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# Direct Investing: Can this be the Second Coming for the family business?

WEEKLY EDITION • OCTOBER 25, 2017

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## From FFI Practitioner

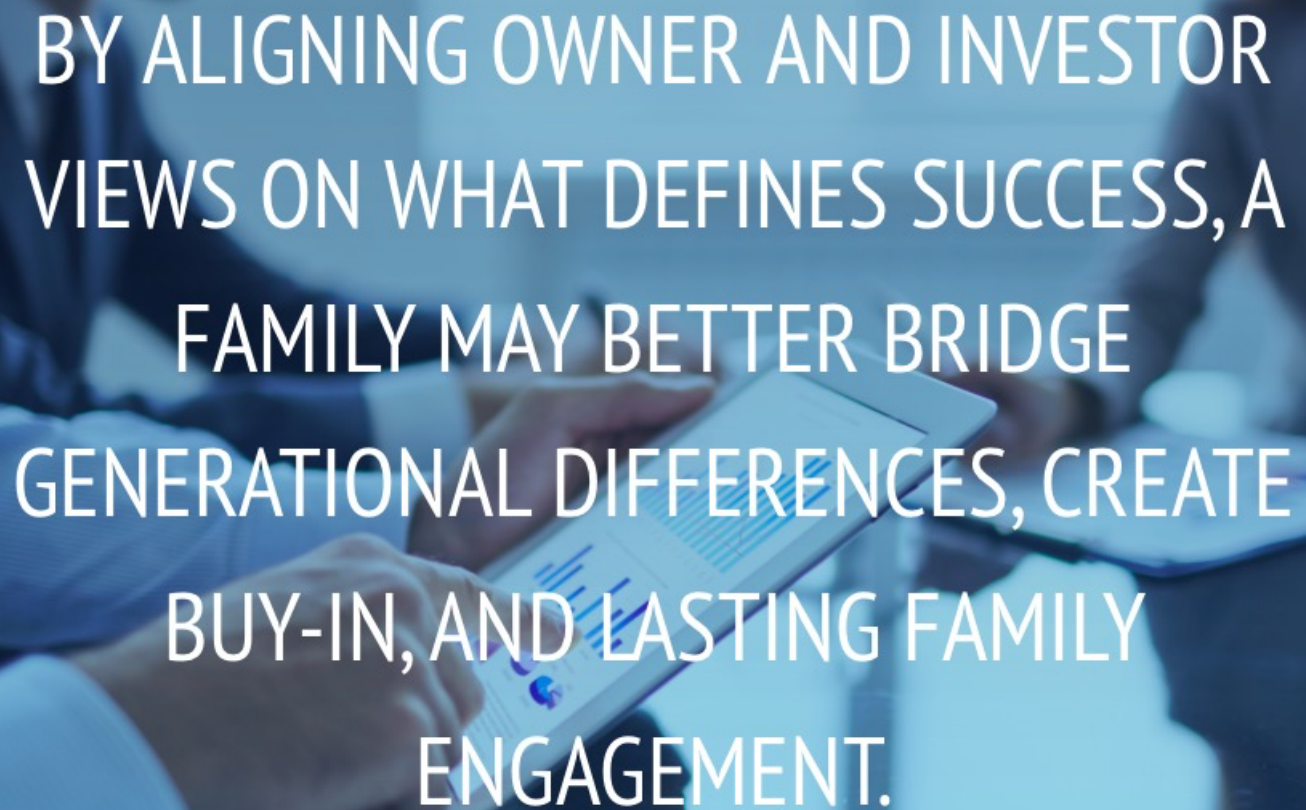
Thanks to Kirby Rosplock, author of *The Complete Direct Investing Handbook*, for this insightful examination of direct investing in the context of family enterprises seeking an alternative path to achieving multi-generational success. The article explores the potential risks and rewards and provides suggestions for family businesses and their advisors who decide to engage in the practice.

Family businesses have their own natural business life cycle. Some will thrive over several decades as their products, services and/or niche keep them relevant and robust. Other family businesses may not be so lucky and find that the business life cycle or aspects of family ownership and management lead them down a path to eventually close and sell all, or a portion, of the business. Direct investing, or the decision to invest in operating privately held companies, may be the key to unlocking family businesses for future generations.

For my recent book, *The Complete Direct Investing Handbook*, I interviewed many family enterprises for which direct investing may be the way to create an on-ramp for the next family enterprise. Of course, statistics show that many of these companies will fail, but some may have the potential to eclipse the founding family enterprise. Direct investing may provide the seeds for future family business growth and wealth appreciation as well as a pathway for Next Gen family members to learn about the pearls and perils of ownership, governance, leadership, and oversight.

Because these new business investments are not necessarily the same as the core family business or tied to the personal identity of one or more family members, these direct investments may allow family members to explore different roles in the new entity: for example, from passive to active shareholder and investor.





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BY ALIGNING OWNER AND INVESTOR  
VIEWS ON WHAT DEFINES SUCCESS, A  
FAMILY MAY BETTER BRIDGE  
GENERATIONAL DIFFERENCES, CREATE  
BUY-IN, AND LASTING FAMILY  
ENGAGEMENT.

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Here are a few suggestions for families and their advisors who may want to pursue this path:

**1) Come up with an investment thesis for doing direct investing prior to investing in the first company.**

A direct investment thesis is the family's statement of beliefs, criteria, and goals used to guide decisions for investing in a business enterprise. It may include guidance for what to buy, when to buy it, when to sell or when to exit. Think of the direct investment thesis as a tool to keep the investors on track and consistent with their approach to this bespoke area of investing.

For example, family business operators, turned direct investors, often have developed a core expertise or strategic advantage within their domain expertise and the knowledge learned from their core business. They leverage that knowledge and may have an expanded focus in their direct investment thesis to their core domain expertise. For example, I interviewed a family whose family business was in healthcare and, post-exit from their family business, they determined they wanted to focus much of their direct investing into other healthcare or medical device-related operating businesses as a function of their knowledge of this field.

## 2) Invite family members to be part of the process to source, vet, and select the appropriate direct investment opportunities.

The process of identifying and deploying capital in “directs” can be a great training ground for family members. It can provide opportunities to learn the building blocks of business from a myriad of angles. Digging into and understanding what makes a business tick, when it is in its development (seed, early, mid- or later stage) can also provide insights to the level of risk the investor might be taking and the discount rate to the cost of capital. For example, investing in an earlier-stage venture that may not have a product or proven service offering requires the investor to take a greater level of risk. With the risk comes the need for more control by the investor. These kinds of learning experiences of “diligencing a deal” can groom family members to think both as operators and investors.

### SIDEBAR



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Carbone**

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## 3) Understand what the desired exit from the investment is before starting.

Perhaps it sounds counter-intuitive to consider the exit strategy before investing, but understanding why you would continue to be invested and the terms and circumstances to exit is a sobering, yet very business-practical approach. What does this require of the investor? A strong understanding of the terms, preferences, return profile, timing, and governance considerations. Investors can also maximize much of their liquidity and illiquid investment through pre-negotiated rights in an investment. Because it is unknown how the direct investment may perform, investors can protect themselves with terms for downside risks upfront that may help with expanded ownership, control, or leverage when/if the investment does not perform as forecasted.

## 4) Define success.

Family members will have different lenses when it comes to defining success. Millennials, for example, have a keen interest in investing in impact-oriented or socially responsible investments with a double bottom line, both positive profits and social impact; or triple bottom line of a positive social, financial and environmental or ecological impact.

A Deloitte survey of 5,000 Millennials with advanced degrees, who were full-time employed, revealed that the primary purpose of business is to 1) “improve society,” followed by 2) “generate profit.”[1] An Oppenheimer Funds/ Campden Wealth Study found that 80% of Millennials surveyed indicated that they want their portfolios to incorporate values in the decision-making process and to increase allocations in impact investing, microfinance, sustainable and responsible Investing (SRI) filters, and venture philanthropy.[2]



For the Millennial generation, what might be deemed success is direct investing with both “purpose and profits,” whereas for others, making a positive impact on the environment, society and/or socially may not be included in a definition of success. Bridging the generational lenses to what “success looks like” and defining the criteria will help align the ownership group.



In conclusion, not all families will have the appetite for direct investments. However, for those who do, taking a disciplined, de-personalized, and objective approach may mean the difference between success and failure. Operating from a well-thought out aligned direct investment thesis can provide the family with its compass to direct investing. Engaging family members in the due diligence of deals may educate, expose, and build family member acumen along the way, providing a sobering dose of reality on the risks and rewards with this type of investing. Gauging the exit strategy before the deal is consummated will help direct investors better negotiate favorable terms such as tag-along rights, drag-along rights, or registration rights. By aligning owner and investor views on what defines success, a family may better bridge generational differences, create buy-in, and lasting family engagement. Finally, for those families that are seeking to invest in operating businesses, direct investing may provide the opportunity to encourage an entrepreneurial orientation within the family ownership group, as well as support the transition from one generation’s success to future generations.

[1] *Millennial Innovation Survey*, Deloitte, 2013, p.9.

[1] *OppenheimerFunds/ Campden Research, Proving Worth: The Values of Affluent Millennials in North America*, 2015, p.19.



## About the contributor

**Kirby Rosplock**, FFI Fellow, PhD, is a consultant, researcher, innovator, advisor, author, facilitator, and speaker in the family business and family office realms. As founder of Tamarind Partners, Inc., she provides leading edge insights and knowledge to the family office domain. Working with families of wealth and enterprise, Kirby understands the nuances and needs of families starting a family office versus those transitioning or unwinding them. She is a 4th generation owner and board member of her family's lumber business.

Her new book is *The Complete Direct Investing Handbook: A guide for family offices, qualified purchasers, and accredited investors*. Kirby can be reached at [Kirby@Rosplock.net](mailto:Kirby@Rosplock.net).

## About Tamarind Partners

**Tamarind Partners** is a full-service, Florida-based consulting practice for family offices and those who serve family offices. It provides a broad array of services; from supporting family offices with research on best practices, to strategic thinking on the cost/benefits of various paths.

## Sneak Peek



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