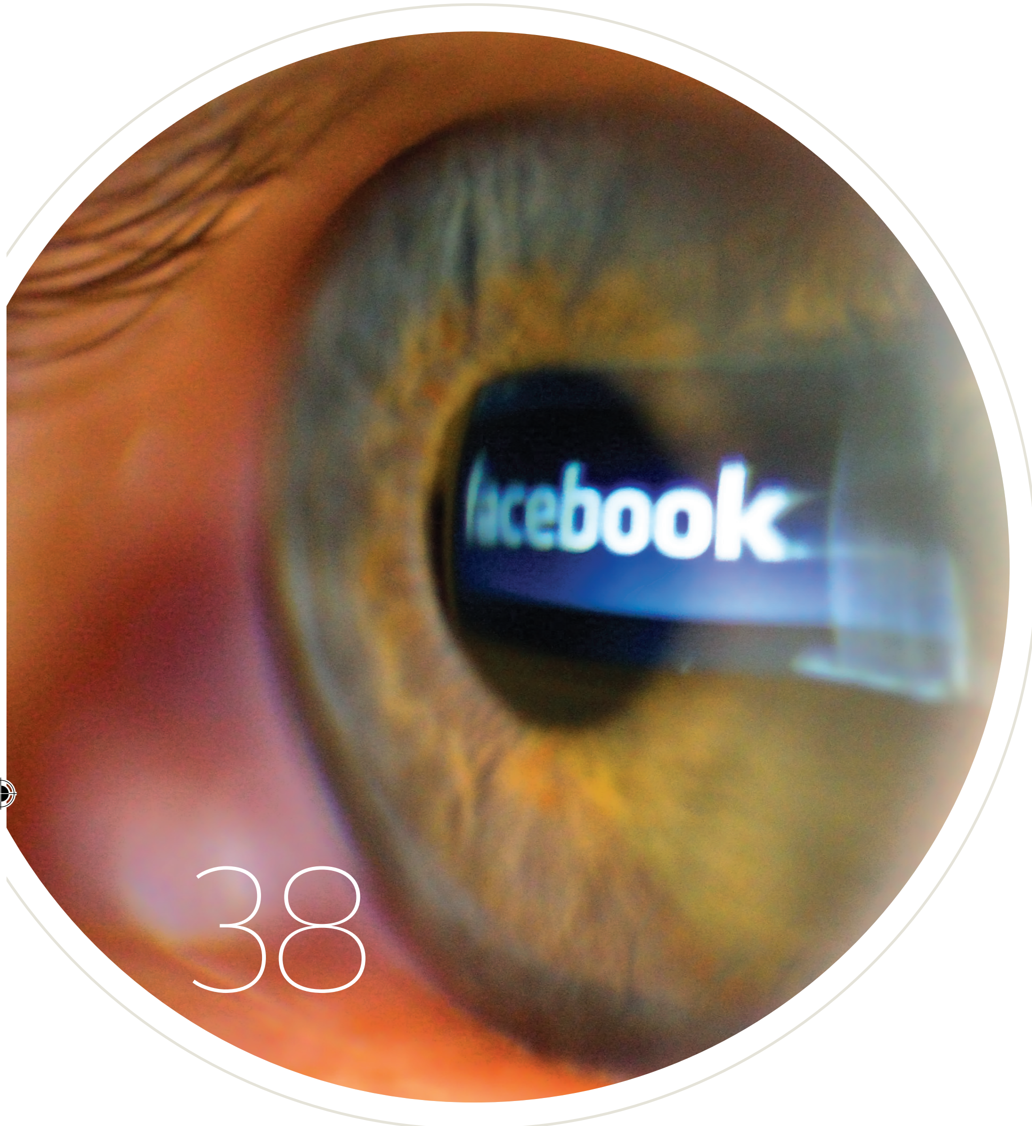

PRIVATE MONEY

Record numbers of companies are looking to private placements for funding. But how can family offices get involved? *Jeremy Hazlehurst* investigates

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Hedge funds haven't covered themselves in glory in recent years. Underperformance, fee structures and redemption restrictions have all angered investors – many of them family offices. *Chris Owen* reports

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Jeff Raikes has been tasked with giving away billions of dollars by the Bill & Melinda Gates Foundation. He tells *Matthew Gwyther* why he's focusing on evidence-based investment and what it's like running the world's biggest foundation

Can an initial public offering be sexy? The flotation of Facebook will probably be the closest you can get. With its mix of Silicon Valley swagger, Mark Zuckerberg's geek glam and mind-boggling numbers – Facebook now has 800 million users and more excitable observers value it at $100 billion (€76.4 billion) – it will have business writers swooning. But Facebook is a one-off, of course, and this mega-flotation will be an unusual event in 2012. No other business has the profile or the potential for profits, and many will be looking to private money for their cash injections.

Numerous other companies, especially in the worlds of technology and mining, have also raised money through private placements recently. That even includes Twitter, the closest thing to Facebook, which in December 2011 took $300 million of Saudi Arabia's Prince Alwaleed bin Talal's money. Private investments are increasingly interesting to both businesses and investors.

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"With private placements you are not at the mercy of the market"

The reasons, from the investor's point of view, are simple. "With private placements you are not at the mercy of the market. You don't have the volatility, the daily mood swings, the news flow that reflects the nervousness of those who invest in the market," says Simon Paul of London-based multi family office Sand Aire. "Because of the dysfunctionality of the public markets, equity and bonds, you are almost being pushed towards having to consider other opportunities like private placements and private equity, because increasingly people feel uncomfortable with the traditional investments."

You might say that short-term volatility in the markets is an irrelevance for those such as family offices who take a long-term view of investments, but that's not the case, says Paul. "From a management point of view senior people are incentivised by being given equity in their business that is subject to the volatility of a quoted share price, and you can see your interest in the business rise or fall by a substantial amount each day. And rather than focusing on the business, you have one eye on the share price. The beauty of unquoted businesses is that you don't have that, you get on and run the business."

The words "private placement" mean different things to different people. For some they are a pre-IPO investment, where the investor hopes to make a paper profit on flotation, but intends to remain invested for a good period of time. For others they are a venture capital-style investment, either at the stage of a start-up or a business looking for follow-on funds. This can either be a pre-IPO situation, or one where there is no imminent plan to float and often – as in the case of Twitter and Prince Alwaleed, who through his investment in News International is close to Rupert Murdoch – the investor will offer expertise and guidance to help the company grow. Thirdly, a private placement can be more like a private equity-style investment where the investor will, perhaps as part of a consortium, take over a business for a shortish period, typically no more than 10 years, to realise a profit in a business. It would be wrong to make any hard-and-fast distinctions between the three types of investments, as they often overlap. Families add an extra

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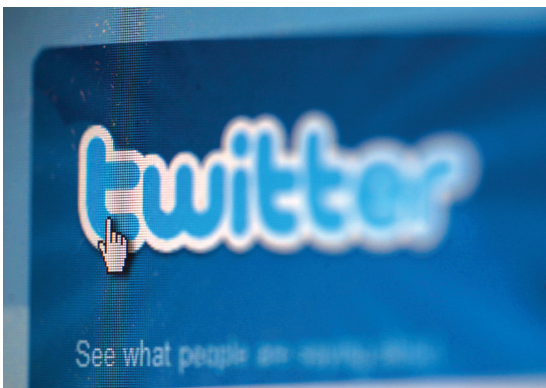

Prince Alwaleed bin Talal invested $300 million in social media site Twitter

> **"Families realise that entrepreneurs, operators and industrialists are going to be the ones adding value to companies in today's environment, while financiers will have little of value to add"**

layer of complexity – they may have contacts in industries or regions that are useful to a company, can offer joint ventures with their own businesses and can offer experience and expertise that can help a business grow. Part of the beauty of this style of investment is that it is fluid.

Clearly, then, the advantages of private investment for family offices go beyond insulating yourself from the markets. Some think of them as a return to old-fashioned investing. Jim Miller, managing director of fund management firm Somerset Capital, says: "For some time families felt that they could make good returns in alternatives, investing passively through funds. It worked for a few years, and then went spectacularly wrong in the financial crisis and as these markets matured. Nowadays many families are investing directly once again in industrial and entrepreneurial ventures." This is what he calls "the re-industrialisation of the family office market". He goes on: "Families realise that entrepreneurs, operators and industrialists are going to be the ones adding value to companies in today's environment, while financiers will have little of value to add." Private investments, done right, can offer proper and not just paper growth.

Another benefit is that, unlike buying shares in a quoted company, you are "not bound to invest only using equity", says Philip Quigley of investment management firm Smith & Williamson. "You can structure a deal with a mix of debt, convertible loans and equity, so you can have layers of investment, which can be negotiated between the investor and company so that everybody can get what they want out of the deal."

Private equity firms and placement agents are ever keener to tap family money, too, as other sources of funding for deals are drying up. Family offices have a number of natural advantages competing in the private equity sector. Family money is so-called evergreen money and families can make decisions more quickly than other investors, who might have to go through layer upon layer of due diligence before making a decision. Families often also bring a culture that might well chime with some companies – most obviously other family businesses.

Those looking for investors are also being pushed towards family businesses because increasing regulation is making it harder to raise funds elsewhere. The private equity industry has until now been fairly loosely regulated, but the global increase in red tape in the wake of the financial crisis is affecting the industry. The new European Union regulations and the Dodd-Frank Act in the US are making it far harder for private equity to raise funds from, for example, insurance companies. Family money is ever more appealing.

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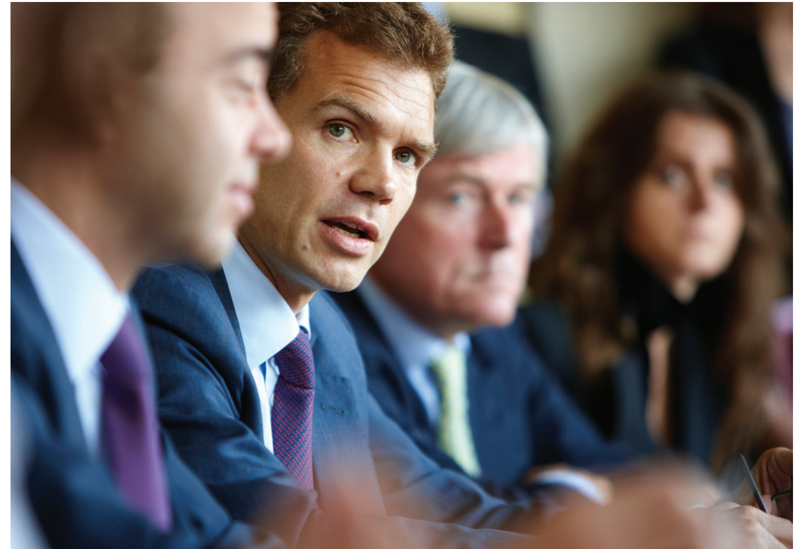
There are some obvious potential problems with private placements, though. "From an investor's point of view, it is an illiquid investment," says Paul. "You don't have the ability to get out when you want to – that is potentially a disadvantage." However, if you go in with your eyes open this is not a problem. "Our investors are sophisticated, have built businesses themselves and understand the characteristics of that kind of investment, and are very happy with them. It gets valued from time to time, but you don't get this daily volatility," he adds.

Some might worry that you can't get sufficient quality and quantity of information about an unlisted company to make an informed decision about investing in it. A listed company is more likely to have a track record and is required to keep the market up to date on financial performance and other developments on a timely basis, which allows you to evaluate the risk better. That potentially makes it more attractive than a private company. But if, as is often the case in a pre-IPO placement in the US, a number of investors are involved – for example in the case of Facebook's placement there were 500 – then it is caught by the same rules as an IPO and a memorandum with detailed financial information has to be issued: the rules are the same for unlisted or listed companies.

The argument that unlisted companies are always more risky does not always hold true, says Quigley. Many companies listed on the London AIM have a market cap of under €60 million and are young businesses, making it difficult to tell when they will make a profit. Anyway one of the attractions of private investments is that the investor can negotiate how much influence it has over the investment, and this will be partly based on the risk being taken. Quigley says: "You can negotiate shareholder agreements saying, for example, that they can't change the board without your approval. This is the way that a private equity firm works: they have the ability to stop management taking certain actions, although they are not interested in running the business day to day. The number of negative controls you have increases the more you put up."

This deal-making is vital to building good private placements, agrees Julien Sevaux, managing director of investment management firm Stanhope Capital, who says you have to make sure you are able to control your investment. "I'd argue that if you are a minority shareholder with no representation, then you are in trouble if the business gets in trouble. If you get involved in a private placement you would have to have control provisions, but again that does depend on the size of your investment. We advise investors that they should seek to be in a position of control – de facto or at least with negative control rights," he says.

Some investors might prefer to be part of a consortium to spread the risk. This has pros and cons. "The banks say you can happily co-invest with a private equity fund and some



From top: Julien Sevaux, managing director of investment management firm Stanhope Capital, says investing in private placements as part of a consortium has pros and cons;

Philip Quigley of investment management firm Smith & Williamson says a benefit of private placements is that you are "not bound to invest only using equity"

"This is the way that a private equity firm works: they have the ability to stop management taking certain actions"

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people like the kudos of being in business with a firm with a big name," Sevaux says. "But I am not interested in that if you are in a position where you have to rely on the private equity firm, because your interests might not be the same as theirs. For example, if a company is in trouble the lending bank and the private equity firm may agree to a restructuring, which results in a wipeout of the equity holders. The private equity firm may not resist this restructuring because their coffers are full and they are going to be able to reinvest in the business at a lower valuation. But you might not be able to do the same."

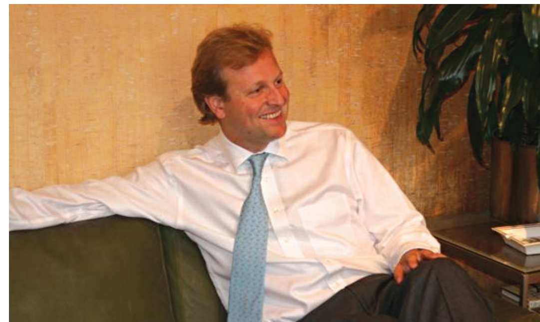
He gives the example of one investment where a client co-invested with a bank and a fund. The bank had part equity and part debt and decided that hosing the equity holders helped them generate a higher blended return, which was not in his client's interests. "There may be reasons why you want to be in a group, but you don't want to rely on others even if everybody looks like they have the same interest at the outset. You have to think about the worst-case scenario. I think that a lot of people get carried away in terms of making investments."

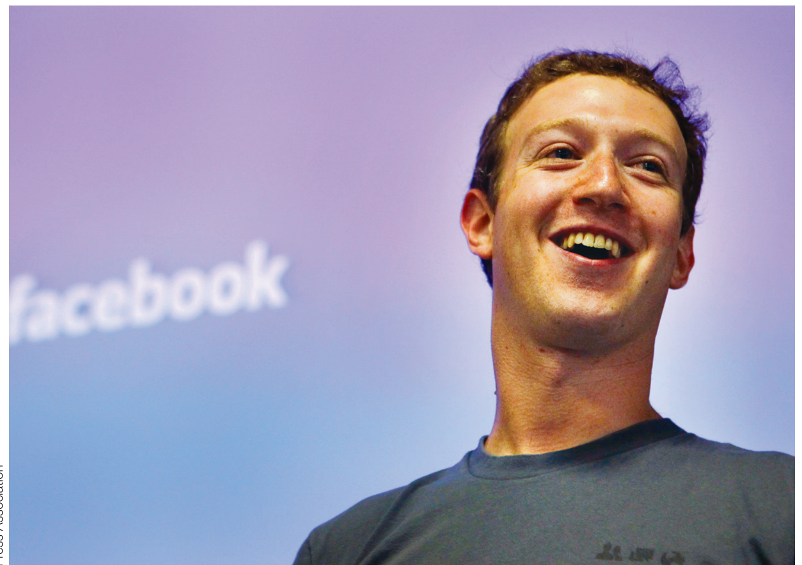
There are plenty of big, reputable private placement agents such as Acanthus, Triago and Monument, which match-make investors and those seeking funds. While they no doubt know their markets and are useful for, say, pension funds, family offices tend to rely on their own knowledge and contacts when looking for investments.

So how do you choose your investment? Miller says there is a matrix of potential private placement opportunities that family offices need to think through as they determine their strategy. Firstly, whether you will be in a controlling or non-controlling position, which involves looking at the stage that the company is in, whether it is start-up, growth, pre-IPO, even distressed or turnaround. Secondly, the geography, looking at whether it's a developed or emerging market, and whether it's a market that makes sense for the family to be active in. "We see examples both of families that will only invest locally and also families that are looking for geographical diversification in their direct investments," he says. Third is the sector, such as whether it's a line of business that the family understands, and where the family has knowledge, experience, contacts and deal-flow. And lastly is the deal size and how large a stake the family will be gaining, what sort of rights will be attached and how much influence the family will have.

Investors don't look likely to fall back in love with financial services any time soon. Investment products, stock markets and government bonds are unattractive, while the combination of low interest rates and high inflation mean cash is a losing game. In the current market, it's all about controlling your risks, nurturing your investments and creating real growth. The smart money is going private. FO

From top: Jim Miller of Somerset Capital says families are turning away from investing passively through funds and instead are investing directly in industrial and entrepreneurial ventures;
Facebook creator and chief executive Mark Zuckerberg used private placements to expand the social media site





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