Are Family Funds a Threat to PE?

by **Mark Selinger**, **McDermott** | Published June 15, 2012 at 12:40 PM

For most of the past two decades, private equity funds have had only two types of competition -- strategic investors and each other. Special purpose acquisition companies, business development companies and hedge fund side pockets all emerged during that period, although none of these vehicles ultimately challenged the primacy of PE funds. But the past few years have seen the emergence of a new form of competitor that may give PE funds a run for their money -- their own limited partners.

Or, to be more specific, the high-net-worth families that used to form the backbone of many a PE fund, before institutional money came pouring in, and HNW investors became more trouble than they were worth. Indeed, in the late 2000s, several funds shunned individual investors, either explicitly or by raising minimum investment requirements.

But the Great Recession brought changes to the financial landscape, and PE funds were not unscathed. The drying up of credit for two years slowed exits to a trickle -- but LPs were still required to pay the yearly management fee (which in the past may have been paid out of a fund's distributions). Both the illiquid nature of LP investments and the restrictions on transfer that are standard in most fund partnership agreements -- provisions that didn't seem problematic when membership in the best funds was like access to a hot private club -- began to rankle at least some HNW investors.

These investors, even if they were unhappy, typically re-upped for the next fund series -- where else were they to go if they needed to diversify their alternative investment portfolio and get access to the best talent and dealflow? But recently, the answer to that question for some became: Why don't I do this myself?

Sure, there have always been HNW families who made direct investments or were significant co-investors in PE fund deals. But to do direct investing right, you need to have the infrastructure and the team, and neither comes cheap or easy. But as PE returns slackened off, some large PE fund investors decided to take the plunge.

One thing that changed in favor of HNW direct investing is the availability of talent. In the past, there was no way to lure a young manager away from the promise of riches offered by even a midmarket PE fund, not to mention the KKRs and Blackstones of the world. But, especially in the midmarket, the Great Recession brought for many reduced (or at least delayed) returns, and the prospect of raising the next fund became even more daunting. In this environment, a well-funded single source of capital, especially one known to the fund manager, became all the more attractive.
The Securities and Exchange Commission gave the emergence of direct investing by HNW families a push in 2011, when the final investment adviser registration regulations eliminated most exemptions available to all but the smallest funds, keeping just one exemption from

registration -- the family office exemption. Combined with the tax benefits of operating as a family office, HNW family direct investing has blossomed.

The investment vehicles utilized by HNW families to make direct investments look to the outside world much like PE funds, but the story these "family funds" tell to prospective investee companies serves to differentiate them from PE funds. Unlike PE funds, there is no requirement to look to exit within the usual three to five years for a PE investment. And often, the patriarch of the family fund is a former operator-entrepreneur, whose story may sound familiar to many founders. Lastly, the family fund operates with no constraints, as opposed to the structural constraints (for example, limits on how much can be invested in one investment, governance and informational requirements, limitations on investing into certain investment areas) contained in many PE fund documents.

To be sure, the family funds lack some things that successful PE funds have -- name recognition, an LP network and, most importantly, a track record. But hiring away a successful manager from a well-regarded PE fund can help overcome the track record obstacle, and a prominent family backer can outweigh the name recognition and networking connections of all but the best-known PE funds.

The emergence of family funds is in its infancy, and there's no doubt there will be missteps along the way. But as PE funds survey the competitive landscape, they will likely find that the seat next to them at the bidding table will be filled not by another PE fund or strategic investor, but by a family fund with deep pockets and a growing appetite for deals.

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