Raising the stakes

PAM's most recent breakfast tackled the issues that accompany ultra-high-net-worth investors taking a stake in a private firm

STEPHANIE BARTUP REPORTS

Wealth advisors need to become more comfortable in the private investment space, the audience at *PAM*'s latest breakfast briefing heard from a panel of four experts.

At the event in New York City, entitled 'Investing in a company pre-IPO: A guide for high-net-worth investors and their advisors', Bill Militello, founder of alternative investment management firm Militello Capital, said that although many ultra-high-net-worth (UHNW) clients were interested in investing in private firms, advisors were often "slow to the party".

"We have to consider that 75% of millionaires in the US are first-generation wealth, and a significant proportion of that wealth was derived through ownership of privately operated companies," he explained. "These investors have always had an affinity for private transactions; it's their advisors who have been slow to the party. Once advisors become more comfortable in the private arena, they'll have a much better time attracting these clients."

Militello spoke on the panel alongside Sam Jacobs, senior vice president for sales and business development at capital and investor connection platform Axial, as well as Tom Petrone, director of capital markets at Dynasty Financial Partners, and Michael D'Addio, tax and business services principal at Marcum LLP.

Jacobs added that an education needed to occur to make the wealth management community comfortable with presenting investments in private companies to their clients as an acceptable form of risk.

"It's a very different game to investing in public stocks and bonds, for example," he said. "A lot of wealth managers have expressed concern over how to defray liability from a failed private investment

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BILL MILITELLO, FOUNDER OF MILITELLO CAPITAL and being responsible for the advisor that made the original recommendation," he said. "The answer is, you can't. This isn't the same as an investment in the public space, it's the nature of investing in private companies. And getting that level of risk accepted from the advisory community is a challenge sometimes."

Petrone observed that a significant proportion of ultra-high-net-worth investors had acquired their fortunes by "putting all their eggs in one basket", through one single successful venture.

"In this respect, it's almost like the act of creating a diversified allocation program can be more foreign to these individuals than investing in private companies," he added. "They're used to this level of risk – the questions usually arise from the investor surrounding access to these opportunities and the due diligence process. The decision to invest is something they are comfortable with – the limiting factor is the people they are dealing with."

In the same regard, Jacobs noted there was a danger the affluent investor might have 'survivor bias' – whereby they might think that because they've made a lot of money in one specific industry, the same will happen with their next investment in another company.

"This obviously cannot be the case all the time," he said. "We have seen many investors thinking that having access to a network of capital means they don't need a team of people to negotiate or help them navigate the deal – you need accountants, lawyers, an investment manager; then you'll have to tackle the due diligence, and there are so many different types of due diligence, from IT infrastructure to environmental."

Discussing similar pitfalls an UHNW client might come across when making an investment in a company before it gets to IPO stage, Petrone emphasized the importance of taking the due diligence process seriously.

"Some investors want to save on the expense of doing the due diligence and the research, and that leads to mistakes which can be caught by having an expert look over the numbers," he said.

One potential pitfall Militello warned against was ensuring that the deal pipeline an investor has access to is broad enough to create diversification.

"Having access to a variety of deal types and industries gives investors a far wider reach – and it allows them to see potential transactions that they might never have considered," he said.

The panel also discussed the different mediums through which affluent investors were finding these prospects, and which kinds of companies they were interested in taking a stake in.

D'Addio said that he had noticed a lot of clients investing in the research and development space, while Jacobs said that business services was a popular arena for investors.

BILL MILITELLO
Militello Capital

SAM JACOBS
Axial

TOM PETRONE
Dynasty Financial Partners

MICHAEL D'ADDIO
Marcum LLP

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SAM JACOBS, SENIOR VICE PRESIDENT FOR SALES AND BUSINESS DEVELOPMENT AT AXIAL

In terms of the means investors use to find the deals, D'Addio said he had witnessed groups of affluent families and individuals creating their own informal networks to search for private equity and direct investing opportunities in specific industries.

"For example, a group might want to find investments in the medical space," he said. "They'll speak to their close peers in this network, and try to find an investment match."

All the panelists agreed that this network 'matchmaking' occurred within the industry – but observed that the process was changing.

"There are groups which deal-share within families," said Jacobs. "Whether it's real estate or other investment opportunities that they share informally – but there's a lack of technical infrastructure. Some groups working with a few hundred families will circulate these prospects in a spreadsheet and figure out matches. A step up from that is connecting through platforms like Axial or angel investing networks.

"But families are starting to realize that you have to step into the public realm in some way if you don't just want to make deals with people you already know."

Militello agreed that these networks were becoming more and more formal, and added that the advisors and families which are seeing the most success in the realm of private investing are speaking and connecting "not only to Wall Street, but to Main Street".

"These investors and their advisors are the ones actually seeking out the incubators and accelerators housing these potential opportunities, not just putting cash into mutual funds," he said. "They're finding these access points and leading the deal. Advisors are looking not just in public markets but also private, and that is where they're finding deals to show their current and prospective clients."

Petrone added: "Increasingly, what I see are advisors who are including allocations to the private equity space as part and parcel to the overall asset allocation process. It's getting past the embryonic stage now, and a growing portion of advisers are willing to consider liquid and illiquid strategies – including these investments into private companies – and it's starting to be meaningful." ■