

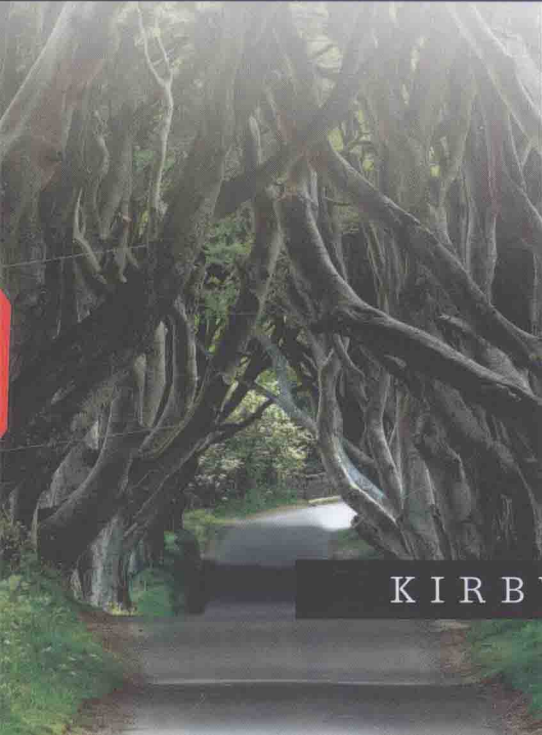
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FINANCIAL SERIES

THE COMPLETE

DIRECT INVESTING

HANDBOOK



A GUIDE FOR
FAMILY OFFICES,
QUALIFIED
PURCHASERS,
AND ACCREDITED
INVESTORS

KIRBY ROSPLOCK, PHD

with Foreword by Patricia W. Chadwick

THE COMPLETE DIRECT INVESTING HANDBOOK

**A Guide for Family Offices, Qualified Purchasers,
and Accredited Investors**

Kirby Rosplock, PhD

WILEY

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This book is dedicated to the memory of my father, Thomas L. Harbeck, who inspired me to dream big and to lean into new endeavors with a passion to first ask, learn, and seek knowledge before jumping off the deep end. His keen business sensibilities and wise counsel will always be treasured and appear throughout this book.

Foreword

Family offices are in the business of exploring the investment landscape for new and creative ways to enhance returns and diversify from traditional models of investing. I have spent the better portion of my career looking at investments through both an institutional as well as a private investor's lens. The array of investment possibilities within the privately held marketplace is vast and growing, affording the burgeoning family office arena significant possibilities for investment. I see this as the new frontier of investing, and where some of the most exciting opportunities will be unearthed.

Dr. Rosplock's book, *The Complete Direct Investing Handbook*, provides a valuable and practical framework for approaching the direct investing landscape that appeal to both the neophyte and the most seasoned investor. It imparts not only her wealth of knowledge, but the insights and experiences of some of the private investment industry's most successful and respected leaders. The book includes valuable case studies, research, and practical tools and metrics to apply to this facet of investing. To date, there have been limited resources beyond the MBA textbooks to delve into this nuanced topic, but finally we have a playbook.

Interest in direct investing over the last decade has caught the attention of accredited investors, angels, and family offices. Yet Dr. Rosplock puts great emphasis on the fact that this specialized type of investing may not be suitable for every family office or accredited investor. She provides sage advice throughout the handbook on the importance of proper sourcing, vetting, due diligence, analysis, and structuring before deploying capital. Investing in private companies carries with it the seeds for outsized returns, but also the corollary risks. It should not be undertaken without a full understanding of the implications of those factors for the total portfolio.

Current research indicates that, despite the enhanced return potential in the private investment arena, the failure rate will still exceed the success rate for all but the most skillful investor. There has no doubt been a sea change in the investment world over the last 40 years, and the pace seems to be accelerating.

As an active investor in both the private and public markets, I have found particular appeal in the nonpublic sector because of the ability to participate in a variety of investment vehicles. The bespoke nature of private investing requires creativity and investment savvy on the part of either the lead investor or the banking firm, and when done well it has the ability to enhance returns while reducing risk in the admittedly risky world of private investing. Investments can be tailored, with carrots and sticks, to provide incentives for management to reach particular milestones. I have found such instruments to have a beneficial impact on both the investor and the company.

Many family offices are uniquely positioned to take advantage of the opportunity of direct investing because they often have the luxury to be patient investors, something that seems to have fallen by the wayside in the larger world of investing, which has adopted a trader's mentality. Focusing on quarterly investment returns defies the concept of true investing, which is long term in nature. Yet it has become the yardstick imposed on the investing public, particularly since the onslaught of hedge funds. The value of making private investments is embedded in the belief that a good investment idea has merit over a period of years, not months. Many family offices are in a position to take advantage of this sound investment concept because, unlike numerous endowments, foundations, pension plans, and private equity firms, they are generally not hostage to the cash flow and exit requirements of these institutions.

The Complete Direct Investing Handbook is the go-to resource for private equity investors and family offices. It compiles insights from leading minds and provides specific examples and recommendations on best practices. Each of its contributors provides a window into an important element of investing in the nonpublic arena. I would recommend that this book be kept nearby for investment decision-makers in the family office world.

Patricia W. Chadwick
President, Ravengate Partners LLC

Preface

If you are reading this book, it is likely that you have a curiosity for, or a pre-existing interest in, direct investing, or are already a seasoned direct investor. Whichever camp you fall into, I hope this book will expand your view on direct investing and provide insights from leading experts, advisors, and consultants within the direct investing space. More than half of the book consists of original chapters from contributing authors who are leaders in the field of direct investing and/or the family office realm; thus, the book provides a wide array of thinking from the best and brightest. Additionally, the book features anonymous case studies and innovative research from multiple institutions as well as proprietary data from a direct investing survey from Tamarind Partners in 2016.

So, what inspired me to write this book? One of my first positions out of college was working in a small brokerage firm in Milwaukee, Wisconsin, as an analyst helping administer a series of private equity partnerships. I was green in my career; however, I admired the passion and interest by accredited investors to back and invest into various direct deals. I quickly learned how these investors found an affinity to invest in this manner that was typically noncorrelated to public markets. Additionally, these investments provided portfolio diversification, the opportunity for outsized returns, and the ability to access niche, specialized investments not typically offered to the public. A few became winners, others barely broke even, and the majority failed. As my career evolved and I became more involved in the family office domain, I quickly realized how important private capital continued to be in closely held businesses. Some family offices continue to have a large segment of capital committed to operating businesses, and for many the source of wealth was a function of one or more of these positions.

Later in my life, I personally deployed capital into direct deals. Some investments succeeded and some failed. Like many of you, I learned the hard way the importance of sourcing, vetting, and due diligence after investing in what I was told would be a “sure homerun” that ultimately failed. My other

co-investors were also confident in what we thought had been sufficient due diligence in the investment and adequate preferences and provisions for the investors. We were completely off-base, and my original investment has yet to return my initial capital. As Oscar Wilde put it, “Experience is simply the name we give our mistakes.”

I relay this quick reference point to provide context that I, too, am still learning, and that even the best and brightest in the direct investment world likely have a similar war story to tell. I know I am not alone or special. After this experience, I decided to look further into the literature on direct investing, and found that most books are texts or casebooks written for MBA programs or focused mainly on venture capital. There are some excellent reads from top business school professors and academics, but few books focus on the narrow domain of direct investing, and none to my knowledge specically look at the subject matter through the unique lens of the family office.

My first book, *The Complete Family Office Handbook* (Wiley/Bloomberg, 2014), revealed the complex landscape of the family office realm and captured some of the building blocks to starting, operating, and managing a family office. During the data capture for that book, I learned the variety of family office types and diverse approaches to building a family office. Similarly, I discovered with writing and editing this book that there is a wide diversity of approaches to direct investing. There is not a one-size-fits-all approach to family office or to direct investing. Everything has to be tailored to you, and this book provides a foundation for readers to create their own unique approach.

This book is designed to appeal to the novice as well as the expert direct investor, and consequently covers a broad array of content and fictionalized cases. The book is organized into three sections. Part I provides a high-level overview of direct investing and the family office context. Part II discusses the steps and process of deploying capital into direct investments. Part III provides some additional unique perspectives on direct investing. Specifically, Chapter 1 lays a foundation on direct investing in the context of family offices. Chapter 2 discusses the increased presence of private capital into directs. Chapter 3 shares the interest in co-investing and club deals, and, finally, Chapter 4 outlines the various private equity strategies and where direct investing may fit. Chapter 5 is the beginning of Part II and outlines the various steps to execute on a direct investment. Chapter 6 discusses the steps to create a direct investment thesis. Chapter 7 shares the importance of sourcing, deal flow, and screening and deploying capital into direct investments. Chapter 8 elaborates on the deal structures, terms, and portfolio construction. Chapter 9 shares what happens after the capital has been deployed and the investment monitoring, exit strategies, and harvesting of returns. Chapter 10 is the start of

Part III and examines the CIO perspective to direct investing. Chapter 11 looks at direct investing with a lens to Millennials' perspective on impact investing. Chapter 12 shares the Sustainable Cycle of Investing Engagement model (SCIE model) as a possible approach. Chapter 13 closes with describing the international approach to direct investing.

Direct investing is not for the faint of heart nor is it for every investor. A quick disclaimer is required to remind readers of the tremendous risks associated with the potential rewards of direct investing. The contributing authors and I are not endorsing that everyone should be direct investors. On the contrary: The reality is very few may want to embrace this approach to investing even if they are technically qualified. There are more losers than winners when investing in this manner, so operating with your eyes wide open to the downside risks of this type of investing is imperative. We hope this book will be a useful resource and guide to aid direct investors as they consider how/whether to deploy private capital into this niche area of private equity.

Acknowledgments

This book took a village to write, and there are many to thank for their involvement. First to the direct investors and advisors who shared their stories—this book is only possible because of your trust. Thank you to my family and especially my husband, John, who provided constant support and encouragement. Thank you to all the contributing authors who shared their experience, wisdom, and technical expertise in their respective chapters.

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THE COMPLETE DIRECT INVESTING HANDBOOK

Contents

Foreword	xv
Preface	xvii
Acknowledgments	xxi

PART I: DIRECT INVESTING AND THE FAMILY OFFICE TEST

CHAPTER 1

Introduction to Direct Investing	3
2008: A Wakeup Call for Investors	5
Role of the Family Office and Private Investors	6
The Opportunity	9
Best Practices	10
Key Considerations	12
Conclusion	15
Notes	16

CHAPTER 2

The Emerging Presence of Private Capital in Direct Investing	18
<i>Contributing Authors: Nathan Hamilton and Sara Hamilton</i>	
The Family Office Marketplace	19
The Unique Benefits of Private Capital	21
Increased Interest in Private Equity	24
Conclusion	30

CHAPTER 3

Co-Investment Strategies in Direct Investing	32
Defining Co-Investing and Providing Context	32
Insights on the Popularity of Co-Investing	33
Interest in Co-Investment Strategies	33
Roles of the Co-Investor	35

Going Solo: Why Co-Investing May Not Be Your Choice	40
The Perils and Pearls of Co-Investing	41
Vetting Co-Investors	44
Club Deals	46
Mini Case Study	51
Conclusion	51
Notes	52
CHAPTER 4	
Private Equity Strategies: Characteristics and Implications	54
<i>Contributing Author: David McCombie</i>	
What Is Private Equity?	55
Real Estate	58
Venture Capital	62
Growth Capital	72
Buyouts	75
Mezzanine Financing	78
Distressed Assets	81
Conclusion: Putting It All Together	85
Notes	86
PART II: DIRECT INVESTING IN ACTION	
CHAPTER 5	
Family Office Considerations to the Direct Investment Process	91
Source of Wealth: Lens of the Family Office	92
SWOT Analysis for Direct Investing	93
Three Phases to the Direct Investing Process	94
A Three-Phase Direct Investing Process	97
Case Study	111
Conclusion	113
Notes	114
CHAPTER 6	
Designing a Direct Investment Thesis	115
Defining the Direct Investment Thesis	115
Asset Mix and the Direct Investment Thesis	117
Family Pathways and the Direct Investment Thesis	119
The Barbell Approach and the Direct Investment Thesis	122
Entrepreneurial Orientation and the Direct Investment Thesis	124
Family Investment Style and the Direct Investment Thesis	128

Case Study	132
Conclusion	137
Notes	138

CHAPTER 7

Sourcing, Deal Flow, Screening, and Deploying Direct Investments	141
<i>Contributing Author: Euclid Walker</i>	
Industry Professionals and Thought Leaders	142
Investment Bankers/Business Brokers	143
Professional Service Providers	144
Commercial Banks	144
Private Equity Funds/Family Offices	145
Screening Process	146
Due Diligence	151
Investment Memorandum	154
Investment Decision Process	155
Conclusion	156
Notes	156

CHAPTER 8

Direct Investments: Deal Structures, Terms, and Portfolio Construction	157
<i>Contributing Author: Jolyne Caruso</i>	
How to Get Started	158
Portfolio Construction	159
The Capital Stack	160
Equity Transactions	162
Types of Debt Instruments	165
Mezzanine Debt	166
Case Study: Early-Stage Solar Energy Finance Company	168
A Primer on Important Term Sheet Items	170
Conclusion	175

CHAPTER 9

Investment Monitoring, Exit Strategies, and Harvesting Returns	177
<i>Contributing Author: Adam Goodfriend</i>	
Introduction	177
Alignment of Objectives	178
Monitoring Direct Investments as a Minority Stake Owner	178
Why Timing of an Investment Exit and Not Just the Investment Return Is Critical	179

Importance of Company Lifecycles with Respect to Timing and Harvesting Returns	181
Exit Valuations and Multiples	184
Maximizing Liquidity of Illiquid Investments through Pre-Negotiated Rights	186
Exit Value Drivers	188
Common Exit Strategies	189
Mergers and Acquisitions	192
Working with Investment Bankers and Key Advisors to the Exit Strategy	192
Conclusion	194
Notes	195

PART III: DIRECT INVESTING PERSPECTIVES

CHAPTER 10

The CIO Perspective 199

Contributing Author: Robert G. Blabey

Sourcing Top CIOs to Oversee Direct Investing in the SFO	200
What's the Edge?	202
What Defines Success for the CIO?	203
The CIO Fit	207
Risk Management at the Investment Level and Portfolio Level	209
CIO Compensation	211
Conclusion	216

CHAPTER 11

The Millennials and Direct Investing: A Look at Impact Investing 218

Contributing Author: Temple Fennell

Who Are the Millennials and What Do They Care About?	219
Millennials' Respect for the Senior Generation	220
Growing Interest in Impact Investing	222
Making the Case for Impact Investing	222
How to Source Impact Investments	227
Experiential Returns: Intangible Benefits of Impact Investing	231
Common Challenges and Barriers to Impact Investing	232
Systems Thinking: Creating and Sustaining Family Knowledge	235
Conclusion	238
Notes	239

CHAPTER 12**SCIE: Sustainable Cycle of Investing Engagement 242***Contributing Author: Temple Fennell*

The Purpose of SCIE 244

The SCIE Framework 246

Family Purpose, Values, and Mission 247

Framing Strategy 249

Developing Strategy 253

Implementing Strategy 259

Capture and Communicate Learning 264

Conclusion 269

Notes 269

CHAPTER 13**International Direct Investing 271***Contributing Author: Anna Nekoranec*

Why Consider International Direct Investing? 272

Key Differences between Investing Abroad versus Investing
in the United States 274

How to Determine Where to Invest 276

How Population Change Can Impact Target Market Opportunities 278

Keys to Success in International Direct Investing 282

The Role of a Partner in International Investing 284

Common Mistakes Made by Investors Venturing Abroad 286

Risk Mitigation 288

Foreign Families in the United States 290

Conclusion 291

Notes 292

APPENDIX A**Private Equity Strategies Summary 293****APPENDIX B****Sample Due Diligence Checklist 299****APPENDIX C****Glossary 306****About the Author 316****About the Chapter Authors 318****Index 323**