AXIAL

A Portrait of Family Office M&A Activity Takes Shape

While HNW and UHNW families tend to keep their investments close to the vest, deal activity in the lower middle market reveals how appetites among family offices is quite distinct from other financial acquirers.

Few if any segments across the M&A market are as enigmatic as the family office. Their growing presence, both in the breadth of new family offices and growing volume of capital at their disposal, is particularly intriguing to sellers and investment banks seeking to forge new relationships. The caveat is that most family offices also tend to maintain a very low profile, prioritizing privacy over unconstrained deal flow. This can make it challenging to not only identify prospective family office acquirers, but also to understand the types of assets that may appeal to a category of investor that has historically been difficult to categorize.

If there's a common denominator, however, it's a growing preference among single- and multi-family offices to focus their origination efforts on the lower middle market. Across the Axial platform, the cumulative number of family offices actively pursuing deals has grown by no less than 25% each year over the past five years. And the number of deals pursued by family office acquirers annually more than doubled in two of the last three years, 2019 and 2020.

This surge of activity shouldn't come as a surprise. The growth in wealth over the past decade arguably benefits family offices more than any other category of buyer. In a low-rate environment, ultra-high-net-worth (UHNW) investors have increasingly turned to private equity in their ongoing hunt for returns. And, more specifically, many are pursuing direct investments to construct portfolios of long-term, potentially evergreen assets that have the potential to grow alongside the economy and deliver consistent dividends into perpetuity.

While it's hard to make any sweeping generalizations, compared to other financial buyers, family offices are every bit as sophisticated as investors in private equity or venture capital. And keen observers might note that many successful sponsors, such as TPG, emerged out of this segment. But the fact that most family offices are investing on behalf of multiple generations creates distinctions from other categories of investors that influence the pace of activity, their appetites for both risk and specific asset types, and even the prevailing investment strategies. Indeed capital preservation often supersedes maximizing investment performance at all costs in every type of market.

What makes the lower middle market so attractive to family offices is that it remains one of the few areas in which buyers can pursue direct-investing strategies without sacrificing the diversification or margin of safety that will protect portfolios over long-term or perpetual time horizons.

WHAT YOU'LL FIND INSIDE:

A More Direct Route into PE

Returns do indeed matter. But through a lens that extends across generations, advancing the family legacy is often paramount than trying to maximize returns over a one- or even five-year investment horizon. Moreover, this more “conservative” posture hasn’t exactly limited the extent to which high-net-worth and ultra-high-net-worth families have been able to keep pace with the broader markets or grow their wealth.

According to the latest Credit Suisse Global Wealth Report, the aggregate wealth of HNW families nearly quadrupled over the last 20 years and, as of the end of 2020, exceeded $191.5 trillion globally. In the UHNW category, defined as having $50 million or more in net assets, the number of individuals in this group surged by approximately 24% from 2020 to 2021, alone. The authors of the report projected that the population of UHNW individuals could grow by as much as much as 60% over the next five years.

Why Pay Two and 20?

UBS, in its latest Global Family Office report published last year, identified that more and more family offices, based on the firm’s latest client survey, are aggressively increasing their strategic asset allocations to both private equity and direct investments. In the U.S., the research documented that allocations to PE currently comprise approximately 21% of family office portfolios, on average, and many plan to grow these exposures even further over the next five years. But within the PE allocation, again among U.S. family offices, the split shows a heavy tilt toward direct investments (comprising 15% of family office portfolios) versus commitments to PE funds or funds of funds (which average 6%).

No two family offices are ever alike. But as the UBS report highlights, these trends reflect a pronounced shift over the past 12 months. In 2020, for instance, 37% of respondents accessed PE through fund investments alone; last year, fewer than a quarter (23%) relied on solely on fund investments for their PE exposures. Meanwhile, just under half (47%) invest through both funds and direct investments, while nearly a third (30%) focus solely on direct investments.

While family offices may prefer a lower profile, it’s becoming impossible to ignore them. Across the Axial platform, the segment accounts for a significant percentage of active acquirers with at least one buy-side mandate initiated on the platform (13.4%).

And while the engagement data around sell-side targets marketed through Axial reflects that family offices may be more particular than other categories of buyers, their share of completed transactions suggests that when family offices are interested, they’re more likely than most to see the deals through to completion (trailing only PE and independent sponsors).

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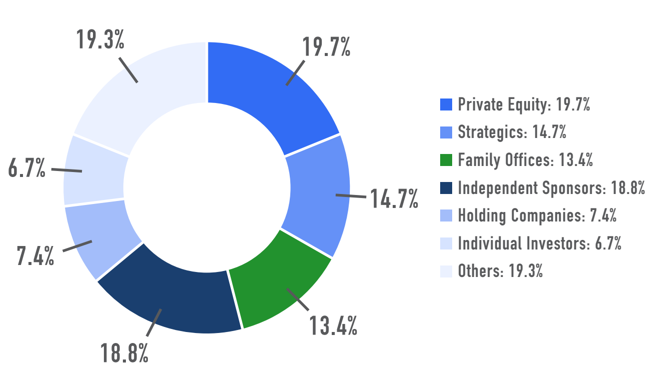
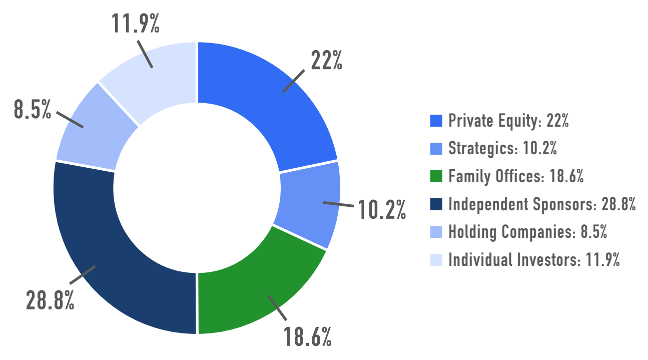
PERCENTAGE OF ACTIVE ACQUIRERS 2022



PERCENTAGE OF CLOSED DEALS 2021



Fewer Constraints and Less Pressure

Before even launching a family office, a number of variables generally factor into the decision to take investment management and other functions in house. The Family Office Exchange, for instance, cites these decisions can revolve around a desire for more control, privacy, and to create a shared purpose across family members and generations. The ability to integrate investment management with tax, estate and philanthropic planning can also improve financial outcomes, while optimizing for a more cohesive strategy across generations.

For context, the typical UHNW investor operating a single-family office will generally have at least $100 million in investable assets, according to the Family Office Exchange. And multi-family offices – in which several families may combine their buying power and share overhead costs – tend to serve HNW investors with $20 million or more.

Finding Diversity

It may not be obvious, but these characteristics do indeed influence strategies and appetites. For instance, even UHNW families with $500 million of investable AUM, if they've allocated 15% for direct investments, will have "just" $75 million of capital to work with or a buying power of approximately $225 million assuming a modest two-to-one leverage ratio. The lower middle market, thus, allows the segment to diversify across investments, vintage years, and sectors. The more traditional middle market, in contrast, may be too rich for even one deal or wouldn't offer the desired control if investors are limited to minority investments.

Managing Risk

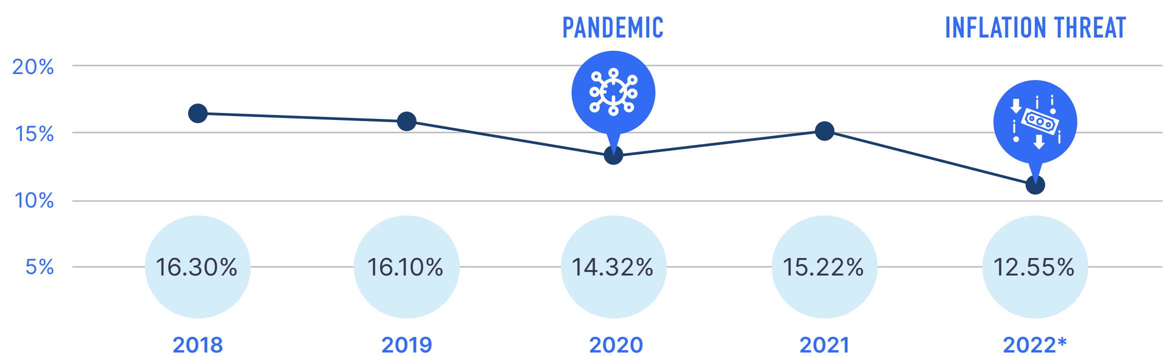
Moreover, the UBS Family Office report noted that more than any other risk, the biggest perceived threat among family office investors revolves around valuations. This again speaks to another draw that beckons family office investors to the lower middle market, where a margin of safety can still be found. Various data services show a delta of roughly five turns separating M&A multiples in the lower middle market versus the middle market.

Other variables also factor in. Many of the highest profile family offices, for instance, are also among the first movers advancing impact investment strategies. This underscores the integration that can occur between philanthropic planning and investment management. It also emphasizes the extent to which "legacy" can shape investment policies.

More Patient Capital

Still, the biggest factor influencing investment strategies, and distinguishing family offices from other buyers, is the extent to which investors aren't constrained by timelines to source, close and exit investments or under any pressure to put capital to work in less-than-inviting conditions. Again, the overriding objective for most HNW and UHNW investors is capital preservation. And the data seems to suggest the family office segment is more likely to move to the sidelines when the economic and geopolitical backdrops become less clear (as was the case in 2020 and in the first two months of this year).

PROPORTION OF NEW BUY-SIDE MANDATES BY FAMILY OFFICES



Appetite for Protection

In looking at the activity across the Axial platform, the prevailing appetites of family offices may not be as obvious as some might assume. As *Forbes* has pointed out and as most might expect, nearly half of the country's wealthiest billionaires – those who make the publication's ranking of the 400 most affluent people – earned their wealth in either the technology or finance sectors. Yet, in parsing out the areas piquing the interest of family office acquirers, the activity in these areas is far more muted compared to other categories of investors.

Branching Out

For instance, in looking at the sell-side data, fewer than one out of every ten inquiries initiated by prospective family office acquirers were made in pursuit of technology assets being marketed over the Axial platform. Similarly, and more acutely, financial services companies attracted fewer than 2% of the total "pursuits" from family offices last year. On the buy-side, the proportion of new mandates from family offices seeking tech deals stood at just 10% of all activity last year and has slumped even further in 2022. Among all other buyers, new mandates for tech deals represented 14% of all buy-side activity last year and the sector has consistently attracted among the highest pursuit rates tracking buyer engagement.

This may go against the conventional wisdom in which investors should invest in what they know. But it also underscores the overriding objective of family offices to preserve, not necessarily multiply, generational wealth.

If the source of family wealth stems from technology or finance, it shouldn't be surprising that investment strategies would be premised on diversifying these assets. Moreover, many founders will leverage their existing networks to back other entrepreneurs through angel- or seed-stage venture capital.

Seeking Stability

This ostensibly leaves direct investment exposures in later stage private equity to function as a ballast with exposures to cash-generative, less-volatile areas of the economy. While buyers certainly have the option to sell their assets at a later point in time, without a heavy operational lift to create value, many will be just as satisfied collecting recurring dividends over an interminable investment horizon.

Last year, looking at the sell-side activity, the pursuits data revealed that family offices engaged with industrial and consumer goods companies far more than any other category.

The two sectors, combined, accounted for more than three fifths of all inquiries from family offices, while business services was a distant third. On the buy-side, the same three categories stood out, although new mandates targeting industrials have leveled off in early 2022.

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TOP FIVE BUY-SIDE FOCUS AREAS (PROPORTION OF NEW MANDATES, 2022)

Industrials: 26%

Consumer Goods: 24%

Business Services: 11.5%

Healthcare: 9.8%

Tech: 9.8%

A Driving Force in the LMM's Development

Family offices have become a dominant player in M&A circles, even if the prevailing preferences for privacy make the segment more of an unseen force that quietly, but with conviction, targets many of the highest quality assets the lower middle market has to offer. If imitation is the highest form of flattery, the recent trend in which private equity managers roll out "long-dated" funds – designed to mimic the more perpetual structures favored by family offices – suggests the family office pitch does indeed resonate to business owners and delivers risk-adjusted returns that can withstand the scrutiny of the most disciplined investment committees.

The fact that family offices have chosen to make the lower middle market their "direct-investing" home also underscores the extent to which this corner of the M&A ecosystem has matured over the last ten years. It will only continue to develop as this growing pool of sophisticated investors continues to shape the deal arena.

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