



The Family Office Emerges as a Middle Market Investor

Private Equity funds are not the only investors to consider.

by Michael J. Black

The private equity market is experiencing a resurgence of activity from an ancestral founder, the family office. We have seen a rise in the number of family offices expressing interest in growth investments, recapitalizations, and purchases of middle market companies in the Pacific Northwest. Those looking to raise capital have the opportunity to access new sources but may find the complexity of navigating the various strategies and unique appetites of family offices challenging.

In 2012, the Wharton Global Family Alliance* (WGFA) published its benchmarking report for the single-family office (SFO). This

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latest report from the WGFA builds on data from surveys conducted in 2007, 2009, and 2011 of global SFOs. The 2012 study found that an increasing percentage of family wealth is tied to operating businesses controlled by the family, rising from 18.3% in 2007 to 34.4% in 2011. While this global data does not specifically address SFOs in the Pacific Northwest or even the United States, it does highlight an important trend in the global allocation of private investment capital.

DIRECT PARTICIPATION INVESTMENT

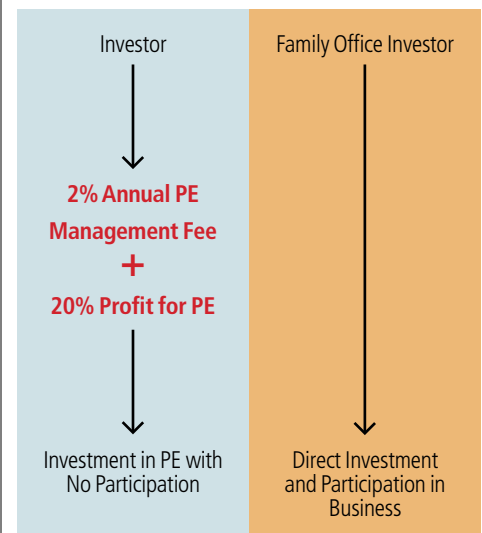
Investors have acquired entire companies and made minority investments in businesses for hundreds of years. Prior to the emergence of the modern private equity industry 40 years ago, wealthy families or individuals made the preponderance of these private company investments. Today, wealthy families and individuals are resurfacing as a direct participant in the in-

vestment process through the use of the family office, a professional organization that provides a wide variety of services to either a single family or multiple families. The duties performed by the family office can vary widely from managing shared family assets to individual concierge services, but the overall directive usually calls for managing the personal and financial affairs of family members. In many cases, the source of family wealth is often still concentrated in a business founded by the family.

There are various factors that drive the appetite for direct investment over the indirect investment model practiced by private equity firms. Today, the modern private equity firm raises capital from many sources (known as limited partners), including wealthy families and individuals, who commit a fixed amount of capital for a period of 10-12 years. The private equity firm uses this committed capital to make investments in various operating businesses, typically for a four to seven year holding period. Analogous to a mutual fund, the private equity fund offers the investor a diversified exposure to multiple capital appreciation opportunities that are vetted by equity investment professionals. However, this opportunity comes with costs: generally a 2% annual management fee and 20% of the gain earned on the investments. Limited partners typically have no governance rights or ability to influence the investment decisions or the strategy or operations of the acquired businesses. The length of commitment time, relatively short holding period of individual investments, annual management fees, profit split, and inability to affect operations directly all bolster the family office's desire to invest directly in businesses rather than through an institutional private equity fund.

HOLDING PERIOD

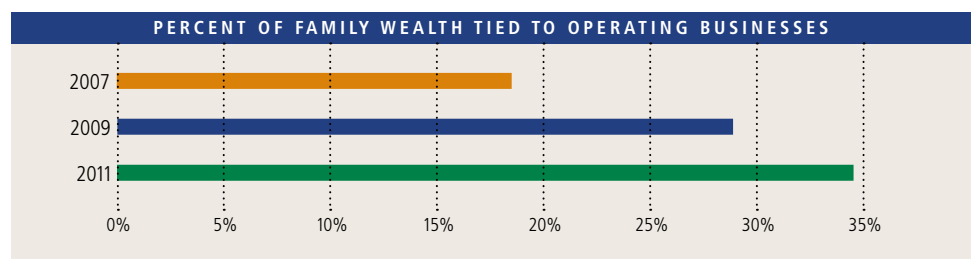
Long-term (perhaps indefinite) ownership of private businesses is a point of differentiation among family offices when compared to traditional private equity firms. Divesting a business may not suit a family's goals. Rather, some family offices wish to find opportunities to enhance operations and profitability of potential acquisitions with an eye toward building the investment's value indefinitely. Specifically, when



expertise, contacts, or proprietary knowledge of an industry exist within the family, strong governance and influence in the investment may accelerate growth and greatly enhance shareholder value. This does not happen as a limited partner in a private equity fund.

STRUCTURE

Direct investment from family offices can embody a variety of forms with great flexibil-



ity. Instead of being tied to a specific industry, geography, or investment thesis (as most institutional funds are), a family office can participate as it sees fit. The direct investor also has the flexibility to invest its money in whatever instrument fits the situation and condition of the business. The investment could be in the form of senior or mezzanine debt, preferred or common equity, or some combination. The adaptability to specific situations allows unique investments to be made on the full scale of business conditions, from distressed turnarounds to slow and stable performers to high growth situations.

OTHER CONSIDERATIONS

The business owner seeking a direct invest-

ment from a family office must carefully balance the pros and cons of this new partnership. If the owner intends to remain with the business, the corporate governance strategy needs well-defined roles and responsibilities. The potential advantages of the family's industry expertise will only be realized if the partners' communications and styles harmonize well. The ability for a family office to hold an investment indefinitely creates uncertainty of liquidity timing for non-family equity holders. Timing, exit mechanisms, and valuation for liquidating an equity holder's stake need to be addressed well in advance of consummating a transaction. Since a direct investment can often be in any security (debt, equity, or a hybrid),

matching the appropriate terms of the security instrument to the situation offers many design options.

Wealthy family offices have invested in private companies for centuries. These intrepid participants have recently reemerged as direct investors, providing a flexible source of liquidity and growth financing for private business owners. While not constrained in structure, the investments reflect the personality, style, and work preferences of the family, all of which can vary widely. The challenge for owners seeking a partnership with a family office lies in finding the best cultural fit and constructing the most suitable terms for an investment. **ZS**



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