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MIDDLE MARKET Growth

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DNS Capital's Family Values

How relationships, humor and country music inform the family office's approach

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Fostering Deal Flow for Families

How a new generation of advisers is meeting the growing demand for direct deals

BY BAILEY McCANN

Family offices have long been a source of capital for midmarket private equity funds as limited partners, but in recent years their influence in the middle market has increased in another important way.

More and more family offices today are investing directly in operating companies, either on their own or alongside other family offices. In response to this trend, a growing number of would-be general partners have changed their business models. Rather than going to market with a commingled fund with capital commitments from LPs, they are launching family office advisory services and bringing individual deals to families.

Illustration by Mitch Blunt

Florida-based Bonaventure Equity is among the firms taking this approach. Its founder and CEO, Ross O'Brien, had over a decade of experience in investment banking and private equity before starting Bonaventure. He says for small and medium-sized family offices, going deal by deal can provide a better return profile than joining a large mega-cap fund or trying to research hundreds of middle-market GPs.

"We work with families to help them diligence companies, create the investment thesis and manage the investment," O'Brien says. "The model works well for both sides. Investors feel like they have more control and entrepreneurs often choose us over a traditional sponsor-backed deal because they prefer our terms."

O'Brien adds that working this way allows him to be more collaborative with investors. "We are regularly in meetings with families to understand what kinds of opportunities they are looking for. And when we can go to them and say we have a deal that fits, you stand out. You're not just another first-time fund."

Austin-based CrowdOut has taken a similar approach to differentiate itself in a packed field of lenders. It specializes in loans to midsize companies and provides financing to middle-market private equity firms and fundless sponsors. The firm also works with families and other investors, bringing them individual financing deals with unique terms.

"Being based in Texas, we work with a lot of investors that are already heavily exposed to energy, for example, so when we talk to them about opportunities, they'll say 'We're up for anything but energy, we want to diversify,'" says J. Sulester, CrowdOut's senior vice president. "We're able to provide that for them with options that are fully exited in a few months to a few years."

Unlike banks or credit funds that ask founders to pay only interest for several months, companies working with CrowdOut begin paying back the principal right away. That lowers risk from Day One and shortens the repayment window, giving both investors and founders a clear timeline for exit. Individual deals also mean that family office investors can tailor their exposure to a greater degree than through a traditional private equity fund.

PRODUCT INNOVATION

Family offices have approximately $1.2 trillion in collective assets, according to a recent report from Capgemini. The increased allocation of those dollars toward bespoke direct investments has served as an anchor for a growing ecosystem of investment product innovation in the middle market. Investors and founders say there is a freedom to experiment when it comes to working with midsize companies because of the dynamism and growth opportunities in this segment of the market. Family offices are positioned to support this creativity because they aren't under the stringent mandates—such as provisions for minimum deal sizes, meant to curb risk—that often restrict how large institutions can invest.

"I think we are just starting to see innovation in deal terms and structures," says Eric Becker, founder and co-chairman of Chicago-based private wealth management firm Cresset Capital Management. The firm recently launched a family office in San Francisco to advise families on deals, governance and leadership development. Cresset is in the process of evaluating several new structures specifically geared toward matching family office investors with middle-market companies. Becker says he's seen investors and founders come together on terms that might lead to a long-term equity interest in a portfolio company, rather than a traditional five- or 10-year investment.

In addition to funding, family office investors often bring operating expertise from running the businesses where their wealth originated.

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Cresset is working with some families to help them partner with other family-owned businesses, enabling them to share firsthand experience and take a more hands-on approach than they could as part of a commingled fund.

Special purpose vehicles, a legal structure that lets founders and investors define specific and narrow financial terms, are also becoming more popular as a way to structure direct investments. They still allow for deal-by-deal evaluation, but they look similar to a traditional private equity fund and can be attractive to family offices that want more external management. Multiple transactions can be included in an SPV, but investors retain control over the investment selections and terms.

MANAGING EXPECTATIONS

It remains to be seen how this experimentation will play out. Investment terms—including the length of the investment, milestones for when new capital is available, or lower fees—may be more favorable to families outside traditional private equity fund structures, but this style of investing requires close monitoring and could potentially warrant operational coaching for businesses. Both require resources and deep expertise, and there may be more hands-on work than some families realize. Meanwhile, the current environment of high prices and intense competition creates the challenge of finding reasonably priced deals that haven't been picked over.

"The issue is how many quality deals are available at reasonable valuations," says Jolyne Caruso, CEO of The Alberleen Group, a family office advisory firm in New York. "Families have to determine what are the best 'unshopped' investments, then they have to diligence them, negotiate deal terms, and ultimately monitor them until they exit. With a diversified portfolio of 10-15 direct deals, it becomes a full-time job to manage a portfolio of direct investments."

Caruso doesn't expect direct investing to slow down anytime soon, but she notes there isn't much data on direct investment performance in aggregate nor in a recessionary environment. "As this cycle matures, it will be interesting to see if many smaller family offices just decide that paying a 1 to 2 percent management fee and 15 to 20 percent [carried interest] is ultimately a more efficient way to generate alpha in their alternative portfolios," she says.

O'Brien and Sulester say that finding quality deals is easier without a fund because they can identify opportunities for families without the pressure to invest against the life cycle of a 10-year vehicle. "This is an old story at the mega-fund level," O'Brien says. "Many of those firms can't find enough high-quality deals at the size that they need, on the timeline they need, so they just do any deal. We see it happening more now in the middle market as well, as valuations have come up and more capital is waiting to be deployed."

O'Brien says investors should be concerned about GPs who are under pressure to invest. In that case, it is less clear where the value will come from and the level of return they'll be able to achieve. To adapt in the current environment, a number of private equity firms have opted to lengthen their investment time horizon or build more flexibility into their deal terms. But many remain beholden to a five- to seven-year investment period, which doesn't fit the long-term needs of some companies.

"I don't have to invest that way," O'Brien says. "We won't do a deal unless we think there is a clear path for value creation." //

Bailey McCann is a business writer and author in New York.

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