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A Disciplined Approach to Single Family Office Venture Capital Investing

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Here is a familiar story for family office investment teams: an email arrives, perhaps from a principle looking to learn more about an opportunity; or a deal comes through trusted advisors or the CIO. A family office management team wants to make sure they thoroughly investigate the opportunity in order to provide value to the family. Resources are allocated, introductory phone calls are made, and before long a young analyst is writing up reports on an industry she's not familiar with, while trying to model an aspirational J-Curve into something that approximates reality. Weeks might be dedicated to such an opportunity before it becomes clear this is not a good fit for the family office. Now imagine emails like that coming in on a daily basis.

According to PitchBook-NVCA Venture Monitor, 2019 saw a record-setting decade in venture, with a 5x increase in deal value to roughly $140 billion.[i] It's an exciting space filled with the promise of tomorrow, but it is also uncertain, filled with risks, and for many marked with embarrassing failures. A disciplined, proactive approach allows a team to mitigate the risks and maximize their upside, while also providing a singular opportunity for learning and leadership development. Despite all of the bad experiences we've all had with early stage investments, there is a real opportunity to bring value to the family office by creating a disciplined approach that fosters exceptional returns, as well as internal learning and skills development.

A reactionary approach to venture capital investing creates more problems than just time management. First, there's the problem of deal quality. In Texas, many of us are familiar with the major features of a "good" oil and gas deal. We know the structural red flags, how to read a reserve report, and how to evaluate

a drill plan. Furthermore, many of us have good contacts in the industry who can provide invaluable insight as we make our initial assessment. Our family office friends and partners outside of Texas are not so lucky. Having worked with family offices in Texas and outside of Texas, we can anecdotally report that the quality of oil and gas deals tends to diminish outside of the state. What's true for oil and gas in Texas is also true of the tech world outside of Silicon Valley. The comparison is not one-to-one, but the general principle stands. As family offices grow and the sources of their deal flow expands, there is an increased exposure to new industries and new kinds of opportunities. Evaluating the quality of these opportunities becomes increasingly difficult, but not impossible.

Second, it is often difficult to properly analyze the relative risks and rewards. Every venture capital pitch book makes strong claims about their path toward profitability, the stability of their future recurring revenues, and their potential valuation once they hit a benchmark that is (always) only 18 months away. All of these claims rely on a solid understanding of the business, the team, their story, and their projected financials. In lieu of historical financials, analysts must make reads on the teams themselves, conduct research into the industry, weigh the various business risks, and proceed with great care. Even in the best of circumstances the likelihood of a profitable outcome is low. SoftBank's vision fund has made a satire out of this in their recent investor relations materials. Slide 51 of their Q1 2020 financials features a graphic of a winged unicorn, this time soaring over the V-shaped valley of Covid-19 recovery.[ii] Jack Ma resigned from the board of SoftBank's vision fund a few hours before this presentation was released to investors.

Third, capital stack and equity considerations often get in the way of a good idea. Promising early stage businesses are sometimes hamstrung by messy capital stacks, convertible notes, and previous investment rounds. All of this adds up to a situation where the price at which one can come into the business is not commensurate with how the business should be valued. Many deals fall through simply because the family office investment team can't get comfortable with the price at which they are coming into the investment.

While the challenges loom large, there is still much to gain from early stage investing. Early stage investing allows one to learn about and enter into industries in a position to make exceptionally outsized returns.

Furthermore, the uncertainties of the space means teams need to do their homework and learn about these industries and businesses from the ground up. This earned knowledge is invaluable and can benefit the team and the family office for years to come. Early stage investment analysis is also a great tool to engage second generation family members that are interested in learning more about capital management. Within investment teams themselves, these opportunities are a great way for younger analysts to develop new knowledge and take ownership of projects without having to be aggressively managed by their managing directors.

The potential benefits from engaging in venture capital investing don't in and of themselves immediately overcome the challenges presented above. One must develop a clear plan in order to get the most from early stage investing. The general principle of this strategy should seek to move away from a reactionary mode, where a team is running in multiple directions trying to catch every pitch that comes through the door, toward a more disciplined and proactive approach, where team members are empowered to go out and seek opportunities that fit specific criteria.

Most important, the investment team should work with the family to develop clear venture capital and early stage investment objectives. Sector identification and investment thesis can come from the team, the family, or a mix of both. Important considerations include the business sector/industry, average deal size, ideal equity stake, and the size of the committed capital allocation. Ultimately, successful early stage investing is a numbers game. Ideally one would invest a small amount in a number of companies and over time lean into the companies that continue to demonstrate success. Having clear metrics also makes you a good partner to companies that you interact with. Having listened to countless pitches from early stage companies, there is nothing that they want more than clear parameters for what kinds of early stage companies you're willing to invest in.

Once the team establishes the overall objectives with the family, they can develop a more specific strategy. On the research side, the team can make contact with industry experts and begin to develop an internal working knowledge of the sector. Strategically, investment teams should endeavor to secure as many co-

investment rights and other upside options, while mitigating as much downside risk as possible. This asymmetric risk to the upside is best achieved when many small investments (all with their own upside risk potential) are made across a single sector. The proactive time spent in sector research can also be spent researching the various term-sheets and capital stack structures and mechanisms that exist in that space. Venture is an industry that has adopted a fairly open-source approach to documentation, to the benefit of all.

A disciplined and proactive approach to venture capital allows teams to more efficiently process deal flow, source higher quality deals by building deeper relationships within a given sector, fulfill investment policy statement objectives and allocations, and engage family office principles and family members with opportunities that they care about. When done this way, a suitable allocation to venture capital in a broadly diversified portfolio can deliver quantitative and qualitative value to the portfolio and to the family office team.

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[i] PitchBook-NVCA Venture Monitor, 2019

[ii] Softbank, “Earnings Results for the Fiscal Year ended March 31, 2020”

[ii] Creating a Single Family Office to Manage Your Family’s Interests, 2020