The growing interest of family offices for investing in venture capital

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A generational shift

As the UAE enters its 50th year and looks back on the remarkable economic developments it has championed, families that played a critical role in nation's economic growth are now living a generational shift. As the first generation retires and passes on the torch to the second, assets are structured, liquidity is invested and governance starts to take on increasing importance.

This has been observed at a regional level and is not limited to the UAE. Many of the region's wealthy families use the family office model to invest on their behalf. Those family offices have the mission to preserve and grow fortunes to protect and guarantee the future of several generations of the family. Often started following success by the first generation in a family business, they tend to invest conservatively at first. However, as diversification into various asset classes increase, family offices will look to increase their risk profile to increase their returns.

Often, the second (or third) generation also wants to diversify from the core family business. A popular avenue to do so has been to invest in founders and innovators in domains linked with the family business. In recent times, one of the most popular asset classes attracting capital through this mindset, is venture capital

Venture capital offers the possibility to allocate capital to a high-risk high-reward asset class and branch out of more traditional family office investments such as real estate and public equity. Venture Capital has a proven track record of success, with the top quartile of funds averaging over 15% annual returns in the past 10 years.

There is no doubt that the Souq.com and Careem deals of recent years acted as a catalyst for rapid expansion of VC fund managers and, with the recent unicorn deals such as Kitopi and SWVL, this is likely to accelerate the sector's evolution at pace. And family offices are coming to the asset class with a vengeance, having realised that venture capital can not only offer good returns, but it can also offer fantastic publicity by linking the family name with cutting-edge innovation. A recent 2020 survey amongst MENA venture capital firms revealed that a third of fund investors are family offices.

Family offices are ideal investors for venture capital funds

Venture capital funds are composed of general partners and limited partners. General partners are tasked with investing the money of the fund into start-ups, and possess a keen understanding of the value-creation dynamics and governance requirements associated with ensuring a rich return on investment. Limited partners are the investors capitalizing the venture capital funds. The capital will in turn be deployed by the general partners with a commitment to hold those investments for a specified period following which they will exit. This is very similar to private equity save that in the case of PE, hold period tend to be around 3-5 years.

Family offices are sought after by venture capital funds as limited partners. Their constraints and objectives align perfectly with what is required for investing in a venture capital fund. Typically, investments into funds will be illiquid for a period of 8 to 10 years. The long term nature of this type of investment is an excellent fit for family offices as their objectives of safeguarding and growing the family's wealth for future generations does not require immediate liquidity. Therefore, family offices are able to enter into those illiquid position for the benefit of greater returns.

Moreover, family offices are often part of networks, and venture capital funds have sought to benefit from those networks to raise from multiple family offices. Oftentimes, initial success of producing returns for one family office will bring many more limited partners in the venture capital fund.

The advantages of investing in venture capital funds

Investing in innovation through venture capital funds has many advantages for family offices. Venture capital investing is a time-consuming endeavour, as the fund's general partners have to build a funnel of opportunities, screen them, meet with the founders, decide to invest, execute the deal, and support the company after the deal is closed.

By investing in funds rather than individual company, family offices can allocate resources to various industries without having to build full teams to support the investments. Given the complex and specialized nature of the startups, investors tend to only invest in their industry of expertise, and being able to allocate resources to several venture capital investors will open a breadth of opportunities.

An investment de-risked by the legal protections

Legal considerations are also a major barrier to entry. Venture capital deals involve protections that are not standard in other types of investments. Legal counsel is extremely important to help family offices understand that despite the high-risk nature of startups, legal protections are put in place to limit the risk exposure of the investor. Those legal protections are often a selling point to convince hesitant family officers to start diversifying into venture capital.

Legal protections come at two levels: at the fund and at the startup level. At the fund level, the family office, as a limited partner, will only be exposed to the extent of the amount invested, which limits the downside, and is strongly rewarded in case of success of the investee companies. This relationship is guided by a limited partners' agreement, which sets the relationships in the fund. At the startup level, the fund will get legal protection that ensure that founders and employees are incentivized to devote their time and grow the investee company. The fund will be a party to a shareholders' agreement which will include those protections. They can range from economic provisions such as a liquidation preference to protect the investment in case the company runs into trouble, to control provisions such as having a seat in the board of directors, to internal governance mechanics such as a vesting period for the shares of the founders to incentive them to stay with the company, or the guidelines for the employee stock option plan, which will help to attract and retain talents.

Venture capital funds are also able to invest in a diverse range of geographies. Family offices would not have the resources nor the expertise to deploy money in many geographies without external advice, and doing so would take a majority of their time. Venture capital funds can hire legal experts in different geographies and dedicate the time to understand in depth the legal implications of investing in fast-growing companies spanning multiple territories. Therefore, family offices rely on being limited partners to venture capital funds to be able to fund innovation in various parts of the world.

Conclusion: A growing trend

Recent successes of technology startups in the region have warmed up family offices to the idea of diversifying into an asset class that was previously seen as too much of a risk. The uptick in interest has led family offices to allocate more resources to venture capital.

The second generation gaining control of family businesses wants to expand outside of the core family business and do corporate development. They are willing to take risks and are pushing to see their family name be associated with cutting-edge innovation.

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