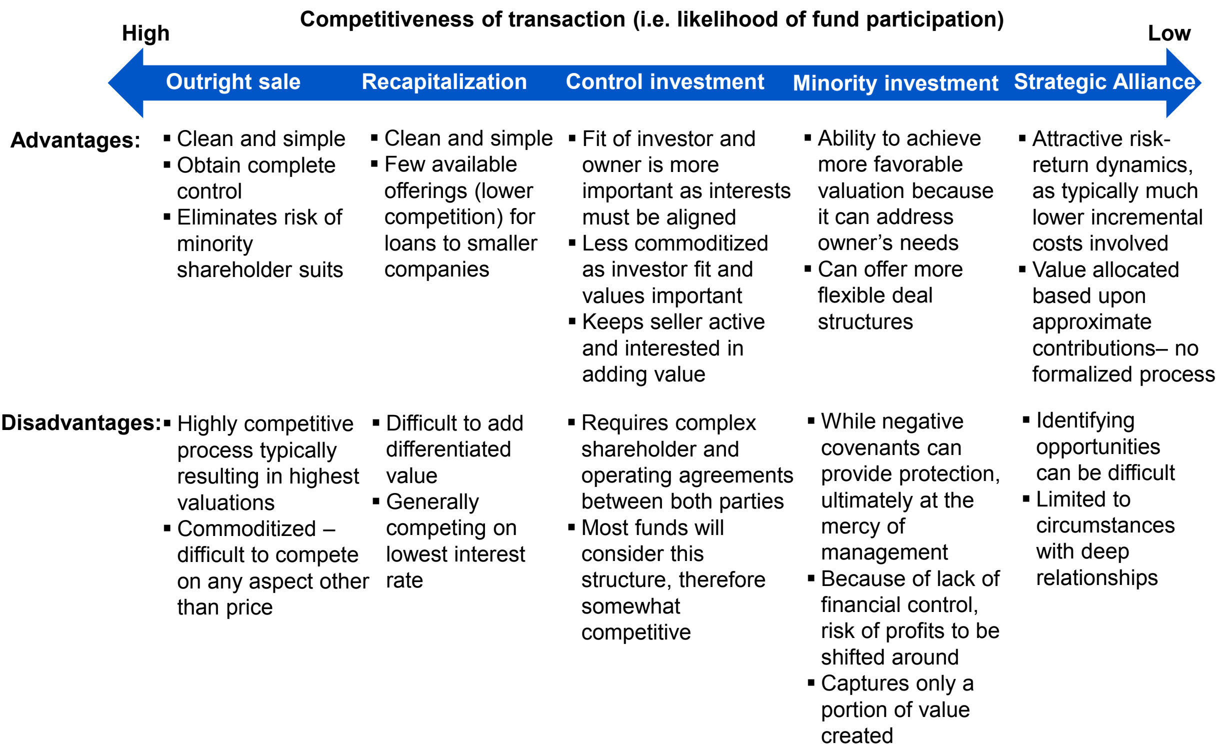

Figure 3. Range of Options for Business Owners to Accomplish Liquidity and Personal Goals

Exploring Different Deal Structures

An outright purchase of an asset is by far the most common investment technique, because it's clean and simple. Since post-merger integration is greatly simplified when outside shareholders are not involved, strategic buyers almost universally utilize this structure as well. Nevertheless, given the inherent competitiveness, it typically results in the highest valuations paid.

Recapitalizations are unsecured debt infusions, with the purpose of allowing business owners to dividend the proceeds to themselves—essentially substituting equity for debt. It allows owners to take some money "off the table" while maintaining full ownership and control of their companies, albeit with significantly higher leverage. That said, recapitalizations are only an option for larger companies within the current market environment.

Since both of the above options are easily comparable and don't require substantive ongoing involvement from the investor, the seller usually chooses the highest price or the lowest interest rate. Because investors do not have the ability to significantly differentiate themselves in these kinds of deals, larger financial institutions, which can and will pay more, typically find themselves submitting the winning offer. On the other hand, more

creative options in the middle are highly contextual and relationship-oriented, which tends to result in greater value for both the investor as well as the owner—a win-win situation. Traditional intermediaries can often shy away from these arrangements because they are unable to fully monetize them, since they are typically compensated on a commission of the sale proceeds. To the extent that one of these parties is involved in a potential transaction, it may be worthwhile to offer to "make them whole," by paying them fees equivalent to if an outright sale had occurred.

In order for the transition of ownership to be as smooth as possible, control investments are also prevalent amongst private equity funds, where the seller retains some residual interest in the company. The maintenance of ownership, even if for just a transition period, is typically achieved through one of two methods:

- Contingent Payouts (i.e. earn-outs) based upon the achievement of specific milestones,
- Purchaser chooses to purchase less than 100% of the company to ensure that the seller maintains "skin in the game" to incent ongoing performance

Oftentimes, business owners select this option as it provides them with immediate liquidity, while enabling them to participate in some of the future upside (i.e. able to "cash out" twice). Any time the seller continues to have an ongoing interaction with the purchaser, the human elements such as values and fit, become increasingly critical.

Minority investments involve taking a less than controlling stake in a business. It can either provide shareholders with some liquidity to cash out or it can be invested into the company as growth capital. Because the investor lacks majority and operating control, there is always the risk that profits are being extracted at his or her expense through techniques such as excessive wage increases and self-dealing (i.e. sitting on both ends of a financial arrangement). Hence, it is important to carefully scrutinize any related party or insider transactions, and to put in place strong negative covenants to protect the minority shareholders' rights. Often, it is helpful to create a sliding scale governance structure in which involvement and authority increases if underperformance occurs. Relatively few institutional funds desire to play in this space because of the more limited control and the lower amounts of capital that can realistically be deployed. Similarly, this structure limits investor upside by letting them capture only a portion of the value that they may be able to create. To this extent, it is often valuable to consider combining the investment capital with additional equity incentives if the family investor can aid in achieving specific milestones (e.g., an extra 2% of equity if a major account is closed). Given the lower competition and higher risks affiliated with these minority investments, valuations tend to be significantly lower than other structures.

If an investor has a relevant pre-existing operating platform that could add value, they might want to consider strategic alliances. Whether structured as a joint venture or a licensing agreement, each party essentially agrees to contribute financial and operational resources to pursue a new de novo opportunity. These arrangements can be particularly useful for extracting economic value when the business owner is adamant about maintaining 100% ownership of his business. The disadvantage is complexity. For example, there is a greater risk of cultural incompatibility, as the two parties must integrate seamlessly. Additionally, without

carefully constructed agreements there exists the potential for misaligned incentives (e.g. one party may be making money while the other is losing). Nevertheless, strategic alliances generally provide superior risk-return dynamics because the process is rarely competitive. Similarly to hiring a job applicant, most "sellers" decide that they would like to work with someone and then negotiate a "fair" arrangement—they rarely invite other less-compelling prospects to compete in an RFP process.

Remember, you have the right to propose any deal structure you want regardless of what the formal process may ask for. For example, a process could ask for "bids" to purchase a target outright and you could throw in a completely different alternative, such as a buy-out of a minority stake. In fact, the dramatic contrast in the deal structure relative to all of the other competing proposals will likely draw significant attention and consideration.

Finding These Opportunities

While a parallel approach is recommended (i.e. you shouldn't reject an opportunity outright just because of its source), all other things equal, a preference should be shown for "owning" deal flow that comes independent of intermediaries, such as investment bankers. Intermediaries are retained to obtain the best possible sales price and terms for their client, which corresponds to less attractive risk-adjusted returns for you. While simplified[10], they utilize two fundamental tactics to accomplish this: either running an open, wide-spread auction process or attempting to privately negotiate a deal with a single promising acquirer. In general smaller deals are biased towards using the latter approach, as there is lower appetite by potential buyers to absorb the high up-front fixed costs of effectively considering the opportunity, when there is the possibility of ultimately walking away empty-handed. Because successfully closing a deal is of utmost importance, intermediaries typically approach marquee private equity firms and strategic buyers first. Given their smaller size and less frequency of executing deals, family offices are generally the last stop for bankers. Consequently, it is crucial to consider that if all of the prior entities (all generally "smart money") have passed on the deal, it could be an indication of a flaw with the opportunity.

Buy-side M&A advisors and fundless sponsors typically accomplish a similar outcome when transacting business in a non-exclusive manner, as they are able to maximize the value they can extract for themselves by shopping it around for the highest fees or least favorable terms. Prior to using these outside resources for deal sourcing, you should clearly establish your exclusivity or preferred access.

Some smaller sellers (i.e. generally with enterprise values less than $50mm) may completely forego retaining an intermediary and will directly transact in a private deal. As these smaller firms usually have a more concentrated shareholder base, they have minimized risk of lawsuits claiming breach of fiduciary duty. These private deals are primarily associated

[10] In reality, hybrid approaches are often utilized. For example, they may choose to attempt to initially negotiate a sale with a promising acquirer, with the ability to convert it into a competitive auction if reasonable terms (e.g., price, deal elements, etc.) cannot be agreed upon.

with sellers who have a desire for discretion, rather than engaging in a publicized transaction, or a need for speed and an absolute certainty of closing. The three life event D's—death, divorce, and debt, also represent high potential candidates for transacting privately as an immediate sale is generally required.

The Art of Deal Sourcing

Sourcing good deals is an important skill in and of itself, which requires considerable time, labor, and capital. Building trusting relationships does not occur overnight, and can often take months or even years to cultivate. Moreover, a business owner may not be ready for a transaction at any given point in time. Tenacity and patience are vital to building long-lasting relationships that can pay off over the long-run. Studies have shown that the median amount of time from the start of a deal's search to its closing is 19 months, and approximately 40% of deals that do close will take in excess of over 2 years[11].

In order to gain greater control over their deal pipelines, the trend has been for private equity firms to implement formal cold-calling programs to identify new hidden leads. Borrowing from the best practices of their B2B portfolio companies, some funds have adopted Customer Relationship Management (CRM) technologies and techniques to aid in systematically communicating with prospective targets over an extended period of time. Aggressive cold-calling programs may not be appropriate for family offices as they are unlikely to have sufficient resources to justify the allocation of human capital to these capacities. Nevertheless, many of these best practices are relevant and applicable to any investor attempting to effectively develop relationships with prospective targets:

(1) Maintaining clear investment criteria (an investment policy) to ensure relationships being developed have a reasonable likelihood of actually closing
(2) Utilizing a formal CRM system (e.g., Salesforce.com) to track your prospective leads in a structured way
(3) Tracking basic metrics (such as quality and number of leads by source, etc.) to hone in on highest return techniques
(4) Maintaining consistent follow up with high priority targets (i.e. they may not be ready today, but could be tomorrow), and
(5) Using multiple outreach methods (phone, email, fax, UPS delivery, etc.) to get the attention of the person you are targeting

A central part of deal sourcing will include networking at various relevant events and tradeshows. The Stanford Graduate School of Business' Primer on Search Funds provides some helpful guidance on how to best prepare for them:

> "[To most effectively use your time, you] should plan well in advance of attending the show by calling the list of relevant targets to schedule meetings [with the target CEOs. You] can map out the exhibition hall and plan [your] route to see the maximum number of targets possible. One

[11] A Primer on Search Funds: a Practical Guide to Entrepreneurs Embarking on a Search Fund, Stanford Graduate School of Business (September 2013)

> searcher recommended creating an information card on each target that contained key statistics such as estimated sales, key personnel, and an opening pitch. Tradeshows can also be an effective place to make other useful contacts with industry consultants, service providers and executives."

Another critical element of strategic deal sourcing is cultivating a network of individuals who can connect you directly with potential sellers. These individuals should be privy to the target business' situation and condition and have trusted relationships with their corresponding owners. The process of cultivating a strong, inbound network takes a lot of time and effort. Ultimately, receiving leads is a non-linear process by definition—you simply do not know when or where your next deal will come from; it is not uncommon to receive an exciting opportunity from someone you haven't heard from in over a year.

The following types of professionals should represent the cornerstone of your network: attorneys (in particular, practitioners focused on corporate, trust and estate, as well as family law), accountants, management and operational consultants, commercial and industrial loan managers at local banks, corporate insurance brokers, as well as retired and current industry executives (current ones are often highly motivated, since they may want the opportunity to run a target venture). Even though these individuals desire a chance to generate corresponding fees from the deal and an opportunity to invest in a reciprocal relationship, they often have fiduciary relationships and are therefore highly sensitive to the deal being perceived as "reasonable and fair" by their client.

Less traditional sources of leads can come from can come from the Chamber of Commerce, Economic Development Directors, university professors, leadership organizations (e.g., YPO, etc.), "relationship brokers" (i.e. well-connected individuals in the country club), and current and former government officials/politicians (they have a vested interest to make meaningful introductions that could keep or increase jobs in their community).

Ideally, you would like for this network to make introductions to relevant business owners prior to when an official need for a transaction has developed and intermediaries have been retained. This timing is optimal because not only will you be competing against fewer contenders for a deal, but there is also overall less "noise" to overcome early in the process, which better facilitates the cultivation of a more meaningful, longer-term relationship. Even though a pain point oftentimes exists (e.g., "I'd like to reduce my time commitment to spend more time with my grandchildren," "I need more capital to pursue a promising opportunity," etc.), it is often difficult for business owners to articulate a specific need or the corresponding solution.

By articulating a well-defined investment policy, you can communicate your investor objectives and "brand" to the market. As an investor, this will preemptively allow you to focus your efforts on opportunities within your "sweet spot." Moreover, it is much easier for individuals within your network to remember you when they understand a clearly defined target (e.g., healthcare companies between $10mm and $20mm of revenue) versus a vague ask

for “interesting deals.” The latter approach will often result in becoming forgotten or being placed in a universal email blast list (i.e. the antithesis of proprietary opportunities).

It is important to note that a fundamental tension often exists between a family office’s desire for privacy and the need to have a public interface sufficiently open (i.e. being known as a “player” that is willing and able to close deals) to allow inbound opportunities to present themselves. Strategies often deployed to minimize these conflicting objectives include creating a separate publicly-facing team or outsourcing deal sourcing to a dedicated third-party. If you are going to hire or retain dedicated resources, it is valuable to screen for personality attributes correlated with successful deal originators. In general, they tend to be extroverted and personable individuals who can approach and win over various fresh leads. They have to show creativity and resourcefulness to get in touch with busy and successful entrepreneurs, and must exhibit sufficient business judgment in order to prioritize their efforts against the most attractive opportunities. “White hair” and a senior title are also valuable in commanding a prospective owner’s attention and respect. Lastly, it’s important for them to have the social awareness and flexibility to accommodate a target’s specific environment (e.g., not wearing a suit to visit a blue-collar factory, etc.).

Most investors would agree that sourcing their first deal is always the hardest; however, investors can engage in the above strategies to help them land their first deal. Once you back a firm you can often leverage the management team and former owners to source other opportunities through their networks, since they know the landscape and major players in their respective industries. Oftentimes, they have access to “insider gossip” that gives them information on who may want to sell or raise capital. These people can be your greatest “advertisers” as they can speak to the value that you offer and the effectiveness of the potential relationship, effectively soothing concerns that owners may have about private equity (e.g., you will endanger their business to make a quick profit). It cannot be emphasized enough that whether with your referral network or with business owners themselves, trust is a pre-requisite to long-lasting relationships and thus any successful proprietary deal. The deal ecosystem is small, and consequently maintaining a stellar reputation within this community is invaluable for long-term success.

Conclusion

Families have numerous particular strengths they can—and should—leverage in order to land deals at the best possible price-points. All the critical aspects we examined characterize family offices’ more involved, personal, and flexible approach to investing that larger institutional investors can usually not offer. When combining these elements with a strategic deal sourcing process that targets the most appropriate deals, family offices maximize their competitive advantage and their potential returns.

About the author:

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 closely-held 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. A thought leader on private equity, he has been a featured speaker at international investment conferences, and teaches a course at the University of Miami School of Business based upon his upcoming book on the subject: "The Family Office Practitioner's Guide to Direct Investments."

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 community, David currently serves as Chairman of the Advisory Board of HistoryMiami. He is a licensed Florida attorney.