Direct or Fund Investments?

Direct Investments or Fund Investments?

Over the last decade, more LPs, especially family offices, have been investing directly in private companies (instead of funds). New LP syndicates, AngelList, and consultants advising on direct investments are examples of this phenomenon. Why this is happening:

- The LPs are more "connected" to underlying companies—they are responsible for underwriting the companies themselves, and post-investment, generally have more governance rights (board membership and/or involvement in the day-to-day management of companies are examples)
- It can be fun and offers sourcing, underwriting, and operating experience to professionals at the LP (which, at family offices, are often future generations)
- Lower fees and better ability to control cash flows in and out of the investment, which can minimize taxes
- Many families have experience operating companies in the sectors in which their family offices invest
- Returns have been good, especially in later stage-venture, which offers more investment opportunities to LPs (in $ terms) than early-stage venture

Types of direct investment include:

- **Co-investing with larger GPs**: More larger GPs (Blackstone, for example) are under pressure from pension LPs to offer co-investment at reduced fees
  - *Advantages*: GPs have a lot to lose if they offer many LPs bad deals; larger deals may also present less idiosyncratic/business risk to LPs
  - *Disadvantages*: Valuations for big deals are generally higher; large GPs offer co-investment in these deals to many LPs
- **Co-investing with emerging GPs and fundless sponsors**: Raising capital for funds is hard, so many sponsors are forced to offer co-invest to get deals done
  - *Advantages*: More upside because valuations are lower; LP co-investors are meaningful and potentially long-term partners for smaller GPs
  - *Disadvantages*: More downside because of idiosyncratic risk at underlying companies as well as at the GPs that lead the deals (ie, the GP dissolves)
- **Directly, and sometimes as lead investor, in companies within the LP's own network**: Many LPs have requisite experience; other GPs will also share deals
  - *Advantages*: Less likely to suffer from adverse selection when sourcing and can help companies post-investment; can more easily underwrite given industry expertise and network; potentially can charge other LPs to co-invest with you
  - *Disadvantages*: Competing with some GPs; may result in a portfolio that is concentrated by sector; investing directly requires a bigger commitment
- **Directly, but sourcing widely by marketing to companies and co-investors the LP's experience, relationships, and non-intermediated capital**:
  - *Advantages*: Can build a more diversified portfolio than a sector-focused, inbound-driven approach; potentially can charge other LPs
  - *Disadvantages*: Directly competing with many GPs; requires significant investment to build and maintain a sourcing engine and direct investment team that can underwrite and manage companies; hard to build a team that will invest opportunistically based on valuations (like GPs, direct investment teams are heavily incentivized to deploy capital; compensating them on the performance of the LP's total portfolio is a way to mitigate this risk)

Direct Investments

A lot of options, so several questions LPs should be considering:

- Does it make sense to start investing in private companies via funds as an LP first and learn how private investing works? If so, for how long?
- In a mature portfolio that has reached its target to private investments, how much capital should be invested in funds versus directly (including co-invest)?
- If the company struggles post-investment, will the entrepreneur and or GP sponsor of the transaction (in the case of co-invest) feel at least sorta bad for me?
- Is my organization structured to make direct investments?
  - For example: If a professional at the LP is a great direct investor, how do I retain them?
  - How do I manage LP professionals that are bad direct investors, but good fund investors? If you fire them for being a poor direct investor, how does that impact your relationships with other GPs/access to good funds?
- How do I mitigate conflict? For example, what if one of my direct investments competes with a company in a fund I'm also invested in (or want to invest in)?
- How can I invest directly consistently, even during downturns?
- How many investments do I need to make in order to build a portfolio that's at least somewhat diversified (at least 20-30 companies over several years)?
- Why is a company letting me invest, especially if I'm investing directly (not via co-invest)? Why are they approaching me and not other GPs and LPs?
- How will I source? And if my approach is to source widely, what value can I add to companies as an owner?
- If I source widely, how do I constantly enhance my brand, which will drive future sourcing (as GPs must)? In a competitive world, isn't it a bad idea to try and be the best in everything? Does this not lead to being bad in everything?
- How do I prevent direct investing from becoming a huge time suck? How do I invest time in building my reputation as a good direct investor while also developing relationships with managers in other asset classes? The GP universe is big!
- Direct programs tend to be later-stage, especially in venture. Is that okay, especially when later-stage companies are valued highly right now?
- For each direct investment, what's the risk of downside beyond cost-basis, especially when leading a deal? What are my fiduciary and legal liabilities?
- How does investing directly affect my exemption from the SEC?
- Do secondaries often make more sense than primary investments, especially if I have relationships with prior owners who are looking for liquidity and already know me, so are less likely to sell me bad assets? Is investing in secondaries less work than investing directly, especially post-investment?
- There isn't evidence that direct investing has outperformed fund investing, especially when factoring in underwriting fees. But there's also not much data on this. So how will I continuously monitor the validity of a direct/co-investment program as well as my own performance (including opportunity costs)?

Direct Investments Appendix

- Kristi Kuechler and Angelo Robles (Family Office Association) YouTube Discussion on Direct Investing
- Forbes Article on How to Get Started with Direct Investments (embedded links and the author's other article on direct investing are also good)
- Angelo Robles and Jeff Stephens Podcast on Family Offices Who Invest in VC Directly
- NEPC on the Challenges of Direct Investments
- Cambridge Associates on Co-Investing
- REO Capital's Direct Investing for LPs: The Pros and Cons
- FINTRX on Why Family Offices Continue to Shift Towards Direct Investments
- New York Times on Families Increasingly Investing Directly
- Family Capital on the Mechanics of Direct and Co-investing
- UBS Global Family Office Report 2020