INVESTMENT

For family offices, when it comes to investing now, it’s like deal or no deal

By James Williams 29th November 2022

Family offices are playing it safe with their investment portfolios. Selling non-core assets, and remaining conservative with respect to seeking opportunities is a theme that some industry professionals are seeing.

Lex van Dam, founding member of SFO Alliance and head of deal sourcing for family office, Rinkelberg Capital, comments: “By their very nature, family offices are very secretive, so it’s hard to get concrete information on the extent to which they may or may not be exploring co-investments with other families.”

Combine that with the fact that interest rates are rising. This dampens valuations and creates an incentive to triage your portfolio and look at what’s working and what's not working

The SFO Alliance is one of the largest networking memberships for family offices to share ideas and insights on deals and funds across asset classes.

Someone who wants to invest in a credit fund could, for example, speak to a family office that has already assessed 50 funds and shortlisted three. This can potentially lead to co-investment opportunities, but in van Dam's opinion, the emphasis right now is more on sharing information than actively seeking out potential deals.

"Valuations are much lower than they were a year ago, and in venture capital, the runway is significantly shorter than people expected. There will be real pain in some VC funds, and investors may not necessarily want to make further commitments because they need liquidity for other parts of their portfolio, maybe to shore up other assets. There are some real issues out there. It's less, I think, about making new general partner commitments and more about how to deal with the current portfolio – and the fact that some assets might have lost value.

"If a family office is looking for other families to co-invest with in this current environment, I think that is a luxury issue because many families are holding off right now."

As entrepreneurs, those who set up their own family offices are only too aware of the challenges of operating profitable businesses in today's economic climate. Rising energy costs and continuing supply chain issues have given them plenty of risks to contend with. In some areas of their investment portfolios, families are keen to understand the extent of current write-downs.

"The more concerning point at the moment is, how do I manage what I've got in my portfolio? How distressed are some of these assets? How bad is the mark-to-market position?" says van Dam.

According to PitchBook, the number of ventures achieving unicorn status has peaked, based on the number of ventures worth $1 billion or more, compared to 2021, when 584 companies broke through. Analysis by *Family Capital* confirms deals are still going through, with co-investment growing in popularity. However, deals are more restricted in number as ventures seek to conserve their cash or seek mergers rather than suffer a down valuation.

Family offices have become more discriminating. UK-based Souter Investments, for example, is putting more stress on finding venture capital opportunities which do business with the state sector, although it is still open for business elsewhere. Some family offices are more interested in co-investing as a route towards risk sharing. But VC fundraising may struggle, where their firms have made a bad call.

Adviser Stephen Martiros, founder of Martiros Strategies says: "There's a tremendous amount of cash and short-term fixed income that could rotate into growth investments.

On the other hand, current funds may have smaller distributions due to a tougher exit environment. Overall, I would think fundraising will be somewhat tougher."

Placement agent Jim Rowe of Rowe Capital Partners says: "I'm finding demand for both direct and co-investment opportunities, the latter perhaps preferred depending on the deal and the associated fees. Direct deals are hard to identify and vet with the smaller staff retained by family offices. Demand for funds is all but gone, unless the fund is very unique and something that a family office cannot replicate and for which families are prepared to pay a fee."

More speculative sectors struggle to find backers. The bankruptcy of crypto exchange FTX has not helped the reputation of several VC firms participating in its funding rounds. Electric vehicles and self-drive cars have brought problems to many more.

Out of the spotlight, family offices can let problems fester away, storing up problems down the line. Matthew McGrath is the founder and managing director of Emissary Partners, a global special situations firm he founded in 2018 to advise family offices on legacy asset resolutions.

He points to a convergence of declining valuations in both public and private market companies in 2022, the only difference being that the mark-to-market exercises for private companies are less frequent. "You may be holding something that a large private equity firm reports on quarterly or annually. And the question is, is the mark they provide historic and optimistic? Or is it current and realistic?

"Combine that with the fact that interest rates are rising. This dampens valuations and creates an incentive to triage your portfolio and look at what's working and what's not working," he says.

In his estimation, most large single-family offices hold approximately 5% of their assets in long-dated alternative investments with low visibility and some kind of impairment on valuation or exit. "We would call these legacy assets," he says.

There could be several reasons why an asset is not performing. It is possible, for example, that entrepreneurs or fund managers are not reporting adequately or inflating an asset's value to forestall difficult questions, geopolitical issues, regulatory impairments or legal issues.

"Families have different reputational incentives relative to more publicly visible institutional investors," says McGrath. "As a result, it creates a feedback loop where, because the family is afraid of something that could become contentious, and might lead to their name being in the press, they end up sitting on legacy assets without a clear view of how to work through them, and make decisions on exit.

"Investors are looking to optimize their portfolios. The cost of doing nothing has increased based on current interest rates."

One trend he is currently seeing, following geopolitical tensions, is a move among

Western family offices to sell assets with direct or indirect exposure to China.

In terms of options, families can decide to hold on and do nothing, try and find a buyer on the secondary market, improve the asset quality or reposition the investment, litigate their way out, or negotiate a redemption with either the GP or the company in question.

"Our business is to try to assess and risk weigh each of those options. In the business school world, you'd call it your BATNA – the best alternative to a negotiated agreement," says McGrath.

He has no doubt that families increasingly have conversations internally and with their peers to address these problems. It is, says McGrath: "One that requires portfolio management and problem-solving in a much more methodical way. The awareness, education and intelligence level has increased on assessing and making choices on legacy assets."

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