Role of Family Offices in Funding and Corporate Governance

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Globally, family offices have a played a very pivotal role in investments over a very long period of time, however, this trend has assumed significant proportions in India only in the last decade. According to a research report of New York based Palico Llc, family offices accounted for almost 8% of $ 4 trillion assets under management of private equity funds. This is also the second biggest category of investors after public pension funds.

It is estimated that there are 200 family offices in India, much higher than our counterpart nations in BRICS.

Wealthy families, who have accumulated wealth over a long period of time, invariably invested surplus funds in their own businesses. In the last decade these offices have diversified their investment profile and looked beyond own businesses. They have invested surplus funds directly or through private equity / venture capital funds in start-up companies, large private companies or even in listed entities.

So, what is driving this significant change in family office's approach to investments?

One of the main reasons is the exposure to the massive entrepreneurial start up ecosystem. India is the third largest hub for startup companies with over 19400 companies registered here. According to a report by Your Story the funding into this ecosystem has grown from $ 6.0billion in 2014 to $ 9.0 billion in 2015. It is substantially higher compared to the cumulative investment in the 2010-14 period.

A large portion of this increased investment is in the areas like e-commerce, healthcare, education, financial services and technology. Start-up companies are trying out new disruptive models of business, which is creating new markets, they are taking inefficiencies out of the system and making the addressable markets more organized. Family offices, especially the younger members of such organizations want to actively participate in this movement rather than allowing this revolution to by-pass them.

Why are the venture capital / private equity funds as well as new age entrepreneurs courting family offices?

a) The successful business families have, in their own right, built large businesses in different sectors including sunrise sectors and have tremendous understanding of what it takes to run businesses in India. They also have built global businesses successfully. Most of these families have successfully transitioned from a "controlled" economy to a "liberalized" one and have demonstrated great agility and adaptability to stay relevant over the years. These qualities are even more important in a fast paced start-up world.

b) The successful "entrepreneurs" from business families understand business risks and cycles, they are willing to take long-term risks and have longer exit windows. Their capital is truly a patient capital and not the one that seeks very quick returns. They also understand the risk and rewards paradigm better and invest at different stages of the life cycle of a company from seed to listed entities.

c) Family offices can bring significant knowledge and operating experience to the table especially, in sectors where their own businesses operate. They understand how disruptive innovation can broaden the market size, what opportunities exist in the ecosystem, where the gaps are, where technology can make a difference and what pitfalls to watch for etc. The CEOs and CXOs of investee companies as well as partners in VC / PE firms can leverage this knowledge and experience in making timely and appropriate decisions.

d) Interaction with professionals of businesses run by family offices can provide a great proof of concept for new products or services introduced by start up companies. This "protected" or "test" environment provides invaluable insights and helps start-up companies to smoothen rough edges and take improved service to the larger market.

e) the sales cycle in new businesses is generally very long companies really struggle to get an audience with the right decision makers. Family offices with their vast network can significantly reduce the sales lead-time and help open doors. The backing by family offices adds significant credibility to the entrepreneurs.

VC / PE firms have acknowledged that in the recent past start-up entrepreneurs have shown tendency to gravitate towards successful entrepreneurs, who have started their family office as they get a lot more than just the capital.

While Indian start-up ecosystem has seen significant increase in funding in 2014 and 2015 the year 2016 has been a lot more difficult for fund raise. The VC / PE firms have become a lot more critical in evaluating new funding requests as they are preserving capital for additional funding needs of the more promising entities in their existing portfolio.

Even while evaluating such additional funding needs of existing portfolio companies they are reaching out to family offices that have businesses in similar sectors to get an in-depth insight on growth prospects of start up company business models. One round of funding done in the past is not the only criteria for the next round of investment by VC / PE firms. Who can give a better advice than the organization, which knows the nuts and bolts of a sector?

How can family offices add value in Governance?

Having evolved over a long period of time through a number of business cycles, family offices truly understand the importance of good business and governance practices. They also understand which risks are worth taking and which are not and what risk mitigation methods need to be put in place. Key stakeholders in family offices zealously guard their business reputation and always advice start-up entrepreneurs to ensure that their own business reputation is never compromised.

Family offices are also able to appreciate when to trust the gut feeling of entrepreneurs and when processes need to be put in place for smooth operations. Having scaled their own businesses, their advice on timely strengthening of management teams in investee companies can be most useful. Most of the successful businesses are known for managing a business thro data and family offices can imbibe that quality by helping their portfolio companies devise relevant business matrices / dashboards.

Compliance with all applicable statutes in every country a business operates in is a very critical component of governance. Start-up entrepreneurs are many-a-times not geared to manage that due to lack of experience and lack of appreciation of the need to comply. Family offices can certainly help alleviate this pain of entrepreneurs by making them understand the importance of compliance and also connect them to the right advisors. This helps entrepreneurs to avoid surprises and keep the cost of compliance very low.

The other area of certain value-add is that of management of finances. Entrepreneurs by nature are very passionate and consumed by the desire to solve the problem on hand by launching new products or services. “Managing finance” is invariably a blind spot and entrepreneurs ignore this aspect till the business has scaled up and by which time they are likely to have finances in a mess. Family offices with years of experience and in-house expertise can certainly help new entrepreneurs overcome these challenges and achieve all-round balanced growth.

What are the pitfalls family offices should watch out for?

While there are many advantages that accrue to business due to involvement of family offices, it is important for family offices to truly differentiate between running own businesses vis-à-vis creating a support system for investee companies. There is a thin dividing line between offering advise / support vs. second guessing entrepreneurs. It would be counter productive if family offices try to control major decisions with a minority interest in enterprises.

While it is expected that family offices would be actively involved in business they have invested in and hold the entrepreneurs accountable, they need to have the right maturity so as not to constantly step on the entrepreneurs’ toes. This is only way for making the desired impact. Both the sides need to be comfortable with the value systems of the organizations they represent and the personal chemistry needs to match. The investment from family office comes as a package and neither the investor or the entrepreneur can subsequently pick and choose only the elements of the other party they are comfortable with. If there is no cultural fit the outcome for both the parties would be sub-optimal.

Family offices also need to refrain from assuming that the steps / processes that have led to success in their own organizations would bring equal or more success in their portfolio companies. They should nudge entrepreneurs in that directions, listen to their viewpoints, engage in constructive dialogue and allow the entrepreneur to chart out his / her own path. They need to behave more like mentors and statesmen, allow the entrepreneurs to make mistakes and learn from those.

Investment in new age businesses presupposes that family offices have spent sufficient amount of time and resources in doing research in areas where they are likely to invest, have hired the right people who bring different skill set than those needed for running own businesses and have a vast network of like minded investors to bounce off new ideas. Investment from such progressive family offices helps portfolio companies build alliances or even to pivot / enter adjacent spaces.

In conclusion, the impact of more active participation of family offices has been hugely positive for the Indian entrepreneurial ecosystem. The capital contribution has become more broad-based and it has generated more wealth creation opportunities in domestic markets. It is very important for the traditional VC / PE segment to work closely with family offices as there are clear synergies and benefits for both. Strengthening of this relationship is very critical for entire sector to grow to the next level and help Indian economy to achieve even higher level of growth in coming years.