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The Evolution of Alternative Family Capital

Family offices and other types of family investment vehicles are more frequently seeking new ways to invest and manage family capital, including ways to leverage outside capital. While there is no single solution that is appropriate for every family office, traditional models are increasingly evolving into new and unique structures.

In this article, we address reasons why traditional single family offices may consider an alternative family capital structure, highlight some of the structures available to family investors, and review some of the benefits and considerations in connection with utilizing such structures.

Reasons Traditional Family Investors May Seek Alternative Structures

- **Limited availability of capital relative to the types of investments the family may seek.** Family office investment teams only have access to the portion of family capital that is made available by the family, which can dictate investment scope and industry focus and often will restrict investment diversification. As a result, despite large amounts of family wealth, a family office may face capital constraints for making investments of a certain size (or for making a certain number of investments) and thus find itself precluded from participating in large segments of the market or in specific investment opportunities where it sees strong potential for favorable returns. The ability to broaden investment opportunities and move up-market based on a family office's analysis of where prospects for outsized returns exist can be very attractive.

- **Required pace of capital deployment.** Family offices are often forced to pace investments over a period of time so as not to overcommit available capital. This can similarly strain the strategic investment initiatives of the office and its ability to execute on opportunities as they arise.

- **Reliance on a certain few strategic relationships and narrow focus on co-investing.** Due in part to capital constraints, family offices rely heavily on co-investing, as opposed to control investing, depending in many cases on a few key relationships for investment opportunities instead of more traditional investment sourcing channels (e.g., investment banking relationships), which channels tend to overlook family offices as a result. Accordingly, passive co-investments or minority investment positions can compose an outsized portion of a portfolio, which often results in a family paying fees and carry on top of the family office expenses.

- **Limited revenue stream to competitively compensate an investment team.** A family office pays expenses and salaries out of the same capital used for investments, which can make it difficult to support a broader investment platform and build out a team with full investment and administrative capabilities that will be competitive in the broader private equity markets.

- **Increasing competition from long-term hold funds.** The proliferation of long-term hold private equity funds has eroded a historically distinct benefit (namely, the application of a long-term growth strategy with respect to a specific investment) that family offices (as opposed to traditional private equity funds) could offer to a founder seller seeking a new partner. This dynamic can result in a family office losing a competitive edge in the broader private equity markets, and adopting an alternative family office structure to utilize outside capital can be helpful to "relevel" the playing field.

- **Opportunity.** Some families may not find any of the foregoing constraints to be a significant or primary concern. Instead, such families may have built a strong track record of investing and assembled a highly experienced team and now have the ability to utilize those assets to expand the platform. Years of successfully investing family wealth can generate a new and valuable opportunity separate from the returns earned over those years — the opportunity to market the investment platform based on prior performance to third-party investors. Such an opportunity may align well with the investment team's desire to stretch their capabilities and step out of the box within which they have been traditionally operating.

A family office that is seeking to overcome existing limitations, expand upon prior success or seize opportunities may consider creating or evolving into a new, alternative family capital structure.

Alternative Family Capital Structures

One alternative is a commingled private equity fund that seeks committed capital investments from third-party investors with the family as a significant anchor investor. In this structure, the fund generally will focus on a specific investment strategy and its available third-party capital will augment family capital that is also allocated and available for that particular strategy. The family office will commit to invest side-by-side with the fund in certain or all of its investments. The fund may be focused only on new investments or seeded with existing investments of the family office, which may provide the family with additional liquidity. The fund can be controlled and managed by the existing management company (i.e., the family office), which may continue to manage the family capital with respect to all other investment strategies. Alternatively, a stark division can be drawn between a new management company overseeing the new fund and a separate management company to house the investment team charged with managing the family's other investments.

Another alternative is for the family office to manage third-party accounts for one or more investments in which the family office participates. For example, a family may invite one or more other families to invest in a single strategy deployed by the family office. Examples include a public markets strategy or a fund of funds, with both families agreeing to a specified capital commitment and the outside family paying fees and carry. Or, families may invite co-investors into special-purpose acquisition vehicles for controlled investments, at times charging fees and carry or, at other times, fee and carry free.

These are just a few alternative family capital structures — there are numerous other structures that can be created, including majority-owned public vehicles, club deals and conglomerate structures.

Benefits and Other Considerations — Alternative Family Capital Structures

Potential Benefits

- Outside capital broadens the scope and amount of potential investments, and also provides possible flexibility around timing of deployment.
- Third-party investor base can increase strategic relationships and partners that can result in expanding potential investment opportunities or a network of industry experts to bolster investment and value-creation capabilities.
- Fee income supports compensation for the investment team and other operational costs.

- Any profit sharing (e.g., carried interest) incentivizes the investment team, helps attract future investment professionals and, in some instances, provides additional income to the family.
- Investor-facing business increases name recognition and goodwill, potentially generating more deal flow while diversifying the family business.

Other Considerations

- Regulatory compliance requirements that come with managing outside capital must be reviewed. This includes potentially registering with the SEC as an investment adviser and complying with all aspects of that regime (such as filings and implementing controls, policies, reporting, etc.). It is unlikely that a family office will have a full team in place to effectively manage such a regulatory undertaking as well as any additional administrative burdens of managing the vehicle, and many offices will need to hire additional personnel to fully support managing third-party capital and ensure sufficient resources are available.
- Compensation for the investment teams required to manage and invest additional outside capital will need to be reviewed and likely increased and/or restructured.
- Some families may be sensitive to opening up their family office to external investors and regulatory/tax scrutiny. That said, there are certain structuring options that may eliminate, or at least significantly mitigate, such issues and create meaningful separation between the internal family office operations and the external investment management business.
- Families may lose some control by involving third-party investors. For example, some traditional institutional investors may seek concentration limits, geographic restrictions, hold period limits or termination rights. Again, careful advance consideration and planning can mitigate these concerns and lead to structures and terms that benefit both the family and its outside capital providers.

Creating the Right Structure for Your Family Office

Every family has its own unique needs and goals, and thus the most attractive option available to each family office may differ. This article sets out just some of the options and related considerations. These and other considerations — including estate tax planning, family cohesion and investment philosophies, and existing family office structures — need to be carefully analyzed to determine whether an alternative model is appropriate for your family office.

If you have questions about the topics addressed in this *Private Investment & Family Office Insights*, please contact familyoffice@kirkland.com or one of the attorneys listed below.

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