THE VIRTUAL FAMILY OFFICE AND PRIVATE EQUITY

By Frans Peeters & Jurgen van Olphen

For most Family Offices (FO) in Europe, these days, low or non-existent returns on government bonds and volatile equity markets have increased the interest for Private Equity investments.

Private equity is a relatively unknown industry in much of the world, yet it is one of the few ways to invest in equity ownership of private companies, generally considered the backbone of Europe's economy. Therefore, it provides an opportunity to diversify a portfolio further. Investments in companies can be broadly categorised by asset type and whether the asset type is publicly traded or not.

Private equity is a form of equity investment into private companies not listed on the stock exchange. It is a medium to long-term investment, characterised by active ownership. On the other hand, stock market investing ('public equity') is characterised by passive, insignificant, ownership.
Privately-held companies come in different shapes and forms; the same holds for private equity funds. There are funds investing in innovative start-ups and funds acquiring established companies in mature industries.

Common investment strategies in private equity following the life cycle of a company include venture capital, growth capital, (leveraged) buyouts, and distressed investments.

Generally speaking, venture capital is when private equity is invested into young, entrepreneur-led, high-potential companies. Venture capital investment are relatively small investments in a minority ownership.

According to Invest Europe's 2017 European Private Equity Activity' report, about 1.400 private equity firms had € 640 billion in capital under management. In the same year, € 71,7 billion in equity was invested in ± 7,000 companies. In addition to providing capital, private equity firms also aim to build better businesses through active ownership. Examples of active ownership are strengthening management expertise, delivering operational improvements and helping companies to access new markets. Besides, active and substantial ownership leads to a better governance structure, aligning interests, thereby evading the 'agency problem' public companies encounter.

The total market for private equity is large, with over 960 billion US-Dollars raised in 2015 and 2016, but is highly tilted geographically towards the Anglo-Saxon world. In Europe in 2017 according to "Invest Europe" only 92 billion Euros were raised and of that amount, just 4% was provided by FO's or individual investors. A far cry from the situation in the US, where today private equity matches public equity as the main investment category (21% portfolio weight each) for FO's. To cater for this high demand in private equity investments, funds tend to become larger and larger. The average size of a private equity fund launched in the US in 2017 was 1.9 billion US-Dollars. Moreover, investors are becoming more demanding for managing partner participation, the managing partners providing on average 55 million US-Dollars of the total funds raised.

To access the best funds, FO's need to have the resources to be able to analyse the different investment opportunities. For example, thorough due diligence should always be a key component of the decision process. However, it also needs to have a considerable size to be interesting as a potential investor for the best funds on the market.

In Europe, apart from a large number of Single-Family Offices (SFO's), there are lots of Virtual Family Offices (VFO's). A VFO is a lean SFO, with a small overhead and thus strongly reduced costs compared to a regular SFO. Most of its specific expertise is outsourced. A VFO typically has a maximum of three employees who act as liaison officers with banks, lawyers and wealth advisors.

This newest branch on the FO-tree can be built from scratch, but more and more wealthy families decide to reduce their SFO to a VFO barebone umbrella support structure for a number of reasons. A VFO can provide more privacy and a better cost structure and give higher flexibility since it works almost exclusively with outside service providers, mainly private banks.

Obviously, this VFO will be able to negotiate terms and respond to specific family requests, but there are of course limitations to its activities. Especially for investments in private equity, the common difficulty a FO faces accessing the best deals will be exacerbated for a VFO. Moreover, with its limited resources a VFO will not have the necessary knowledge even to consider direct investments in private equity.

Contrary to investing in listed equity, which is usually just a financial transaction, investing in private equity, be it as a direct investment or through a specialised fund, does not consist of only providing money but should also aim to improve business through active ownership. For a VFO, this will be very difficult to accomplish, resource constraints and knowledge gaps being the obvious obstacles.

Also, because of this, there is a clear bias in the direct investments in private equity a FO, especially an SFO, tends to make. A wealthy family that has gathered its wealth in a particular sector will try to add value by making direct private equity investment in this same sector. Market knowledge and a network within the sector can provide valuable input but will result in investments being tilted to this one sector. Diversification will then be limited, which is, of course, a risk factor in itself.

With the market booming and awash with investment opportunities, how should VFO's choose the best-suited vehicle?
An SFO and especially a VFO will need to choose a private equity firm to invest in this asset class. The fund focus and investment strategy should fit the FO's interest and risk appetite. It is clear that venture capital and distressed investments have a significantly higher risk profile than the overall private equity market. The investment team should have the right level of experience and should show continuity.
The track record and both the historical and expected returns of the fund should also be assessed. Also, to add value, there should also be an active involvement with the portfolio companies of the private equity fund, even more so in the venture capital and distressed investments space.

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