15 questions you need to answer before participating in any club deal

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Families are increasingly expressing a desire to invest in private equity opportunities on an individual, deal-by-deal basis. Club deals, which are quickly becoming the preferred vehicle of investment for families, offer more flexibility than traditional blind-pool funds, which require a long-term financial commitment and limited control. Given their relative complexity and novelty, club deals require significant due diligence on the part of the investor. For that reason, we have organized fifteen Frequently Asked Questions, based on our experience analyzing hundreds of club deals.

1. What is a Club Deal?

While there are numerous permutations of investing in private equity, there are fundamentally three different approaches:

Invest in a private equity fund	**Participating passively as a limited partner in a discretionary private equity fund, with a finite lifespan (10 to 12 years)[1].** Of all of the paths, families are most likely to have had prior experience with this approach. Although there exists a wide variability in investment size, the minimum is typically $25+mm, with some funds having the capacity to pursue very large deals (multi-billion dollar equity checks). While the press gives a lot of attention to situations where funds open up specific deals to co-investments, it is relatively rare and the allocation is typically restricted to the fund's limited partners on a pro rata basis.
Participate in individual club deals	**Choosing to invest in individual opportunities on a deal-by-deal basis, in conjunction with other investors, generally for a finite period of time (5 to 8 years)**. Depending on the relative check size, the investor may have some involvement (such as sitting on the Board of Directors or Advisory Board). While club deals can vary greatly in size, most tend to require equity checks between $5 and $50mm—anything less than that would not be economical for the sponsor to pursue, while anything greater becomes much more difficult to fundraise for on an individual basis.
Replicate a full private equity firm internally	**Choosing to fully fund individual deals, allowing total control and privacy.** The investor has total discretion regarding governance, hold-period, strategy, etc. Moreover, the equity check can range dramatically—from under $5mm to hundreds of millions.

[1] Wall Street Journal, "Average Private Equity Fund Life Span Exceeds 13 Years" (May 31, 2015)

	PE Fund	Club Deal	Replicate PE firm internally
Close rate	1 of 5	1 of 10-20	1 of 50-100
Minimum check (to allocate efficiently)	$250k+	$2.5mm+	$5mm+
Time commitment (per deal)	<1 hours/ month	~10 hours/ month	40-80 hours/ month
Level of sophistication required	Low	Medium	High

As you move across this continuum from passive fund investments to actively replicating your own captive private equity firm, the level of involvement and control generally increases. Because of the increase in time commitment and expenses associated with performing the more intensive tasks, the minimum scale to efficiently invest also rises. From our experience, the total fee levels across each approach are fairly similar, as families still need to mimic fund compensation structures to attract and motivate the right talent internally.

All private equity investments have a "sponsor," who takes responsibility for quarterbacking the deal—this includes: underwriting, negotiating, structuring, and then maximizing the performance of the investment (equivalent to a developer in real estate). The sponsor typically receives an equity interest or "promote" based on the success of the project as their compensation. While a family can theoretically single-handedly find, fund, and quarterback a deal themselves by internally replicating a private equity firm (thus assuming the "sponsor" role), this is fairly atypical given the associated time and cost commitments. When this does occur, it is more often associated with real estate investments.

We will focus on club deals throughout the rest of this paper, given it is relatively easy for those looking to get started in direct investing and its overwhelming prevalence. Over time, if the frequency and check size of your investments becomes sufficiently large, you may decide to consider fully replicating a private equity firm internally, which, as previously mentioned, involves a much larger time and financial commitment.

2. What constitutes an ideal club deal?

While no opportunity is perfect, it is important to articulate what the ideal excellent opportunity could look like. An optimal deal has both excellent deal fundamentals and a stellar sponsor.

Despite the complexity associated with underwriting opportunities, the following three characteristics are highly correlated with outperformance and useful for understanding the process: 1) Enter at below market terms, 2) Seek favorable structures that minimize risk, and 3) Seek a proven management team committed to the venture.

As Benjamin Graham described almost a century ago, having a 'margin of safety' (i.e. buying cheap relative to an asset's intrinsic value) is the most reliable approach for achieving outsized investment returns. Despite a number of confounding variables (e.g., economic cycle, industry, size, etc.), you should pay particular attention to securing reasonable earnings-based valuation multiples. While some sponsors try to position their investments relative to future pro forma earnings, we prefer to use historical earnings as they provide a more conservative, realistic perspective on what future earnings are likely to be (how many times are projections missed?). Finally, while an investment could be priced at a "market rate," it's important to also assess its relative attractiveness against alternative asset classes and industries where that money could be deployed (e.g., tech companies may be overpriced relative to pharmaceuticals, etc.).

The best deals are typically obtained in an off-market fashion, which avoid a formalized sales process. Because investment bankers are paid to run an auction process to maximize the number of interested buyers and the sales price of an asset, their involvement is negatively correlated with price and investment returns. To the extent that you outbid professional institutional investors and strategic acquirers, both of whom have a low cost of capital, it's likely to be a Pyrrhic victory (i.e. the dreaded "winner's curse" of overpaying). While the ideal scenario is a simple, private negotiation between the seller and sponsor, without the involvement of a sell-side intermediary, opportunities derived from informal brokers that run a limited process can also yield compelling opportunities. In addition to better pricing, obtaining a company outside of an auction process generally results in a slower deal pace, which permits more comprehensive due diligence and often enhanced terms and structures (e.g., not having to settle for more expensive debt that can quickly close). In addition, when only one suitor is in the mix it becomes easier to plan for the future of the target post-close.

Moreover, the right deal structure can add a significant amount of value by providing downside protection derived from shifting the risk of underperformance to other parties. Typically the seller is in the best position to assume many of these risks, given their intimate knowledge of their former business or asset. Devices such as earn-outs, seller notes, and requiring the seller to reinvest a portion of their proceeds all help reduce risks, while aligning incentives.

Finally, great deals have strong management teams with a track record of execution—these managers either ran the firm previously and will remain or are being brought in for the purpose of assuming the reigns post-closing. Talent is a prerequisite for success,

particularly among smaller businesses, which are so prevalent in club deals. Although some talent gaps are not completely addressed during the initial phases of due diligence, we recommend against closing a deal where key leadership roles remain unaddressed..

While a deal's fundamentals are important, one cannot underemphasize the importance of a great sponsor in a club deal. Remember that you are fundamentally dependent on their judgment and discretion to represent your interests post-closing. While there is a high degree of subjectivity, "Grade A" sponsors tend to have specific characteristics.

From our experience, the most important factor is attitude. Great sponsors behave as stewards who treat investments as if it were their own money. When opportunities are presented, pay careful attention to how they are described. Every company has its risks and challenges, the important question, however, is how they are addressed and how the investors are compensated for taking on those risks. A sponsor who focuses exclusively on the deal's merits, while glossing over areas of concern is a salesman, not a sponsor. An objective steward candidly discloses weaknesses and risks.

Stewards should also possess a willingness to align interests—demonstrating commitment with personal capital. In particular, a sponsor should invest a significant percentage of their total net worth into a deal. While the specific amount is of less importance, and can be contextual based on various personal factors (e.g., net worth, family situation, etc.), the amount should be meaningful relative to their available liquid net worth (10-50% is a good range).

In contrast to opportunistic generalists, great sponsors have deep, subject matter expertise within their relevant industry, giving them a distinct edge. Over years of working with relevant managers and participating in industry events (e.g., conferences, etc.), these specialists should have a network of current and retired industry executives, who can potentially assist in underwriting specific deals, assuming management and Board positions, and helping to make value-add introductions to potential customers and suppliers. Given prior industry experience and relationships, sponsors should also be able to better identify and originate off-market opportunities, as well as ensure that the company is operating optimally.

Sponsors pursuing individual deals are typically either experienced C-Suite level industry executives in their late 40s or 50s or private equity professionals in their mid 30s to late 40s, who were formerly with a top private equity firm and chose to go independent. While some sponsors operate solo, most work in pairs or small teams of three or four. This is advantageous as it provides redundancy in case a single individual were to become incapacitated. The "holy grail" is a team that has a mix of both private equity and operating experience.

Prior experience at smaller, lower-middle market funds (versus mega-funds) is optimal considering their similarities to club deals in terms of company and check sizes. Not only do smaller deals have very different issues than billion dollar deals (e.g., typically less professionalized organizational structures and staff, poor systems in place, etc.), but these

smaller funds typically require more entrepreneurial and versatile roles and skillsets. For example, large funds typically have separate, specialized professionals to help with origination, executive recruiting, management consulting, etc.

Considering the average deal size of club deals is smaller than that of private equity funds, sponsors need to be flexible and nimble to minimize the relative drag of fees. Aside from assuming a variety of different roles and responsibilities (from origination, to execution, to operational consulting, etc.), they should be highly conscious of minimizing transaction costs, particularly those associated with third party professionals. Sponsors should be willing to perform some of the tasks that many funds would completely outsource, such as collecting relevant documents for the professional firms and assisting these firms with time intensive tasks (e.g., inventory counts, etc.) in order to keep costs down. Similarly, instead of preserving previous allegiances to former "white shoe" law firms, sponsors should demonstrate cost sensitivity while achieving the task at hand adequately. For example, many high-quality lawyers and accountants can be found in smaller markets (e.g., Atlanta, Dallas, Charlotte, etc.) for much lower rates. At a minimum, sponsors should be able to present a choice among competing quotes. It's not inappropriate to question the judgment of a sponsor who chooses not to be frugal with expenses (whether third party professional fees, premium hotels or rental cars, etc.).

[Sidebar]
Here are some club deal "red flags" indicating that you should proceed with caution:

- Tight timelines, particularly if they require bypassing critical due diligence activities
- Inability to verify a sponsor's background or track record
- Lack of transparency or candidness from a sponsor answering questions
- Using semantics and technicalities to sell the opportunity (e.g., hyped teaser that mischaracterizes the total purchase price, atypical add-backs, etc.)
    - Avoiding or downplaying weaknesses and risks
- Fees that differ dramatically from typical averages, with no good explanation
- Anything insinuating that little to no rigorous, objective due diligence has occurred (e.g., repackaging the Confidential Investment Memo prepared by the selling broker as their own, etc.)

3. Why do I need to independently due diligence a deal from a sponsor?

Once a club deal has been identified, the real work begins. Sponsors and their deals should be carefully vetted if for no other reason than the fact that *it's your money* being entrusted to them. Knowing that you are investing alongside other smart and successful people is <u>not</u> a substitute for vetting the sponsor, the underlying deal and its structure.

Even if an opportunity comes from a reputable individual with a pedigree, there are a variety of reasons why you would still want to independently vet the investment case (we end up recommending less than 5% of the opportunities we review, all of which are presented by impressive sponsors).

First, the deal and compensation structure can often create distorted incentives. A successful deal will provide a considerable payoff to the sponsor. There's nothing inherently wrong this. Any well-structured deal should compensate the sponsor for sourcing, negotiating and financing the investment. It should also incentivize them to maximize the financial and operational performance of the company post-closing. However, the potential financial rewards to the sponsor, in particular as it relates to the amount of capital they're investing (if any), provides them with a natural tendency to underwrite aggressively and focus on the potential upside of an opportunity (creating a "heads I win, tails you lose" payoff scenario).

Additionally, unlike a traditional private equity fund that charges ongoing fees to cover overhead and operational costs, independent sponsors are most likely to cover these expenses themselves. Particularly after a long period of searching (with some "failed deals" along the way), this financial pressure can often motivate a sponsor to pursue marginal deals. This risk is particularly pronounced in today's "frothy" marketplace, with high valuations and much competition.

Although infrequent, it is also important to mention the risk of fraud. Just because someone is (or claims to be) a graduate of a top university, or formerly employed at a marquee firm, does not eliminate the potential for fraud.

Finally, there can be legitimate differences of opinion regarding risk assessment. Some people are overly optimistic or pessimistic in their projections. Given that it is extremely hard to calibrate with a sponsor, it is incumbent upon the investor to independently develop a personal perspective regarding reasonable assumptions.

4. What should I be focusing on when due diligencing a club deal?

"All happy families are alike; each unhappy family is unhappy in its own way." – Leo Tolstoy

A deal must pass each and every element in order to be successful. The goal is not to recreate all of the sponsors work, but to "check their homework" to determine if you feel comfortable with the presented opportunity on three levels:

A. Deal: Does this deal present an attractive risk-adjusted return?
B. Sponsor: Do I feel confident that the sponsor will make good decisions after closing, when I'm not around to check on him?
C. Structure: Are interests aligned with the sponsor?

While an entire book could be dedicated to each of these areas, let's briefly discuss the intent of each element:

A. Deal

Compelling deals provide strong fundamentals with structural elements to protect downside risk. Some of the key underlying questions include:

- Is the purchase price reasonable?
  - How does the purchase price compare to other similar transactions?
  - Where are we in the industry cycle? Are we buying in at the peak?
  - How widely marketed was the transaction? Why do we believe we outbid other sophisticated bidders while still earning a sufficient risk-adjusted return?
  - Are there alternative investments that provide higher returns for the same level of risk or similar returns with less risk?
- Are projected cash flows realistic?
  - Has anything changed or might potentially change that likely will make future performance materially different than today?
  - Does this company or industry experience cyclicality?
  - How did the company fare historically, including during the Great Recession?
  - Do projections account for sufficient capital expenditures and marketing investments to sustain future growth?
  - Does the underwriting include significant upward adjustments to earnings? Can these expenses realistically be expected to go away post-transaction?
- What are the relevant industry dynamics and trends?
  - Is the company reliant upon a few customers or suppliers?
  - How is the company viewed in the marketplace?
  - Are there any potential or pending regulations that could materially impact performance?
- Can the management team successfully execute?
  - What is their track record in similar circumstances?
  - Does the company have sufficient policies, procedures, and systems to be successful and are they being properly implemented?
  - Are unions involved and what is their impact?
- How will this investment perform under various scenarios? What is the potential likelihood and magnitude for losses?
  - What would have to occur for principal to be jeopardized?
  - Who is absorbing the risk of underperformance in a downside scenario (i.e. Are structures in place that prioritize distributions relative to others)?
- What are the major assumptions that this deal is predicated upon?

B. Sponsor

While you maintain the discretion on whether or not to participate in a given investment, once the investment is made, the sponsor maintains a disproportionate amount of influence. It is therefore imperative that you trust their character and discretion. Some of the key underlying questions include:

- What is the sponsor's track record in similar investments?

  - Does the sponsor freely share information regarding all of their prior deals, including their roles, level of involvement, and performance (both ones that performed well and those that did not)?
  - Can the sponsor's performance and prior roles be validated by third parties?
  - Does the sponsor bring unique value (or risk mitigation) to this investment?
- Does the sponsor exhibit good judgment and trustworthiness?
  - Has the sponsor exhibited a thorough due diligence process? (Please see question 7)
  - Did the sponsor choose conservative assumptions in their underwriting?
  - Is the sponsor open and transparent, proactively bringing up risks and downside potential?
  - Do the sponsor's prior actions indicate they will act as a steward (i.e. treating the money exactly the same as if it were their own)?
  - Do I feel comfortable with the sponsor on a personal level?

C. Structure

Good deals provide a fair structure that maximizes the alignment of interests and ensures a symmetry of both gains *and* losses (otherwise you experience a "heads I win, tails you lose" scenario). Relative to more institutional investors (who primarily focus on IRR), many families are particularly sensitive to fee structures, as a matter of principal. Some of the key underlying questions include:

- Are interests aligned in both the upside and downside?
  - Under what circumstances can the sponsor make money while I lose money?
  - How much is the sponsor personally investing? How significant is this relative to their net worth?
  - If this deal were to perform poorly, will they allocate their full efforts to remediating or will they refocus their time on potentially more lucrative endeavors?
- Are fees reasonable?
  - Are fees consistent with market rates?
  - Is the sponsor willing to waive annual management fees in low performance scenarios (e.g., if EBITDA declines by more than 50%, fees reduced to zero)?
  - Do annual management fees represent a minimal percentage of the total proceeds the sponsor stands to earn in performance-based compensation under the base case scenario (typical goal is 25% or less)?

[Sidebar] Here are some helpful questions to ask when interviewing a prospective sponsor presenting a specific deal (The sponsor's transparency and candidness—or lack thereof—can often speak volumes):

- Is there a sell-side broker? If so, how long has the deal been on the market and what is the process? How did the deal come to you?
- What is the story behind the deal? Why is the seller selling?
- Are you under exclusivity? If so, for how long?
- Will you be investing out-of-pocket into the transaction? How much is this relative to your total and liquid net worth? If not, why?
- What are the biggest weaknesses and risks of this deal?
- Tell me about your worst investment. Why did it go poorly and what would you do differently?
- What are the last five deals you've reviewed and passed on? Why?
- How much time will you be committing to this deal? What other investments do you currently have in your portfolio and how will you allocate your time?

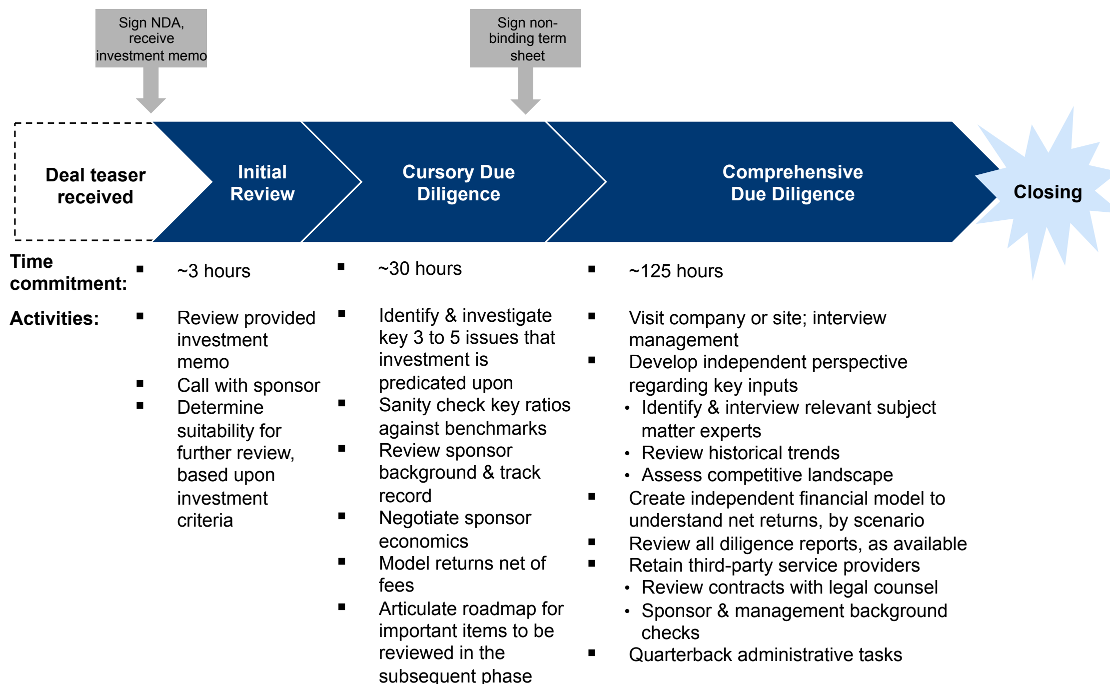
5. What process should I be following to adequately due diligence a club deal?

Our work with clients indicates that unqualified or under-qualified deal flow—based on an arbitrarily limited subset of sources—often invites a high percentage of 'false-positives'— seemingly worthwhile investments that end up being "too good to be true."

False-positives can, of course, arise for a variety of reasons— the most obvious being unforeseeable negative developments. But, typically, when a 'promising' investment fails, the deviation from expectations stems from exaggerated projections or detectable risks that went unacknowledged in the first place. The deal did not 'turn bad;' rather, it was always a dud that passed through an inadequate filter.

Due diligence is never going to provide you with a clear-cut affirmation of a deal. "Approved" deals will simply survive a series of consecutively more restrictive filters where no "deal-killer" has been uncovered. Knowing when to stop vetting an opportunity is more art than science, but theoretically occurs when the cost of performing the analysis exceeds the magnitude of the risk. Because there is typically declining marginal returns, it is most efficient and economical to begin with filters that are most restrictive and inclined to exclude potential opportunities. It is important to prioritize the biggest risks in terms of likelihood and magnitude and dedicate a disproportionate amount of time focusing on the most concerning areas, rather than blindly following a due diligence checklist.

Our due diligence is structured into three distinct phases:



Initial Review: Given the basic details of the opportunity (size, industry, geography, returns, etc.), does this investment meet our basic investment criteria (for additional details, please see question 13)? This is generally something that can be answered quickly and consistently, and should help filter out most of the deals you receive. If this is something you would consider, continue on with cursory due diligence.

Cursory Due Diligence: Taking the information provided to you on face value, does the investment generate the returns you require at a risk that's acceptable and under a structure that's appropriate? When digging into the deal further, you may see that attractive returns have been generated based on very aggressive assumptions, such as double-digit revenue growth indefinitely or being able to exit the business at a substantially higher price. Better understanding the structure can also highlight risks such as the departure of key employees who will be cashing out with this transaction or overleverage, which while magnifying returns can also undermine the company's stability. Given that most sponsors inherently have a bias towards optimism, the deal's projected returns should have significant "cushion" before proceeding to the next stage, where you will most likely revise assumptions to more conservative levels.

Comprehensive Due Diligence: If the deal continues to look attractive, a more thorough analysis of the sponsor's underwriting methods needs to take place. Ultimately, its important for you to develop an independent perspective regarding key inputs. This involves understanding the key assumptions behind the investment, where those assumptions came from, and what the investment looks like when those assumptions are stress-tested. For example, if an important driver

of returns is the ability to raise prices, the sponsor should have a well-supported reason as to why they think that's possible. If that claim is solely coming from the current owners (i.e., the sellers) or their advisors, the sponsor has not done the requisite due diligence for this investment. More importantly, both you and the sponsor should have a clear understanding as to what happens to the investment returns if prices cannot be raised. What if prices actually decline? Can you, as an investor accept what those returns would be under such a scenario?

6. How much time and money should I expect to spend to fully underwrite a transaction?

Properly vetting a prospective club deal opportunity is an expensive and time intensive process. Given that you will approve only a fraction of the deals that you review, it is important to take into consideration the time and cost (both opportunity cost and out-of-pocket expense) for both the successful and the "failed deals."

There is a cost to performing these functions, regardless of whether you are hiring internal analysts or outsourcing. Even when some of these tasks can be completed internally, it is valuable to impute an opportunity cost of your time, since you could have chosen to allocate it away from other value creating opportunities.

The best way to be efficient is to minimize the time spent on deals of poor quality or with a low likelihood of closing. While the investment memorandum can be read and a first impression formed in a matter of hours, subsequent due diligence is significantly more time intensive. Given that sponsors often initially present deals still in the early stages with a number of outstanding contingencies, (i.e. pre-IOI or pre-LOI), you will want to manage your time investment carefully. Working with the independent sponsor to understand where in the process a deal is can help. For instance, if the business owner is willing to sell but doesn't seem highly motivated, you may want to limit your time spent until things progress further.

Performing cursory due diligence takes ~30 hours per deal on average, with only 40% surviving to the comprehensive due diligence phase. Completing comprehensive due diligence and handling all of the administrative tasks required to close generally takes nearly triple this amount of time. Even if a deal does obtain approval, from our experience, there's still a ~50% chance that it will not close due to external circumstances (e.g., negative factors discovered, seller backs out, etc.).

Although the sponsor is responsible for overseeing the due diligence of the deal's risks, there are two third party service providers you should retain individually to represent your interests. First, a competent lawyer should assist you in reviewing and negotiating the subscription and charter documents . Depending on the complexity and amount you rely upon them, you should budget $2,000-10,000. Additionally, we recommend running background checks on the sponsors, which should cost $200 to $1,000 per individual. As reflected in the below chart, when incorporating for all of the time and associated expenses, the total cost per successfully closed deal averages between $100,000 and $150,000.

Deal pursuant costs assuming 1 out of 15 deals close, with time valued at $200/ hour

Activities	Number of deals considered	% of deals surviving to next stage	on activity per deal (hours)	Cost per activity and deal (Dollars)	Total cost per activity (Dollars)
First impression review	15	0%	3	$ 600	$ 9,000
Cursory due diligence	6	60%	30	$ 6,000	$ 36,000
Comprehensive due diligence	2	33%	125	$ 25,000	$ 50,000
Third-party professional Fees	1	50%	N/A	$ 5,000	$ 5,000
Total cost per closed deal					**$ 100,000**

7. What signs are indicative of good underwriting by a sponsor?

First and foremost, a good sponsor should be prepared to provide all of the requisite documentation in an organized fashion. While not all of these documents will be available initially, all of the following documents are customarily shared prior to closing:

- Internal documents independently prepared by a sponsor
  - Investment memorandum- typically ~30 pages
  - Back-up Appendices to the Investment Memo- typically 100+ pages
    - Review of industry and competitive landscape
    - Back up of key analyses
    - ‘100 Day Plan’ that they intend to implement upon closing
  - Financial model
    - Dynamic, linked financial statements (Income statement, Balance sheet, and Cash Flow Statement) with adjustable assumptions
    - Sensitivity table based upon key variables
    - Returns presented both pre and post-fees.
  - Signed Letter of Intent
  - Third party professional diligence reports completed by reputable firms (completion of this will likely wait until close to closing)
    - Quality of Earnings from an Accounting firm
    - Legal due diligence review from a law firm
    - Insurance review report
    - Human resources review report
    - Background checks
    - Environmental reports, for associated real estate
- Access to external documents
  - Original Confidential Information Memorandum, if a broker or investment banker was involved
  - Management’s internal budget and/or projections
  - Overview of due diligence request and summary of the status of all items (Access to data room of all materials provided by the seller is optional)
- Deal documents
  - Operating agreement that will govern the investment
  - Definitive purchase agreement

- Key contracts (e.g., employment agreements, related leases, etc.)

Remember that the objective of due diligence for a club deal is not to replicate the sponsor's efforts, but rather to "spot check their homework" to develop a perspective regarding their thoroughness and trustworthiness (please see elements A and B of Question 4 above). In particular, you are trying to ensure that key assumptions are conservative relative to historical numbers, external industry benchmarks, etc. Moreover, it is imperative that you independently validate some vital claims to ensure that there are no material inconsistencies. We have found the follow tactics to be useful conducting this exercise:

- Interviewing independent Subject Matter Experts, who can often be found through LinkedIn or alumni directories. If you want to quickly obtain a targeted expert, consider using GLG or a similar expert network platform.
- Assessing assumptions relative to historic trends (pay particular attention to cyclicality, especially how the company performed through the Great Recession)
- Public filings of similar companies—both financial statements and publicly-released investor presentations
- Third-party industry reports and analyst coverage

Clear, organized backup materials should be provided, evidencing all key analyses have been performed. While the specific analyses are somewhat contextual based upon the specific risks that confront a particular investment, some nearly universal activities include:

- Identification of where the company really makes money (e.g., distribution of revenues, gross margin, and profits broken down by division, product line, customer type, etc.)
- Benchmarking of key financial and operational metrics against peerset
- Trends in key operational and financial metrics over time
- Customer concentration analysis
- Customer and other stakeholder interviews to validate key claims and satisfaction
- Review of leases and related-party agreements to ensure they are market rate

Finally, we like to interview sponsors and make sure that they are fully familiar with the specifics of how they will implement strong compliance protections post-closing, with a particular emphasis on cash management. Fraud and theft at both the company and holding company levels are real, yet addressable risks. Basic protections, such as requiring double signatures for all checks over a certain amount and segregation of duties, can materially reduce the risk of improprieties.

8. What is market compensation and terms for a sponsor?

The compensation level and structure that a sponsor can command is highly dependent upon their negotiating leverage. For example, if a sponsor already has a strong track record of performance on their prior deals, they may be oversubscribed and can command

significant premiums from their limited partners. Conversely, first-time sponsors, who have recently left a private equity fund, may have less capital options, and will generally command lower fees. That said, nearly all sponsors are compensated using a similar framework, and we will briefly discuss the general market rates for each component. In general, independent sponsors receive compensation structured three ways:

First, an up-front acquisition fee is charged, which compensates the sponsor for originating and underwriting the opportunity, arranging financing, and reimbursing any costs spent prior to the investor's arrival. It is typically stated as a percentage of the total Enterprise Value of the acquired entity, with 1 to 2% being "market" (growth capital or minority investments may slightly deviate). At a bare minimum, we require all sponsors to invest 100% of this net amount (net of any associated tax liabilities that may emerge) to be reinvested as equity *pari passu* to the investors. The sponsor will ideally invest a meaningful amount into the deal out-of-pocket as well.

Next, an ongoing management/consulting fee is assessed, which compensates the sponsor for handling administrative matters (e.g., annual K-1 filings, etc.), serving on the Board, and assisting management as an advisor/consultant. This annual fee is generally quoted as a percentage of the company's EBITDA, often with a maximum cap, and is paid out through the operating company's P&L. The sponsor should not be getting wealthy from these fees, as they are designed to roughly cover their costs. Depending on the sponsor's expected level of involvement, this fee ranges from 3 to 6% of EBITDA with a cap of $250,000-500,000.

Finally, a sponsor will receive a performance fee (or promote), which is expressed as a percentage of gains after the return of principal and often a baseline hurdle rate has been received (i.e. carried interest). If the sponsor fails to achieve this baseline hurdle, they will receive nothing. The distribution waterfall has nearly limitless permutations, as the sponsor may structure increased profit sharing as various benchmarks are achieved (often based upon an IRR percentage or cash multiple).

The concept of a "catch-up" is often confused, yet it can have significant implications. A "catch-up" is a mechanism whereby 100% of the proceeds are diverted to the sponsor until they receive the agreed upon carried interest percentage over the cumulative cash flows to-date (after the investor's principal and hurdle have been repaid). Once the sponsor receives their share of distributions, all future proceeds will be split as agreed. Remember, that there is always going to be an indifference point between a low promote deal with a catch-up and a higher promote deal without a catch-up. In general, a catch-up structure better aligns incentives for more conservative investments, while a structure without a catch-up incents higher risk-taking. Market rates range from 15 to 25%, after a 5 to 10% hurdle (with a full-catch up), for operating businesses, and up to 20% increasing to 50% after various hurdles have been met (without a catch-up), for real estate ventures.

While in the aggregate this compensation may sound high, it generally is much lower than what traditional private equity funds charge and is generally the product of greater transparency. If you read all of the fine print, funds generally charge most of the

aforementioned fees, but also charge 2% annually on all committed capital (some fee offsets may occur). This generally represents the biggest drag on returns as it is paid up-front, independent of performance. Moreover, funds rarely have minimum hurdles in place or caps on management/consulting fees.

9. **What net returns can I realistically expect?**
At a bare minimum, direct deals should be able to yield net returns (after fees) in excess of public market investments, given the underlying risks and lack of liquidity. As a reference point, CalPERS and CalSTERS have generated across all of their private equity fund investments over a 40 year period, under 11.0% net of fees[2]. Given the increasingly competitive environment, most industry observers believe that money being invested in a fund today should average net returns between 9.5 and 10.5%. While there is a lot of variability across strategies, our experience indicates strong club deal investments should average yields between 15 and 20%, when accounting for all fees.

There is often a significant discrepancy between gross returns and net returns. Because fees are often negotiable, most sponsors will show their return projections on a gross basis. Depending on performance and how well the structure aligns interests, the sponsor is typically receiving between 15 & 35% of all the distributions (when accounting for all sources of compensation). As a rule of thumb, gross returns typically experience a 4 to 10% drag net of fees.

Given the smaller deal sizes of club deals relative to funds, and the expected off-market setting of these opportunities, *base case* (i.e. using conservative assumptions, such as average market performance, etc.) gross returns should be underwritten at 20-25% or above for lower risk buyout investments and 25-35% for higher-risk growth investments.

10. What governance rights should I be requesting?
Most club deals are structured as an LLC and are governed by a single document, called the Operating Agreement (for corporations, this is called Corporate Bylaws). While you will be likely presented with a summary of the sponsor's terms and economics, this document governs decisions under a variety of different circumstances. Moreover, this document is intended to protect the interests of the equity holders, which is particularly important for more passive investors. One of the primary protections is information rights, which allows investors to receive periodic updates regarding the company's financial and operational performance. It is customary for investors to receive annual audited financial statements and quarterly unaudited statements. In addition to this, we generally request that any materials that are prepared for the Board should also be made available to the remaining investors (e.g., presentations, projections, etc.).

The best way to monitor your investment and to help add value is to participate on the Board of Directors. For most club deals, the single largest investor (and sometimes second largest as well) is generally invited to assume a Board seat. For the other smaller, yet meaningful investors (owning ~10+% of the entity), they may be granted a Board

[2] CalPERS and CalSTERS filings (2016)

Observer seat (functionally a non-voting Director role with complete visibility on the Board process).

As with many things, the "devil is in the details." From our experience, the following elements are heavily negotiated and have the greatest potential to materially impact your interest (note that some deals will involve multiple layers of entities, and therefore it is important to review all pertinent documents):

- Percentage ownership of each member
- Prioritization of distributions (i.e. carried interest waterfall)
- Delineation of decisions made by the Board versus the broader shareholders (day to day management vs. "big ticket" decisions).
- Delineation of decisions made by majority versus supermajority (e.g., 66% or 75% vote necessary)
- Process for calling additional capital if the venture requires additional money
- Ability to experience dilution upon certain events
- Rights and/or restrictions on exiting (particularly if the investment is a minority investment)
- Ability to amend the agreement

11. Who should cover the up-front due diligence costs?
The sponsor will almost always hire outside professionals to due diligence the underlying investment. The costs can be significant, as the following service providers are generally retained:

- Attorneys to perform legal diligence and draft the various agreements
- Accountants to perform a Quality of Earnings assessment
- Human resource consultants to ensure there are no employment liabilities
- Private investigation firms to conduct relevant background checks
- Environmental consultants to opine regarding contamination
- Insurance consultants to review in-place insurance coverage
- Other technical subject matter experts, as needed

Who will incur these up-front due diligence costs will almost always be a discussion between a sponsor and potential investors. In the majority of cases, if the deal successfully closes, this issue becomes irrelevant, as these expenses simply get rolled into the total purchase price. However, for deals that don't close for whatever reason (e.g., you find a major negative development, seller backs out, etc.), someone must be accountable for covering these costs. This is not a theoretical risk, as a significant number of deals fail after some out-of-pocket money has been spent on third-party professionals. From our experience, paying these expenses after a significant amount of time and energy has already been wasted adds insult to injury.

Absorbing this risk is a non-issue for funds, since they receive up-front fees that can cover these expenses and are able to average out their successful and failed deals. However, independent sponsors are generally not in the best position to absorb this risk. Paying for failed deal expenses often represents a significant portion of their net worth. Many cannot afford to lose a deal, as it has the potential to jeopardize their ability to fund

their search for subsequent opportunities. From our experience, we have seen it both ways: the sponsor self-funding these expenses, or the limited partners paying for this up-front cost. To the extent that you do agree to cover some of these expenses, you should request a corresponding reduction in fees and/or promote. To ensure alignment of interests, we recommend that you cover a certain percentage of expenses pro rata alongside the sponsor. Under no circumstance, should the sponsor be compensated for their time and effort—this should be "sweat equity" that is covered by their up-front acquisition fee upon closing.

Regardless of who covers the cost, it is important that the sponsor take the initiative to sequence the various service providers (versus having all professionals working in parallel) based upon the relative risks in order to minimize out-of-pocket expenses. There is unfortunately no hard and fast rule regarding the ordering of service providers, as the likelihood and magnitude of certain risks is highly dependent upon the industry and context. Even for a specific service provider, it is usually a good idea to sequence the diligence in phases. If at any point, a "red flag" is discovered, you can "pull the plug," incurring just a fraction of the total potential due diligence expense.

It is important to remember that deals experience economies of scale. In other words, the out of pocket expenses for a $10mm deal are not double that of a $5mm investment. While larger companies often require greater complexity than small firms, they tend to have better accounting and legal procedures in place, making sound due diligence easier. On a net-net basis, as deals double in size, the cost of third-party diligence should increase by 10 to 25% on average.

12. How can/should I monitor my investment post-closing?
One of the biggest fears shared by all investors is the possibility that their investment fails to perform after closing. Adequate monitoring can help mitigate this risk, by quickly addressing any negative developments before they can get out of hand. While the sponsor is being delegated primary responsibility for performing these monitoring functions, if your stake is sufficiently large, we believe its accretive to invest the time and energy to assume a Board of Director or Board Observer role. Knowing that someone is watching can have a meaningful effect on deterring negligence or malfeasance on behalf of both management and the sponsor. There are three primary scenarios to watch for: deterioration in operating performance, insufficient attention allocated by the sponsor (perhaps because they are focusing their attention on other deals or efforts), and outright fraud. In addition to having a much closer vantage point, participating as a Board member also places you in a position to add value, by leveraging your relationships and expertise.

The Board of Directors fundamentally has three primary roles: A) Represent and protect the owners' interests in the company, by holding management accountable, B) Approve and monitor long-term strategic plans, and C) Select and cultivate the management team and create corresponding contingency and succession plans. In conjunction with management, you should immediately establish detailed goals and milestones, for which management should be held accountable. Topics that a Board should review during these meetings include: monthly financials and operational metrics, budget and historical

variance analysis, and any other material updates deemed relevant by the company's corporate officers.

From our experience, meaningfully participating on the Board of a stable, healthy business requires dedicating approximately 10 hours a month towards meeting preparation and attendance, informal consultation with other members and management, and regular review of relevant materials to keep up with industry and corporate developments (not including travel time). If the company is encountering issues (e.g., senior manager needs to be replaced, financial distress, etc.) this figure can easily multiply many-fold. Most club deals have four to six scheduled Board meetings per year, with nearly all permitting virtual participation (via telephone or videoconference). While this can significantly reduce the required time commitment, we recommend annually participating in person to get an unbiased perspective. The sponsor should be visiting the company's facilities in-person on a quarterly basis at a minimum. To the extent you are a completely passive investor, we recommend that you request and carefully review the periodic financial, operational and strategic reports provided by management and the Board. To the extent that something appears worrisome, bring up the issue to the sponsor.

13. How can I gain access to good private equity sponsored deals?
At any given time there are thousands of companies for sale and thousands of sponsors pursuing acquisitions. An investor must carefully allocate their two most precious resources, time and money, to find attractive opportunities.

The first step in sourcing club deals is to make sure you are getting the "right" ones. This involves establishing the investment criteria needed for you to even consider an opportunity. By defining your risk tolerance, target returns, liquidity needs, preferred industries, and geographic focus, you should be able to filter out a vast majority of the investments that may come your way. For instance, if current income/dividends are important for you in an investment, an early-stage company that isn't yet profitable should be automatically rejected.

These investment parameters then need to be communicated to the right independent sponsors—those who are out there looking for opportunities that you may want to invest. This requires a proactive effort on the part of the investor and one should not expect the independent sponsor to find them. This is a time intensive undertaking because although some information may be available on their website, you won't be able to fully understand their strategy without speaking with them and seeing some of their actual opportunities.

A great independent sponsor is likely to have multiple sources of capital. Your goal should be to proactively maintain regular contact with your preferred sponsors in order to remain "top of mind" and to get them to prioritize you as an investor. This can be accomplished by positioning yourself as a value-add partner, who can address some of their major "pain points," such as the ability to quickly make decisions, willingness to creatively assist early in the deal process (e.g., offering to provide proof of funds during the bidding process), and willingness to continue funding their future deals and/or funds.

In particular, most sponsors view individual club deals as a temporary approach until they have a sufficient independent track record to raise their own discretionary fund. Expressing a willingness to support their future fundraising efforts should the investment perform well is highly valued by most sponsors. Note that this also means that you must constantly be cultivating relationships with new emerging sponsors, since there will be a selection bias as your best sponsors graduate from being an independent sponsor to running their own fund.

14. What size checks and deal sizes should I be focusing on?

Your club deal investments should be sufficiently large to efficiently absorb the requisite costs necessary to perform proper due diligence. In the absence of doing the necessary homework, deals should simply be viewed as "passion investments," whose primary purpose is independent of financial returns. The vexing reality is that the check size should be large enough to cover not only the fees involved in successful opportunities, but also the fees incurred in deals 'killed' along the way. There is no escaping budgeting for bad deals; all you can strive for is reducing their frequency (please see question 5 for additional context).

As a general rule of thumb, deals should only be pursued if the anticipated up-front expenses can be performed for less than 5%of the total invested amount. Anything greater will threaten to substantially erode your returns, requiring you to seriously consider investing in pooled alternatives, such as funds. Consequently, from our practical experience, the check size should be a minimum of $2.5 million in order to be efficient.[3] The opportunity exists to further reduce this minimum, if you can coordinate with other prospective investors to share in the associated deal costs. Alternatively, some investors may allow you to piggyback off of their origination and due diligence efforts in exchange for sharing a small percentage of the profits, which functionally achieves the same objective of permitting smaller check sizes.

Finally, regarding the optimal size of the underlying deal, there is no clear-cut answer. In general, the market for smaller companies is much less efficient, resulting in lower purchase price multiples. While these smaller companies may be associated with greater underlying risks, from our experience their lower net purchase prices do present a superior risk-adjusted return. That said, one of the challenges of very small deals is the lack of scale, which can absorb up-front diligence expenses and the cost of hiring professional managers. We personally believe that companies with $3 to 10 million of annual EBITDA present the optimal tradeoff between scale, valuation, and risk.

15. Who can help me with all of these efforts?

Investing in private equity and club deals requires a very different skillset than the portfolio management and public market roles traditionally found within family offices. Even if you have the capacity to perform the requisite functions yourself, you may decide that it is worth the investment to have the duplicativeness and continuity associated with

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[3] Assuming total costs of ~$125,000 per closed deal (please see question number 6), a deal would need to be $2.5 million for up-front transaction expenses to be below this 5% level.

having additional resources, in order to protect your heir's interests in the unlikely event of death or incapacitation.

In general, families choose to either hire a full-time internal resource focused on private equity investments or to retain a third party professional analyst to analyze opportunities on a one-off basis. With both approaches, it is vital to ensure that these resources are compensated in an aligned fashion and fully understand your desires and goals. Success-based compensation, contingent upon making investments (particularly when paid up-front) is likely to result in a lot of approvals— "You get what you incent."

Another tactic that could that could be used to obtain outside expertise, without incurring the up-front expense, is to participate in an investment syndicate. Our firm's Curated Club Deal program periodically presents high quality opportunities, along with an objective due diligence report containing all of the materials and analyses discussed in this paper—in order to ensure alignment of interests, we personally invest out-of-pocket in any opportunity we recommend and tie our compensation to achieving baseline market returns (i.e. outperforming average fund net returns).

About the Author[4]:
David McCombie is Founder and Chief Executive Officer of McCombie Group, LLC— a collection of influential families actively seeking to directly invest in private equity opportunities. A thought leader on private equity, he has been a featured speaker at various international investment conferences and has been profiled in the Wall Street Journal and Bloomberg. David also serves as an Adjunct Professor at the University of Miami School of Business.

David is a former McKinsey & Company management consultant—A specialist in corporate strategy, he managed multiple client teams across a variety of industries to quickly develop strategic recommendations within complex, uncertain environments. In 2009, he was selected as a McKinsey Global Institute Fellow to further develop the firm's regulatory capabilities (approximately 10 of 10,000 McKinsey consultants selected/ year). Prior to joining McKinsey, he briefly worked as an associate within the financial institution group at Citigroup Global Banking in New York.

David graduated from Harvard Law School where he focused on corporate law & negotiation strategy, and also did extensive coursework in corporate finance at the Harvard Business School. His thesis, "Hispanic Private Equity: A Cultural Approach to Achieving Superior Investment Returns" was published in the Harvard Latino Law Review. He graduated Phi Beta Kappa from the University of Miami with a degree in Economics/Finance, where he was a Cuban American National Foundation Mas Scholar. He is also a licensed Florida attorney.

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About McCombie Group, LLC:
McCombie Group offers a modular private equity platform that can better accommodate a family's unique needs and preferences. We are principal investors committing our own money alongside the capital of our families, who we have dutifully served for years. Additionally, our clients can access our team and its resources on a fee-for-service basis. Our families ultimately benefit from a comprehensive, dedicated team whose interests are fully-aligned with theirs without the burden of hiring full-time resources. More information can be found at: mccombiegroup.com.

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[4] Special thanks to Jay S. Lipsey, Michael Hoyos, Daniel Barcia, and Jackie Hodes for their assistance in creating this paper.