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Generations Spring 2024 - Aligning Family Office Compensation and Governance in Response to Rise in Direct Investing

Over the past decade, family offices have increasingly embraced direct investing as a central component of their investment strategies. Taking a more active approach to investment sourcing, diligence, and execution naturally requires a different talent profile for a family office's full-time investment professionals. It also requires that members of family office advisory boards and investment committees take on greater responsibility and devote more time to their roles. As a result, we will likely see the more sophisticated family offices increasingly adopting incentive-driven reward structures that more closely resemble private equity compensation structures, not only for full-time in-house investment professionals but also for advisory board and investment committee members.

The Shift to Direct Investing

The family office landscape is evolving rapidly. As assets under management at larger family offices have ballooned in recent years, many have evolved from merely "family" entities into fully professionalized investment institutions. Staffed by sophisticated investment personnel, this new breed of family office is not content to rely solely on the traditional model of gaining exposure to alternative investments through third-party fund managers. Rather, there is a growing desire to make direct investments in real estate, venture capital, and private equity and various other asset classes. The appetite for direct investing is especially strong among newer family offices launched by younger principals, many of whom built their wealth in the technology sector or alternative investment space. Whereas longer-standing family offices have traditionally viewed wealth preservation as their primary mandate, the new generation is more likely to aim for wealth *acceleration* and to seek increased access to deal flow through technology and proprietary networks. This trend has also been fueled by the growing prevalence of "investment offices"—family offices for which investing is the core activity rather than just one component of a broader aggregation of professional and lifestyle services for family members. The benefits of direct investing for family offices may include greater control, lower fees, and potentially increased returns. Family office direct investments take many forms, including minority stakes, growth equity positions, and control acquisitions. In some cases, the family office fully funds the direct investment. In others, the investment involves a larger set of individuals (inside or outside the family) or other family offices, banding together in the context of a co-investment or "club deal."

Implications for Compensation

Because direct investments are more operationally demanding than allocating funds to third-party managers is, investment professionals with different skill sets and experience are needed to support a direct investing program as compared to more traditional wealth-preservation strategies. Teams that have the expertise and relationships to source, diligence, execute, monitor, and harvest direct investments tend to come from private equity firms or similar buy-side backgrounds. Because these top-tier professionals are unlikely to accept a compensation package that does not offer significant upside for successful investments, family offices that wish to attract such talent in today's competitive landscape will need to offer chief investment officers and other senior investment team members incentive compensation arrangements that mimic those offered by venture capital and private equity firms. The move toward increased use of incentive-based compensation extends beyond the full-time professionals to encompass members of advisory boards and investment committees. (It is less

prevalent among members of boards of directors, also referred to as "fiduciary boards.") This reflects a recognition among family offices of the need for more formalized governance structures and rigorous decision-making processes to oversee direct investing, which in turn require greater expertise and workload from the advisors providing oversight. In some cases, family office advisors may be called upon to take on board or advisory roles with the family's portfolio companies, which can require a meaningful time commitment. Components and attributes of these more Private Equity-like compensation arrangements may include:

- a share of the *carried interest* attributable to investment returns;
- grants of *profits interests* in the underlying portfolio companies;
- favorable *co-invest rights*, possibly including loans from the family office to increase available capital contributions;
- *phantom equity* arrangements (used to limit non-family member direct equity ownership in the family's portfolio investments);
- *vesting* of equity over time to promote retention and align with the family's longer-term goals; and/or
- *put rights* or a predetermined *sell-down schedule* to create liquidity for the advisor even if the family plans to buy and hold a position for many years.

The shift to a more engaged, more experienced, better-compensated advisory board or investment committee may involve delicate management of family members who have previously overseen these governance functions. If mitigating risk and improving investment returns are to be the top priority, heightened vetting and qualification requirements must apply to family members involved in governance as well as to nonfamily advisors. Challenging macroeconomic conditions such as higher interest rates and inflation, as well as tighter credit markets, have put downward pressure on the direct investing portfolios of many family offices over the past couple of years. Some have responded by slowing or ceasing direct investing. But the family offices with the greatest AUM have tended to take the opposite approach, doubling down in the expectation of benefiting from lower valuations and opportunistic situations. These family offices are increasingly recruiting experts such as serial entrepreneurs and CEOs with deep industry knowledge, contacts, and networks to serve as advisors to gain an edge in their direct investing programs. Through access to superior deal flow, as well as improved diligence capabilities, family offices are aiming to build successful direct investing programs for the long term. And they are prepared to pay what it takes to secure that advantage. As family offices expand their direct investing programs and professionalize their teams, they must implement processes, compensation arrangements, and governance structures to align non-family member service providers with the family's values and mission, while promoting communication with, and input from, their constituents to preserve family cohesion and continuity.

Authors



R. Scott Beach

Partner

Greenwich, CT | (203) 862-7824

Stamford, CT | (203) 977-7336

rsbeach@daypitney.com