FAMILY OFFICE EXCHANGE INSIGHT

Managing Direct Investing Deal Flow

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You've run your own successful company. It should be relatively easy to build out a holding company of other portfolio businesses, right? Not so fast.

One of the greatest direct investing struggles is how to manage deal flow once offers start to come in. It sounds simple enough, but it is quite actually complex – in ways that might surprise you. Mainly, once word gets out you're looking to invest, you'll be inundated with opportunities. So before you work with your network to surface deals, be sure to proactively build your deal architecture and guidelines.

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IT ALL STARTS WITH AN IPS

If your family doesn't have a direct investment policy statement (IPS), don't take another step. An IPS articulates all the factors involved in investing, such as why your family invests, how much risk and financial exposure they'll tolerate, and what kind of segments or industries they want to consider. In the end, your family's direct investing IPS should represent an honest understanding of your family's preferences and, more importantly, investing skills. Without that objective assessment, your direct IPS won't function as it should – to effectively test for investing preferences and skill matches.

You likely already have an IPS for your traditional investing portfolio. But families can struggle with creating an IPS for direct investing, assuming a more complicated process. Fear not – you can set up a basic IPS for the purpose of screening deals by answering the following questions.

- **Are we investing for passion or profits?** Each requires very different lenses. Understanding your motivation will drive your consideration set. Keep in mind, passion investments are often not objective. Sometimes supporting inspirational causes may not make the most financial sense – so being clear from the start about your intentions will help you stay focused on what you're trying to achieve.
- **Do we invest in industries we know, or do we broaden our horizons?** There are pros and cons to each. For instance, you might know the tool and die business really well, and look only in that arena. But if the world is going to 3D printing, you might be limiting your opportunity set. On the other hand, sticking with what you know allows you to focus narrowly on your strengths and optimize your expertise in a certain field. Even if you do take a broader approach, picking a select number of industries to focus on is required, or you'll have to consider every offer that crosses your desk. And that you don't have time for.
- **How much risk are we willing to take?** Primarily, financial risk. Put some basic financial parameters around what is acceptable. What is your minimum investment size, and what's the maximum? What stage of company is in your sweet spot – early or late? Keep in mind, the checks you cut may not be limited to your initial investment – you'll want to consider any future capital needs as well.

WHAT IS YOUR PROCESS?

Here's a pro move: let the selling party know what they're dealing with. If you are slow, picky, only invest behind a lead investor, or won't write more than a certain check size, it's really important to tell them. That doesn't mean you give away your secret sauce, but clarity certainly helps set the stage for well-managed expectations.

Another pro tip: use your direct investing IPS as a screen and front-end data onboarding tool. Given your IPS sets the parameters for what type of investing you'll do, an upfront request for data will get you to a decision point much easier and faster. For example, you can use a simple survey tool to ask for data salient to the deal, such as:

- **Industry**
- **Capital raise amount**
- **Percent of company available for purchase**
- **Market size**
- **Management team members**
- **Other investors**
- **Financial history**
- **Previous and current valuations**
- **Any piece of information you deem a must-have to review a deal**

This survey can capture the data you need to act as a quick screen and whether you should even review the deal to begin with. Many company executives will send you something to read, but when you're drinking from a firehose of deal proposals, you would be buried if you had to sift through reading material to find what you need. If the deal were to go forward, this data is something you'd need to obtain regardless, so have them give it to you up front.

MANAGE EXPECTATIONS

Crucially, you'll need to learn how to say "no" while preserving the seller's dignity and your hard-earned reputation. Every company looking for capital has an owner with a deep emotional tie to "their baby." Showing courtesy and respect will set the stage for future conversations, referrals, and positive market feedback.

That said, you still need to mind your fences. Sellers will want to get answers, quick, and won't hesitate to call you repeatedly to get one. Just remember, you are in control, not the seller. There is nothing worse than a pushy CEO who pesters you for answers or feedback. So let them know they have only one time to ask you for an update; more than that means they're becoming a pest and will be banished.

And never open up your personal Rolodex® just to be nice. Sellers are often fine with a firm but polite no, but they likely will ask for a referral. Think of this as the guilty quid pro quo. But it's not your job to do the seller's marketing. Tell them up front you don't make referrals as a simple business policy. There is nothing to argue here other than you hold your co-investor Rolodex dear and will not share it arbitrarily.

Once you become an active direct investor, it's your business to be looking at other peoples' business plans. As such, don't get trapped into signing a nondisclosure agreement (NDA) too early in the diligence process. You want to avoid giving someone else control over your own intellectual capital. Presumably they're approaching you for your expertise; don't tie your hands in a way that prevents you using your expertise elsewhere, particularly if the deal doesn't go through.

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Additionally, signing an NDA too early actually puts you at a legal disadvantage, given you will be looking at hundreds of proposals every year. If you sign an NDA for one company, and then look at a similar company a few months later, what's to stop the first seller from alleging you shared proprietary information with the second and infringed on their intellectual property? Ultimately, there may come a point where an NDA is necessary, but that's typically once a deal has progressed to the point where you want to sign one.

SETTING YOUR RINGFENCE

Direct investing would be so much easier if having intimate knowledge of your organization qualified you for understanding other companies. But there's more to investing in someone else's business than just having the means. Not the least of which are well-articulated direct investing strategies, policies, and an honest understanding of what you bring to the table. Because once you open the door to prospective opportunities, you'll be amazed at how little time you have left for anything else.

For more guidance on direct investing, consider attending FOX's upcoming public, virtual **Direct Investing Workshop**, November 9-10, 2021.

Open to members and nonmembers alike, the Direct Investing Workshop covers the specialized skills and knowledge needed to have an active and successful direct investing platform for your family. In this virtual workshop, attendees will learn the key steps to direct investing, from sourcing deals and due diligence to the best practices in family investment governance. In addition, sessions will cover the risks of direct investing and the structures and practices families engage in in order to realize the potential for outsized returns. Learn from experts in the industry and network with your peers in this two-day workshop.

To learn more about the event or to register, please visit **www.familyoffice.com/diw21**.

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