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# Direct Investing 101

Trends & Perspectives For 2017

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# Outline

- I. Overview of Direct Investing
- II. The Direct Investing Landscape
- III. Role of the Private Investor
- IV. The Direct Investing Process
- V. Conclusions



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# I. Overview of Direct Investing

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# I. Overview of Direct Investing

- ❑ “Direct Investing” is a term that is front and center for investors today. What is the attraction and what do we mean by calling an investment “Direct”?
- ❑ We define direct investing as acquiring a financial and operational interest in illiquid assets such as privately held companies or real estate, and that the future asset owner is making the decision to take part in a specific investment.
- ❑ In this report direct investing refers to an overall approach that includes originating, analyzing, processing and structuring of private equity and real estate investments.
- ❑ Many private investors are looking at direct investments as a focal part of their alternative asset allocations in 2017 and beyond.



# I. Overview of Direct Investing

- The overall process for sourcing, vetting, structuring and closing a direct investment is virtually indistinguishable from an institutional private equity process. Success is reliant upon exceptional deal origination, a defined investment thesis, sophisticated due diligence and analysis, specific terms, and structural best practices.
- The nuance to direct investing is that investors are funding investments from their internal sources of capital they directly control.
- Direct investing is a high risk investment strategy and since it is not suitable for most investors, remains primarily the domain of family offices, ultra high net worth individuals and other private investors.



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## II. The Direct Investing Landscape

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## II. The Direct Investing Landscape

- Many investors view direct investments as assets within their alternative allocations that offer more control, alignment of returns, and a counter cyclical long-term investment. The majority of direct investments map back to the institutional private equity and real estate market.
- When investors controlling the investment decision, and take risks through their internal sources of capital this often leads to an alternative and customized process.
- Many direct investors will look for specialized oversight methods and may have more flexibility with respect to timeframes compared to formal funds where investors are allocating to a blind pool of investments.

## II. The Direct Investing Landscape

- There are many types of direct deals that typically map to the boarder investment markets that institutional funds and investment groups focus on:
  - Private Equity (operating business and real estate)
  - Venture Capital
  - Club Deals/Pledge Funds
  - Debt and Equity Financings
  
- In each of these sectors there are institutional quality investors with long standing industry specific expertise and track records whose sole purpose is to find the most attractive deals with the highest probability of generating extraordinary returns.



## II. The Direct Investing Landscape

- Therefore it is relevant to evaluate the broader private equity markets as it relates to:
  - Sector focus – where are the investments going?
  - Transaction types – where is the capital flowing?
  - Risk/IRR – what types of investments present the highest/lowest risk and return profiles?
- Our analysis indicates that 2017 will continue to be a strong year for buyouts and valuations will continue to be strong as private equity funds have record levels of capital to deploy.

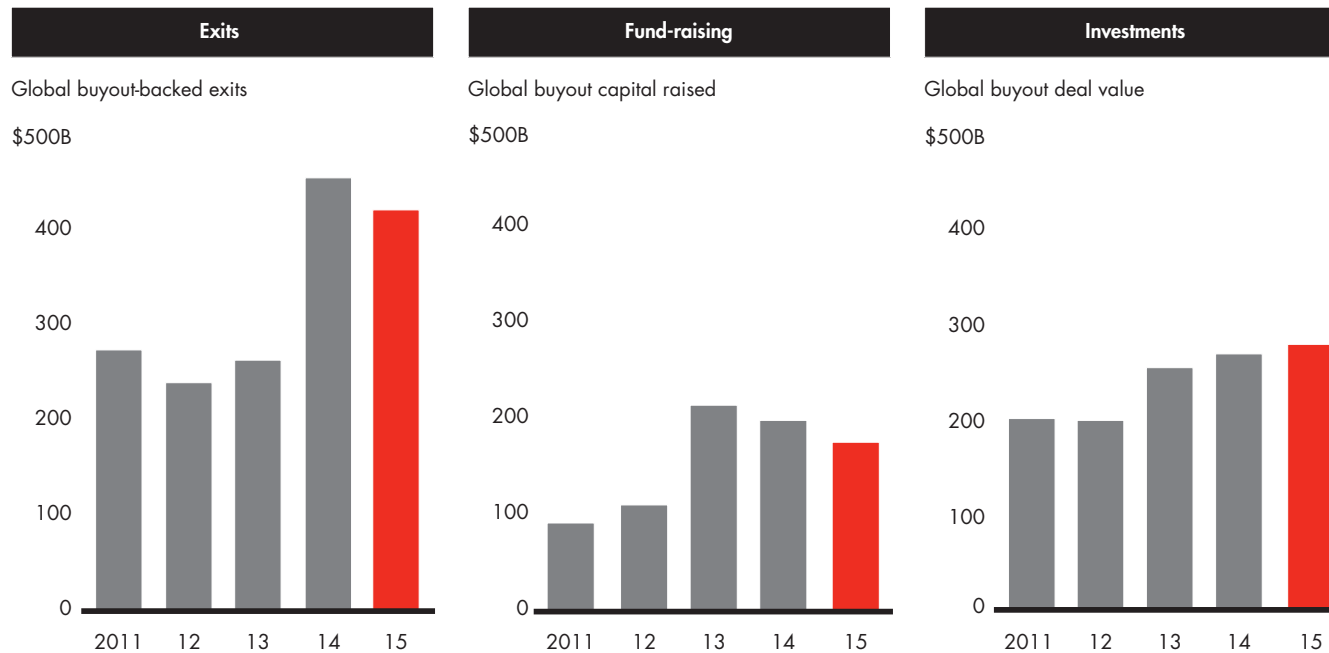
## II. The Direct Investing Landscape

- 2015 was another record year for private equity buyouts exceeding \$450 billion.\*
- 2015 was the 5<sup>th</sup> consecutive year that distributions outpaced capital calls.
- This record flow of capital has resulted in steady fundraising by PE funds that now have an all time record amount of capital available for investment (“Dry Powder”) while continuing to increase topping \$1.2 trillion globally.
- Deals remain scarce, driving up valuations.

\*Source: Bain & Company, Inc. Global Private Equity Report 2016

## II. The Direct Investing Landscape

- 2015 was a record year for exits, while fundraising and investments held steady\*

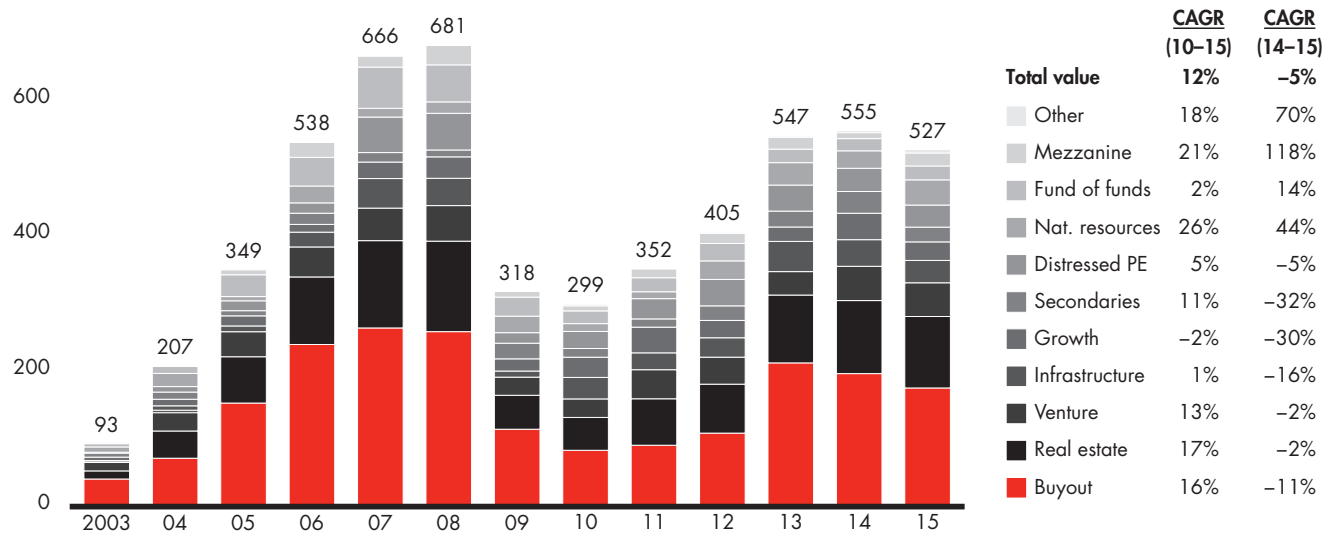


\*Source: Bain & Company, Inc. Global Private Equity Report 2016

# II. The Direct Investing Landscape

- Global Private Equity Dry Powder is at an all time high

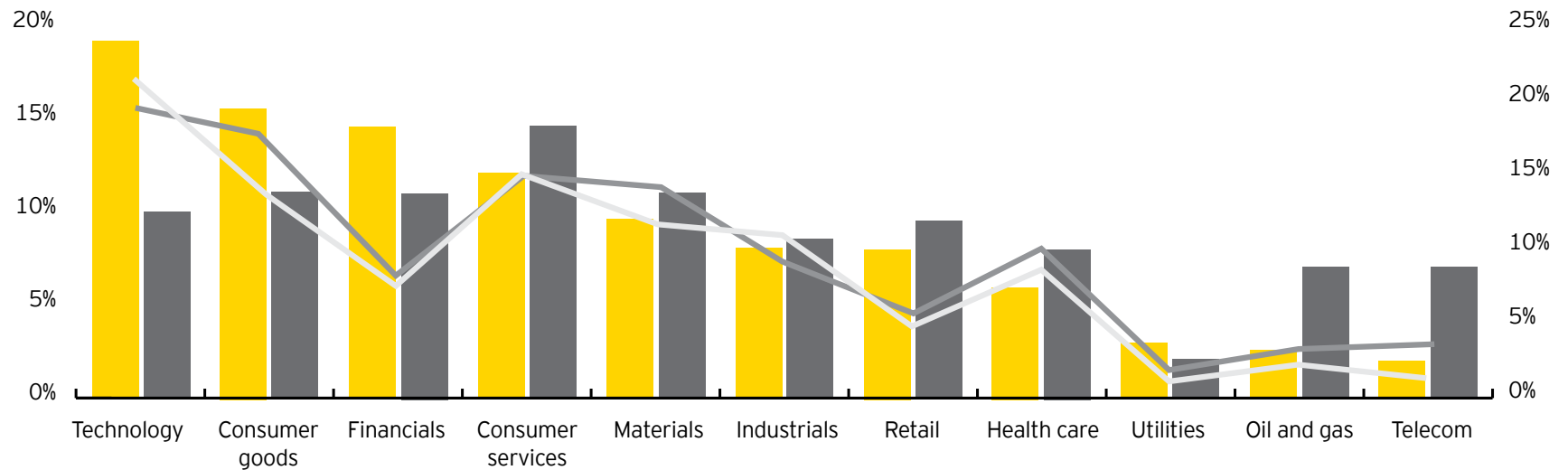
Global PE capital raised (by fund type)  
\$800B



\*Source: Bain & Company, Inc. Global Private Equity Report 2016

## II. The Direct Investing Landscape

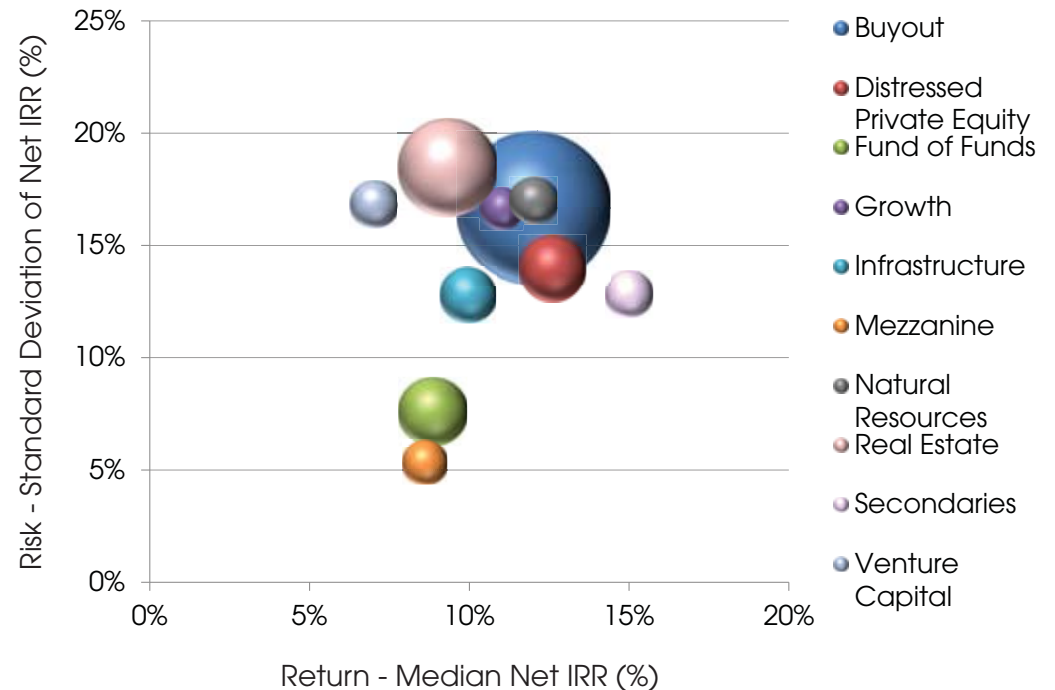
- ▣ The following sectors continue to attract the most investment from PE funds by sector, value and volume of transactions (not including real estate)



\*Source: Dealogic

## II. The Direct Investing Landscape

- ▣ The Risk/Return profile comparisons of different private equity strategies



\*Source: Preqin Ltd. Quarterly Private Equity Update 2015

## II. The Direct Investing Landscape

- Conclusions:
  - Institutional investors are likely to continue to focus on larger investments in strong later stage companies
  - These transactions continue to be competitive for investors, driving strong valuations
  - M&A will continue to be strong in 2017 and the primary exit strategy for direct investments
  - IPOs however are likely to reemerge at the top end of the market
  - Many opportunities will continue to exist in the smaller private investment market whereby investors can find unique opportunities that offer compelling value creation



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## III. Role of the Private Investor

Direct Investing 101



## III. Role of the Private Investor

- Allocations to alternative assets by family offices has continually increased and is expected to continue to increase serving as a good benchmark for private investors.\*
- Many family offices are drawn to the direct deal marketplace for a variety of reasons including:
  - Wealth was originated through company ownership and they understand the extraordinary value that can be created through privately held enterprises.
  - Limited partner interests in funds as a blind pool may not achieve performance expectations while top quartile performance funds are closed to new investors.
  - The investible capital controlled by family offices is growing significantly, therefore family offices can compete with institutional private equity funds for deals.
  - Investors want direct engagement with a portfolio company.
  - Investors are scrutinizing the fee structure of traditional funds.
  - Motivated by deep sector expertise and provide significant value.

\*Source: The World Economic Forum, Direct Investing by Institutional Investors

## III. Role of the Private Investor

- Returns & a Tailored Portfolio – direct investments can provide a counter cyclical asset class to a customized portfolio designed to achieve unique and specific returns and long-term performance.
- Control – investors have more control over when to sell an asset, and investing directly removes layers of intermediaries and asset managers.
- Value & Alignment – many investors can build out sophisticated direct investment capabilities at a similar cost basis to external fund managers with closer alignment to an office specific strategy.

## III. Role of the Private Investor

### Modes for Direct Investing

- ▣ There are three main pathways to making direct investments:
  - ▣ Solo – has the most discretion but is also the most demanding requiring significant infrastructure, rigor and resources.
  - ▣ Partnering (co-investing with other family offices) – aligning with other asset owners to share risks and responsibilities.
  - ▣ Fund Co-investing – investing alongside a fund leveraging their process, due diligence and ongoing oversight.

## III. Role of the Private Investor

### Risks

- Many critical risk factors and considerations exist with any direct investing strategy:
  - Direct company/asset ownership presents many operational, governance, oversight and control issues. Operating businesses require “care and feeding” and achieving returns is predicated on exceptional operational execution.
  - The discipline to NOT move forward with an investment is critical to avoiding future losses but also requires a high level of deal scrutiny and process rigor.
  - Investors may find themselves involved in transactions as co-investors as friends and personal contacts draw them into transactions that are not suitable.

## III. Role of the Private Investor

### Risks

- ▣ There are many instances of unsuccessful investments in the direct marketplace for a variety of reasons:
  - ▣ Generating desired returns (defined) is reliant on a business operating and executing at the highest possible levels. The ongoing oversight, monitoring and operational participation is extremely high.
  - ▣ Company level – operational risks (internal)
  - ▣ Market level – competition and sector risks (external)
  - ▣ Product or Service level – e.g. technology obsolescence (unseen)
  - ▣ Investor level – continued requirements for additional capital (unplanned)
  - ▣ Investor was fee driven, cut transaction costs, and underestimated what was required to process and oversee the investment which reduces the return expectations below that of a traditional fund.\*

*\*According to research by the World Economic Forum, very few institutions say their direct investing programs are principally a cost-avoidance tactic.*

## III. Role of the Private Investor

### Types of Investors

- There are many types of private investors that participate in the direct investment marketplace, with different objectives, capabilities and characteristics.
- Family offices are unique in the private equity investment market primarily because they operate without a specific mandate allowing for more flexibility in terms and time horizon/exit strategies.
- General types
  - Sophisticated and experienced – has strong capabilities as an investment office and views direct investing as an economic engine for continued multi-generational wealth creation (focused staff and infrastructure)
  - Opportunistic – will look at deals as they come along but generally more focused on wealth preservation (outsourced capabilities and not the focus of overall investment structure)
  - Unplanned – brought into deals through friends or family (has small portfolio and high concentration of risk with only one or two investments)



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## IV. The Direct Investing Process

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Direct investors will likely have gone through, a customized and disciplined rigorous process specific to its direct investing activities.

Many times additional resources, both internal and external, are required.

- Sourcing
- Vetting
- Negotiating
- Due Diligence
- Post Closing Monitoring
- Operational Oversight & Board Participation
- Exit Strategies



## IV. The Direct Investing Process: Sourcing

- The first step to identifying suitable opportunities is to have a defined investment thesis that will serve as a screen to evaluate opportunities:
  - What are you looking for and why? Growth equity? Venture Capital?
  - What sectors are suitable (and why)?
  - What are the value added capabilities or advantage the investor has in this particular transaction compared to other investors?
  - What is the desired outcome(s)?
  
- Sourcing opportunities that fit a defined investment thesis requires a concerted and sustained effort that leverages the investor's ecosystem:
  - Attorneys, accountants, investment bankers, lenders, rolodex...etc.
  - Each investor has a unique ecosystem that should be considered when defining an investment thesis

## IV. The Direct Investing Process: Vetting

- Once an opportunity passes the first level of evaluation and warrants a closer look typically a formal vetting process takes place.
  - Preliminary information request
  - Multiple meetings with management
  - Defined & organized investment committee
  - Vetting memorandum
- Investment committee established and makes a go vs. no-go decision

## IV. The Direct Investing Process: Negotiating

- Once an investor desires to move forward with a specific opportunity they typically submit a term sheet before entering into due diligence.
- General transaction terms should be proposed and negotiated so all parties know that if the due diligence process is positive, all parties have agreed to a structure up front and can move forward.
- Negotiating with Management (seller)
  - Valuation analysis
  - Aligned objectives
  - Investor value add/advantage

## IV. The Direct Investing Process: Due Diligence

- ▣ It is critical to run a detailed and intensive due diligence process with a “quarterback” for the family office responsible for driving the activities and analysis.
- ▣ Industry experts may be hired as consultants and advisors.
- ▣ Focus areas:
  - ▣ Legal
  - ▣ Accounting
  - ▣ Operations
  - ▣ Management
  - ▣ Business Plan
  - ▣ Risk assessments
  - ▣ Industry and regulatory

## IV. The Direct Investing Process: Post Closing & Oversight

- The most overlooked question in the direct investing marketplace is; “what do you do after you write the check”?
- Governance established in closing documents.
- There should be a clear alignment between investors and operating teams as to the business plan and objectives.
- With an alignment of the business plan, the appropriate interactions, involvement, and communication types and frequency can be implemented.

## IV. The Direct Investing Process: Exit Strategies

- Typical private equity exit strategy is 10x (cash on cash multiple) return within 5 years.
- Is this right for a private investor?
- Considerations:
  - Buy and sell – build value quickly, growth oriented and then sell to strategic or financial buyer
  - Buy and hold – looking for dividend return of capital over extended period of time
  - Family member participation – succession planning
  - Legal Trust as an investor – wealth transfer strategy and tax considerations

## V. Conclusions

- ❑ Direct investing is not just a passing fad and is predicted to continue to increase.
- ❑ Success will be driven through a dedicated or refocused investment thesis, processes, rigor and resources.
- ❑ Investors must distinguish between ownership and control.
- ❑ A direct investing strategy should not be undertaken solely as a cost reduction activity.
- ❑ There are multiple pathways to the market with co-investing being the most prevalent.
- ❑ The investor who is interested in direct investing, should honestly answer the question “does direct investing play to our strengths?”



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