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THE COMPLETE  
DIRECT  
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A GUIDE FOR  
FAMILY OFFICES,  
QUALIFIED  
PURCHASERS,  
AND ACCREDITED  
INVESTORS

KIRBY ROSPLOCK, PHD



## ADDITIONAL PRAISE FOR THE COMPLETE DIRECT INVESTING HANDBOOK

Dr. Kirby Rosplock has created an indispensable resource for family offices seeking to invest in private equity. She explains how to analyze winners and avoid the pitfalls, and discusses the extensive due diligence required even after initial investment. This is the conclusive guide to direct investing, which provides investors with the information necessary to ascertain how to proceed. Rosplock has written the essential manual for what will be a major investment trend for family offices in the years to come.

*Howard Cooper, CEO, Cooper Family Office*

Once again Dr. Rosplock gets it right! In my experience, few have the insider's knowledge that comes shining through in this book. Not only was it helpful, it was a pleasure to read.

*Wendy L Craft, COO, Favara, LLC (SFO), New York, NYC*

Kirby Rosplock's *The Complete Direct Investing Handbook* is a must read for *anyone* interested in direct investing. With key insights reinforced by practical case studies from noted experts in the field, this is an essential guide for current and potential direct investors.

*Joanne Pace, Former Managing Director and Chief Operating Officer,  
Morgan Stanley Investment Management*

The world's best and brightest family offices are devoting ever more capital to direct investing. Now is the critical time for advisors, CIOs, and family members to share a common understanding on how to source, screen, diligence, structure, monitor, and harvest direct investments. Dr. Rosplock's handbook provides the roadmap.

*Brian Smiga, Partner & Co-founder, Alpha Venture Partners*



# **THE COMPLETE DIRECT INVESTING HANDBOOK**

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# **THE COMPLETE DIRECT INVESTING HANDBOOK**

**A Guide for Family Offices, Qualified Purchasers,  
and Accredited Investors**

**Kirby Rosplock, PhD**

**WILEY**

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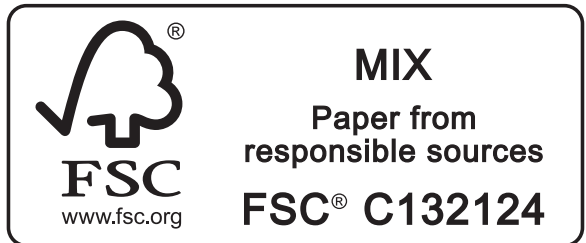
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*This book is dedicated to the memory of my father, Thomas L. Harbeck, who inspired me to dream big and to lean into new endeavors with a passion to first ask, learn, and seek knowledge before jumping off the deep end. His keen business sensibilities and wise counsel will always be treasured and appear throughout this book.*



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# Foreword

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Family offices are in the business of exploring the investment landscape for new and creative ways to enhance returns and diversify from traditional models of investing. I have spent the better portion of my career looking at investments through both an institutional as well as a private investor's lens. The array of investment possibilities within the privately held marketplace is vast and growing, affording the burgeoning family office arena significant possibilities for investment. I see this as the new frontier of investing, and where some of the most exciting opportunities will be unearthed.

Dr. Rosplock's book, *The Complete Direct Investing Handbook*, provides a valuable and practical framework for approaching the direct investing landscape that appeal to both the neophyte and the most seasoned investor. It imparts not only her wealth of knowledge, but the insights and experiences of some of the private investment industry's most successful and respected leaders. The book includes valuable case studies, research, and practical tools and metrics to apply to this facet of investing. To date, there have been limited resources beyond the MBA textbooks to delve into this nuanced topic, but finally we have a playbook.

Interest in direct investing over the last decade has caught the attention of accredited investors, angels, and family offices. Yet Dr. Rosplock puts great emphasis on the fact that this specialized type of investing may not be suitable for every family office or accredited investor. She provides sage advice throughout the handbook on the importance of proper sourcing, vetting, due diligence, analysis, and structuring before deploying capital. Investing in private companies carries with it the seeds for outsized returns, but also the corollary risks. It should not be undertaken without a full understanding of the implications of those factors for the total portfolio.

Current research indicates that, despite the enhanced return potential in the private investment arena, the failure rate will still exceed the success rate for all but the most skillful investor. There has no doubt been a sea change in the investment world over the last 40 years, and the pace seems to be accelerating.

As an active investor in both the private and public markets, I have found particular appeal in the nonpublic sector because of the ability to participate in a variety of investment vehicles. The bespoke nature of private investing requires creativity and investment savvy on the part of either the lead investor or the banking firm, and when done well it has the ability to enhance returns while reducing risk in the admittedly risky world of private investing. Investments can be tailored, with carrots and sticks, to provide incentives for management to reach particular milestones. I have found such instruments to have a beneficial impact on both the investor and the company.

Many family offices are uniquely positioned to take advantage of the opportunity of direct investing because they often have the luxury to be patient investors, something that seems to have fallen by the wayside in the larger world of investing, which has adopted a trader's mentality. Focusing on quarterly investment returns defies the concept of true investing, which is long term in nature. Yet it has become the yardstick imposed on the investing public, particularly since the onslaught of hedge funds. The value of making private investments is embedded in the belief that a good investment idea has merit over a period of years, not months. Many family offices are in a position to take advantage of this sound investment concept because, unlike numerous endowments, foundations, pension plans, and private equity firms, they are generally not hostage to the cash flow and exit requirements of these institutions.

*The Complete Direct Investing Handbook* is the go-to resource for private equity investors and family offices. It compiles insights from leading minds and provides specific examples and recommendations on best practices. Each of its contributors provides a window into an important element of investing in the nonpublic arena. I would recommend that this book be kept nearby for investment decision-makers in the family office world.

Patricia W. Chadwick  
President, Ravengate Partners LLC

# Preface

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If you are reading this book, it is likely that you have a curiosity for, or a pre-existing interest in, direct investing, or are already a seasoned direct investor. Whichever camp you fall into, I hope this book will expand your view on direct investing and provide insights from leading experts, advisors, and consultants within the direct investing space. More than half of the book consists of original chapters from contributing authors who are leaders in the field of direct investing and/or the family office realm; thus, the book provides a wide array of thinking from the best and brightest. Additionally, the book features anonymous case studies and innovative research from multiple institutions as well as proprietary data from a direct investing survey from Tamarind Partners in 2016.

So, what inspired me to write this book? One of my first positions out of college was working in a small brokerage firm in Milwaukee, Wisconsin, as an analyst helping administer a series of private equity partnerships. I was green in my career; however, I admired the passion and interest by accredited investors to back and invest into various direct deals. I quickly learned how these investors found an affinity to invest in this manner that was typically noncorrelated to public markets. Additionally, these investments provided portfolio diversification, the opportunity for outsized returns, and the ability to access niche, specialized investments not typically offered to the public. A few became winners, others barely broke even, and the majority failed. As my career evolved and I became more involved in the family office domain, I quickly realized how important private capital continued to be in closely held businesses. Some family offices continue to have a large segment of capital committed to operating businesses, and for many the source of wealth was a function of one or more of these positions.

Later in my life, I personally deployed capital into direct deals. Some investments succeeded and some failed. Like many of you, I learned the hard way the importance of sourcing, vetting, and due diligence after investing in what I was told would be a “sure homerun” that ultimately failed. My other

co-investors were also confident in what we thought had been sufficient due diligence in the investment and adequate preferences and provisions for the investors. We were completely off-base, and my original investment has yet to return my initial capital. As Oscar Wilde put it, “Experience is simply the name we give our mistakes.”

I relay this quick reference point to provide context that I, too, am still learning, and that even the best and brightest in the direct investment world likely have a similar war story to tell. I know I am not alone or special. After this experience, I decided to look further into the literature on direct investing, and found that most books are texts or casebooks written for MBA programs or focused mainly on venture capital. There are some excellent reads from top business school professors and academics, but few books focus on the narrow domain of direct investing, and none to my knowledge specifically look at the subject matter through the unique lens of the family office.

My first book, *The Complete Family Office Handbook* (Wiley/Bloomberg, 2014), revealed the complex landscape of the family office realm and captured some of the building blocks to starting, operating, and managing a family office. During the data capture for that book, I learned the variety of family office types and diverse approaches to building a family office. Similarly, I discovered with writing and editing this book that there is a wide diversity of approaches to direct investing. There is not a one-size-fits-all approach to family office or to direct investing. Everything has to be tailored to you, and this book provides a foundation for readers to create their own unique approach.

This book is designed to appeal to the novice as well as the expert direct investor, and consequently covers a broad array of content and fictionalized cases. The book is organized into three sections. Part I provides a high-level overview of direct investing and the family office context. Part II discusses the steps and process of deploying capital into direct investments. Part III provides some additional unique perspectives on direct investing. Specifically, Chapter 1 lays a foundation on direct investing in the context of family offices. Chapter 2 discusses the increased presence of private capital into directs. Chapter 3 shares the interest in co-investing and club deals, and, finally, Chapter 4 outlines the various private equity strategies and where direct investing may fit. Chapter 5 is the beginning of Part II and outlines the various steps to execute on a direct investment. Chapter 6 discusses the steps to create a direct investment thesis. Chapter 7 shares the importance of sourcing, deal flow, and screening and deploying capital into direct investments. Chapter 8 elaborates on the deal structures, terms, and portfolio construction. Chapter 9 shares what happens after the capital has been deployed and the investment monitoring, exit strategies, and harvesting of returns. Chapter 10 is the start of

Part III and examines the CIO perspective to direct investing. Chapter 11 looks at direct investing with a lens to Millennials' perspective on impact investing. Chapter 12 shares the Sustainable Cycle of Investing Engagement model (SCIE model) as a possible approach. Chapter 13 closes with describing the international approach to direct investing.

Direct investing is not for the faint of heart nor is it for every investor. A quick disclaimer is required to remind readers of the tremendous risks associated with the potential rewards of direct investing. The contributing authors and I are not endorsing that everyone should be direct investors. On the contrary: The reality is very few may want to embrace this approach to investing even if they are technically qualified. There are more losers than winners when investing in this manner, so operating with your eyes wide open to the downside risks of this type of investing is imperative. We hope this book will be a useful resource and guide to aid direct investors as they consider how/whether to deploy private capital into this niche area of private equity.



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# **THE COMPLETE DIRECT INVESTING HANDBOOK**



**PART I**

# **Direct Investing and the Family Office Test**



## CHAPTER 1

# Introduction to Direct Investing

Investors have more and more options than ever before for methods to deploy capital in the aim of generating financial returns. Today many family offices, high-net-worth individuals, and institutional private equity investors have amassed wealth through private company ownership.

Many of these successful business-building investors are looking for more avenues to deploy large investments in private equity-oriented investments. Today, for many investors, from early stage *angel* investors who deploy tens of thousands of dollars through mega funds with billions of dollars under management, the strategy is the same: Invest in the ownership *directly* of a privately held company or illiquid asset like real estate, and sell your ownership interest for a profit at some point in the future.

Where historically extraordinary wealth has been created through building and owning equity in privately held enterprises, options range from public securities to esoteric hedge fund strategies. Investors can typically access any type of investment that meets their objectives defined in a risk-versus-return profile. As investment risk increases, the opportunity to generate outsized returns also increases. With innumerable choice for investors, from

longstanding established asset classes through newly formed financial instruments, there continues to be a sustained interest in a form of investing referred to as *direct investing*.

Direct investing may be defined as investments that meet the following criteria:

- The investor is making the decision to participate in a specific investment that is closely held (not publicly traded).
- The investment capital is funded directly by the investor (from a balance sheet under their control).
- The investor will own an operating asset through a direct investment that has unique and specific operating requirements.

Investment strategies designed to capture the value created through private company ownership have typically been the domain of private equity (PE) and venture capital (VC) funds. “The MoneyTree™ Report by PricewaterhouseCoopers LLP (PwC) and the National Venture Capital Association (NVCA) based on Data from Thomson Reuters” revealed that “venture capitalists invested \$48.3 billion in 4,356 deals in 2014, an increase of 61 percent in dollars and a 4 percent increase in deals over the prior year. In Q4 2014, \$14.8 billion went into 1,109 deals.”<sup>1</sup> To gain exposure to the outsized returns offered by these funds, family offices and ultra-high-net-worth individuals have invested as limited partners in a blind portfolio of fund investments. These funds, on one hand, may offer exceptional return expectations but also require large capital commitments that are illiquid for the long term with little visibility into the underlying companies for the investor. These funds also charged investors management fees and carried interest. In 2014, there were 33,429 Regulation D offerings reported on Form D filings, accounting for more than \$1.3 trillion, with approximately 301,000 investors participating in these offerings.<sup>2</sup> To achieve high returns in the PE market as a limited partner, investors must gain access to the top-performing funds that are rarely open to new investors. This leaves family offices struggling to generate returns by investing with mid-tier fund managers, in turn making direct investing into specific deals more and more attractive.

Direct investing is not a strategy that is one-size-fits-all or for that matter appropriate for all investors to consider. At the end of any investment process, investors have an illiquid investment in an operating company and “own” the business, including the operational and execution risk associated that all companies are subject to regardless of size, sector, or stage.