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Family Offices: New Beginnings for Alternative Capital Arrangements

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"Everything must have a beginning . . . and that beginning must be linked to something that went before."

Veteran family office operators and managers may have other quotations (or visions) from Mary Shelley's "Frankenstein" in mind, but her comment on origins, invention and creativity describes a theme familiar to those seeking new avenues for investing family capital. In the growing trend of expansion into third-party capital management and other alternative family capital arrangements, this article introduces some of the considerations for family offices interested in charting a new beginning.

Factors Driving the Trend

Traditional family offices examine alternative capital arrangements for a number of reasons, many of which focus on accessing a wider range of attractive investment opportunities and recruiting and retaining talented investment and operating professionals. This is increasingly important in the current competitive market for direct private investment and the emergence of alternatives to traditional private equity models. Family office motivations typically include:

- Mitigating family capital investment constraints (e.g., available capital, concentration or diversification limits, timing of capital deployment and pacing requirements) that potentially limit actionable opportunities. Outside capital often enhances flexibility regarding scope and timing of potential investments;
- Maintaining competitiveness with long-term hold private equity sponsors that increasingly encroach on the territory of this traditional family office investment strategy. The ability to invest in more in-scope transactions promotes family office strategies to a wider audience;
- Using upscaled assets under management to create competitive compensation packages that will recruit and retain key investment personnel. Stability and cohesion of personnel is critical for achieving family office objectives, and higher cash flows generated by upscaling the firm can help level the compensation playing field;
- Enhancing profitability and investment returns by reducing exposure to third-party managers where fees and carried interest may be charged. Larger investment checks lead to greater demand and more leverage in the process;
- Decreasing dependence on strategic relationships and co-investment opportunities for transaction sourcing;
- Building a broader network and enhancing name/brand recognition. Increases in deal flow

and a widening investor base create new opportunities for capital raising, capital expansion and building out internal operational expertise; and

- Converting an attractive long-term track record into a competitive marketing advantage for new assets, as many first-time fund sponsors lack credible long-term performance. Prior relevant experience is hugely important in attracting third-party capital, and many family offices are sitting on significant untapped value in their track records.

What are the Alternatives?

Alternative family capital arrangements typically are aimed at increasing the total pool of capital available for investment. There is no one-size-fits-all approach, as each family office has unique circumstances, priorities and sensitivities. However, common approaches include:

- Offering co-investment opportunities without compensation to a network of other family offices or other market relationships;
- Raising a commingled fund that seeks committed capital investments from third-party investors with the family as a significant anchor investor in the fund (or co-investor alongside the fund);
- Managing third-party accounts for one or more strategies in which the family office also participates (e.g., a public markets strategy or a fund of funds); and
- Utilizing special purpose acquisition vehicles or majority-owned public vehicles to raise third-party capital for control investments.

How to Structure?

In light of the wide variety of possible structures, family offices give great consideration to tailoring the structure of the new alternative family capital enterprise for the particular needs of the family. In many cases, the primary consideration is the extent to which the new enterprise involving third-party capital will be (i) integrated with or (ii) separate from the family office structure. Although the options appear simple enough, choosing between them implicates differing operational, legal, tax and regulatory goals, as well as potential family concerns regarding reputation, privacy and control.

To illustrate the complexity, consider that an integrated approach may have tax efficiencies and promote greater continuity with historical practices: However, integration also raises the potential for tax or regulatory scrutiny and heightens family privacy concerns. For example, the Investment Advisers Act of 1940 regulates a wide variety of asset managers. The Advisers Act's compliance directives are not well-suited to regulate families managing their own wealth, and traditional family offices typically rely on an exemption from investment adviser registration under an SEC rule. However, this rule is narrowly tailored and substantially restricts the ability of family offices to manage third-party capital. As a result, family offices expanding into alternative capital arrangements generally must reckon with Advisers Act registration and compliance as it pertains to the new venture, or seek another available exemption.

Related and sometimes thorny questions also tend to arise, including:

- Is the family office large enough to establish ownership and control of the new venture distinct from that of the family office in a manner that will satisfy Advisers Act and other regulatory considerations?
- To what extent will family principals wish to exercise governance or voting rights over the enterprise and its investment activities?
- To what extent will family principals wish to be involved in the ongoing operational oversight of investments post-acquisition?

- Will the enterprise oversee any historical investments made by the family, or will portfolio management services be limited to investments made within the new strategy or structure?
- Will the new enterprise complicate or limit the investment scope or allocation for exclusive family office investment activity?
- Which entity will employ key personnel?
- Will the new enterprise stand apart from the existing family office from an operational standpoint, or will there be any shared services or other linkages to legacy operations? For example, will the economics of the new enterprise support separate accounting, information technology and benefits services?
- Will the family's capital be invested alongside third-party capital? If so, how will the family's capital be treated relative to non-family capital?

Pritzker Private Capital Experience

The evolution of Pritzker Private Capital (PPC) illustrates the decision process employed by a family group considering alternative capital structures. Brothers Tony and J.B. Pritzker founded Pritzker Group Private Capital (the predecessor to PPC) in 2002 to invest their combined capital in middle-market companies in the manufactured products, services and healthcare sectors. With a focus on flexible capital and long-term value creation, the firm acquired several companies and over time grew its team to over 30 investment and operating professionals. As the pace and size of each investment continued to accelerate, the brothers looked to alternative structures to achieve the family's goals while managing risk. These objectives included:

- Generating better returns at lower costs;
- Taking full advantage of the deal flow being generated;
- Attracting, retaining and developing top talent; and
- Continuing to diversify investments by size, sector and time.

These considerations ultimately led to the establishment of PPC in 2017 to invest committed capital on behalf of the Pritzkers and other like-minded investors. According to PPC Managing Partner Paul Carbone, the decision to form a committed club was driven in part by the need to execute with speed and certainty while not jeopardizing PPC's competitive advantages in the marketplace. "The committed club structure helped us retain our long-term approach to building great businesses while enabling us to scale the enterprise by partnering with other families that share our vision."

Furthermore, investments in infrastructure and talent allowed PPC to establish new and independent operations that are additive to but substantially separate from the family's legacy operations. These investments, coupled with clearly defined investment parameters in the club vehicle's organizational documents, helped preserve the family's ability to continue making investments unrelated to PPC's stated mandate.

The committed club structure may not be desirable for all family offices, especially those sensitive to the duties and requirements imposed by the Advisers Act. In the case of PPC, the benefits of the committed club structure outweighed the costs of added complexity, and the updated structure continues to generate new opportunities for growth and capital deployment.

Takeaways

The summary here is that there are good and established paths for navigating the expansion into alternative capital arrangements and the related changes, but careful and considered planning is critical. The unique dynamics of each family office will require sophisticated and thoughtful solutions to these questions, with input from not only family principals and family office personnel but also outside counsel, accounting professionals and other experienced consultants. With forethought, family alternative capital arrangements can be additive to a family's legacy investment philosophy and approach, without creating a Frankenstein's monster for all involved.

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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