PKF
Funds and Family Office
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Family-to-Family and Family-to-Fund Co-investing

www.pkffundsfamily.com

Is the deal right for us?

Wealthy families have been working together on co-investing opportunities for as long as there have been wealthy families – and opportunities. The 2008 financial crisis brought renewed focus, with many looking for more control and more alignment between themselves and their trusted co-investment partners.

How might we benefit?

It's natural to want to work more closely with peers whose interests and motivations more closely mirror your own. And there are other benefits. The potential for higher returns, access to geographic and sector expertise, cost advantages and risk mitigation.

Your family may be looking at ways to partner with your fund manager in order to have more control over your investments. It also means being able to access the fund manager's internal resources, particularly their ability to assess new investment opportunities. In exchange, you may make up- front capital commitments as the LP, in order to have more say and control in future investments.

This seems to be synonymous with a broader trend for families to look at ways to become more active with co-investment deals, whether as a minority or majority investor.

Who can we trust?

'Trust' is perhaps the single most important issue to consider. And this is especially relevant in the context of diversification. If you are typical, your family has made a lot of money doing what it does and knows best. Now you're looking to make that money work harder, achieve more – which inevitably means venturing outside your comfort zone.

But who can you turn to as a guide in such unknown territory? Ideally a peer who you feel you can trust. Very often such trust forms the basis for the pooling of expertise. 'We know real estate; you've done well in financial technology; let's create deals which allow us to capitalise on your expertise, and you on ours.'

Find a partner you trust - even if this takes time – and make sure that your interests are aligned.

Make the most of your network of personal contacts to create deal flow. Look for partners that have a track record of successful deals. Understand what specifically you want from a co-investing deal. What resources can you bring to the deal (other than capital)? How can you incorporate exit clauses as this can help mitigate conflict? And, ultimately, go with what you know – years of experience can pay off.

Is it just about the money?

No, it's not only about the money, but in a way it is. Some families want more than just to write a cheque and wait. They genuinely want to 'do things'. Co-investments involving complementary yet cooperative engagement, can offer greater potential for participants to feel something more than just money is involved. To feel they can really contribute, help, achieve and create something worthwhile. That said, the primary driver for co-investments is the desire for outsized returns. So more involvement can lead to more control, reduced fees and potentially better outcomes. But this does come with increased risk.

What should we look for in a partner?

It's not only about trust, either. You need to know not just that they can be trusted with your money, but that their people are the kind you want to work with. Who are they? What do they believe in? What are their ethical underpinnings, ambitions, and drivers? The bottom line is that if you are a family contemplating such a co-investment, you bring a lot more to the table than cash. And you will look to take away from such a deal more than just a good return on your investment.

So you must find strategic partners who not only offer a complementary skill set, but whose values and ethical convictions align with your own. Most likely you don't want just to work together or make money together. You probably want to achieve something worthwhile together – and that demands more than just trust and commercial capability.

What should you consider when choosing a co-investment partner?

- Industry-related experience
- Value creation record
- Co-investment experience
- Alignment of value and objectives
- Financial alignment

Trusted relationships are always important. But you must look beyond that and make sure due diligence is conducted independently on your prospective co-investment partners, and on the deals you plan to be involved in.

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Sourcing the deal

So wealthy families have been engaging in co-investments for centuries. One thing that's brought such arrangements into greater focus now is the emergence of new facilitating mechanisms.

Where are the deal flow opportunities?

Traditionally you might have worked with a family you know, from down the road. Today, with the help of peer associations, you can access opportunities from far further afield – and seek partners from around the world. Typically, though, you will source from your trusted network, which can present its own challenges (of which more later).

As co-investing has become more attractive, so the opportunities to access deal flow have increased. We are seeing families looking to partner with other investors via their personal contacts, as the primary source of deal flow. But we are also seeing a growth in the number of family-to-family investor platforms which are bringing like-minded families together to share and collaborate. There is more deal-sharing facilitated by the banks. More families are researching their own deals, in some cases using AI and other technology to drive their proprietary deal flow. And others are using existing fund relationships. The key, as always, is sourcing attractive deals and being able to assess their suitability.

What are the greatest challenges?

When you consider co-investing, you will face several challenges. We've looked at some of them above, but to summarise:

So why do it?

It seems like a lot of work just to find attractive deals. Let alone resource the due diligence for both partner and deal, manage ongoing opportunities and continual assessment. So why get involved and what can you expect in return?

There are several motivations for families' participation in co-investment opportunities. The primary driver is that you expect outsized returns. You also anticipate lower fees and greater control. There's a preference to underwrite a single asset, to have a more hands-on approach, perhaps because of a need to feel like an operator/entrepreneur. You want to use your strategic advantage (sector and geographic knowledge), to share knowledge, maximise the value of your network, and access new market opportunities.

The technical due diligence – your check list

Not only it is vital your partner is right for you. But also the deal itself. Here are some musts when undertaking due diligence on the deal:

Step 1

Ensure that EBITDA is realistic, and the completion accounts and historical numbers are calculated by a competent accountant. Assess the financial reporting function and consistency of maintaining the accounts for the past 3-4 years. Check the accounts are kept in accordance with applicable accounting standards.

Step 2

Spend time understanding the true working capital needs of the business. Does the company have a practice of enforcing terms (against debtors/ receivables) or paying within terms for vendors? If working capital appears too high or too low based on past practices, that may not be sustainable after a change in ownership.

Step 3

Assess business relationships with related parties – is everything at arms-length? Are services being provided or received that may not be available post-transaction?

Step 4

Assess senior management/owners' salaries over a minimum period of 3-4 years. If they have been looking to sell the company, they may have reduced all senior level salaries and/or benefits to boost results and therefore the sell on multiple.

Step 5

Assess the level of personal use assets in the business, such as cars or rental properties to verify these are all at arm's length.

Step 6

Review the non-current asset base closely to check that the value is accurate and up to date. Many businesses tend to relax their watch on non-current asset values and don't always grasp the benefits of amortisation and depreciation.

Step 7

Intangible assets tend to hold more value to the seller than the buyer. **Ensure third parties are used to value** these accurately and fairly.

Step 8

If the business holds stock, **make sure a stock take is carried out on the date to which the completion accounts are drawn up.** This seems like a no-brainer, but we have seen hundreds of thousands in stock written off because of inaccuracies in accounting for stock held and how it has been valued.

Step 9

Assess the management team's impact on the results and whether the business value lies with them rather than the 'Company'.

Step 10

If the numbers seem too good to be true, they probably are.

Step 11

When appointing advisors for the due diligence, **make sure at least one in-house team member is running the project to keep the deadlines required.** The advisors should complete the hard graft while the deal is run by the family office. Develop a detailed work plan and time line for each of the key due diligence work streams, in order to keep everyone in sync and focused on a time-lined closing.

Step 12

Ensure the information provided by all sides is in a secure data room to which all parties have access. This makes people culpable if they have not kept to deadlines for providing information in an orderly fashion.

Step 13

Make sure you have the right fit. Is the deal right for you?

Doing the deal

Assessing a potential opportunity is a three-step process:

- **Is this deal right for you?**
  Does it feel right – does it feel 'you'?'
- **If you look under the bonnet, what do you find?**
  Do the numbers add up? Does the rationale make sense? Are the ethical aspects in order?
- **Can you work with this family/partner?**
  Are they like you? Can you trust them? Do they trust you? Will you see eye to eye on any issues that may arise?

What else should we beware of?

Even more complicated are deals originating with people you don't know, proposed by people that you do. Trust once removed – or more than once. Or deals where the web of participants has become tangled or unclear. Many family-to-family deals, by their very nature, involve not person-to-person relationships, but people-to-people relationships. For example, you might feel perfectly comfortable dealing with family members with whom you are familiar, but things can become uncomfortable if a less 'qualified' family member who is yet to earn your trust starts to introduce new opportunities.

Ultimately, you will want to avoid a disaster in which value is lost and family disputes arise. The absence of third-party professional advisors places greater responsibility for due diligence on direct participants.

It's up to those proposing to co-invest to ensure that the bonds of trust aren't overstretched, that they maintain a clear picture of what's really involved – and who's in control. So it makes sense to put emphasis on assessment and due diligence in order to mitigate any negative impact. We would always recommend you outsource this work to a trusted partner.

What if it all turns bad?

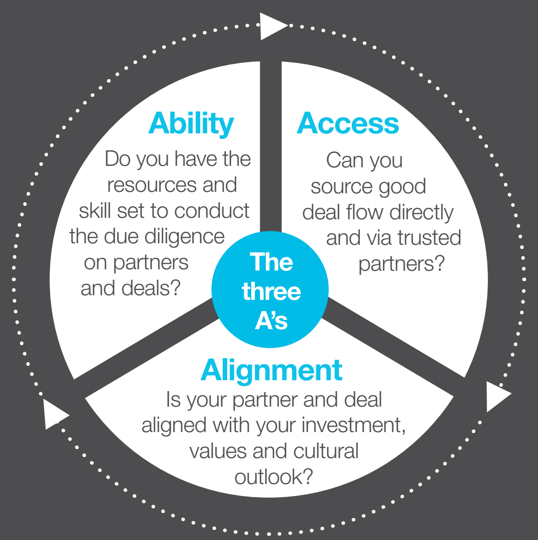
Obviously, the nightmare scenario is getting involved in a deal where everything goes wrong and all involved lose money. As a potential deal-maker you must be aware of the risks, be confident you know what you're getting into. and that you have a sound fall-back position if worst comes to worst.

Your family might consider actively rejecting deals brought to you, for counter-intuitive reasons. Not because you didn't like or trust the family proposing, but the exact opposite. Sometimes the value of the relationship is worth more than the potential of the deal. Counter-intuitively, when investing with those you know and trust it makes sense to apply more stringent scrutiny to the process and your due diligence. That way, if things don't go to plan, you can pin the blame on some aspect of the process, rather than on the family that has introduced the deal to you.

Key points

Families are constantly looking to do direct deals together and co-invest with fund partners. However, it's important to consider a number of pitfalls. The most important are linked to:

- **Access** - Can you source good deal flow directly and via trusted partners?
- **Ability** - Do you have the resources and skill set to conduct the due diligence on partners and deals?
- **Alignment** - Is your partner and deal aligned with your investment, values and cultural outlook?



We see co-investments helping to drive more impact investing as family members look to align broader family values with financial objectives.

Finally, you should have enough understanding of the sector you invest in, excellent communication and trust between your co-investment partners, alignment of investment timescales, and the facility for additional capital calls.

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