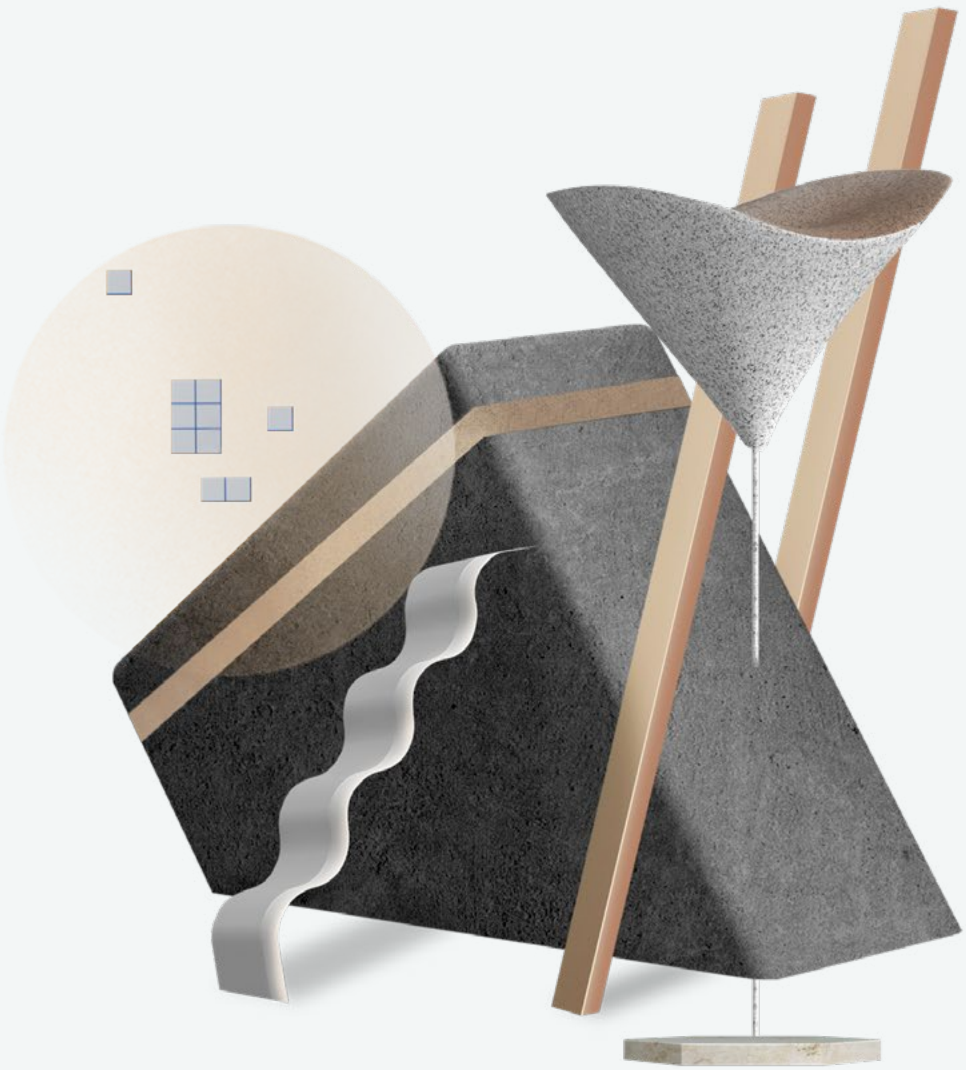
Private Bank

Private investing:

Key questions and due diligence best practices for early-stage family offices



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Foreword

Private investing[1] – whether via private equity or real estate funds, direct holdings of real estate, or equity or debt positions in private companies – continues to be a key priority for family offices.

In our flagship survey of family office clients in 2022, 29% of respondents reported 10–20% of their portfolio was allocated to direct investments, with 35% allocating more than 30%.[2]

We expect family office appetite for private asset classes to remain strong. Over time, a growing proportion of companies have shifted from stock market–listed to privately owned. In other words, private investments now represent a larger – but less readily accessible – part of the opportunity set than ever before.

While our clients' interest in this area is high, many of you also tell us that you have concerns when it comes to performing due diligence on potential private investments. Early-stage family offices, in particular, believe they may not have necessary resources and expertise to perform this vital process effectively.

Indeed, we hear growing concerns that some investments have been or continue to be made without a complete assessment of risk and returns. This applies to positions in their own right and their significance within a portfolio context.

Citi Private Bank's Global Family Office Group has the privilege of serving some of the world's wealthiest individuals and families. In this white paper, we set out a framework for those seeking to understand and apply best practices for private investing due diligence. To do so, we draw on our long experience working with leading family office clients worldwide.

If you would like to discuss how your family office might apply some of the learnings and best practices discussed in this paper or have other queries, we would be delighted to hear from you.

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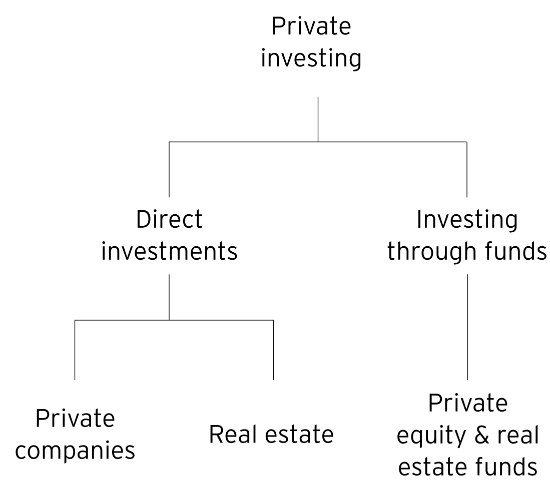
[1] This is a complex product and investors should exercise caution in relation to the product. Please find additional disclosure with respect to this product here: https://www.privatebank.citibank.com/pdf/marketing/Complex-Product-Disclosure.pdf

[2] Citi Private Bank's Family Office Survey Report 2022. The referenced information is a summary of the Family Office Survey responses collected from Citi Private Bank Family Office clients over nearly a thirty-day period starting June 7th through the first week of July 2022. The information provided does not constitute a solicitation for the purchase or sale of any security.

The private investing landscape

While many of these terms are used interchangeably, for our purposes here we consider private investing categories and the scope of the due diligence best practices as shown in **figure 1.**

FIGURE 1: TYPES OF PRIVATE INVESTING



Key questions for private investors

As many family offices contemplate making further allocations to private investments, we outline some of the key considerations that early-stage family offices face:

1. Are private investments right for us?
Private investing is generally considered higher risk with higher return potential. Whether such investments may be suitable for a family office will depend on the goals, risk tolerance and other considerations set out in the family's investment policy statement. It is essential to determine an appropriate cap on the amount that can be allocated to private investments.

2. How much illiquidity can we tolerate?
Private investments are typically highly illiquid. It is common for exit events to take 8–10 years, with investors also required to make capital commitments over an extended period. That said, there may also be potential for a family office to receive cash flows in the form of real estate income, dividends or interest payments, at least in the case of mature companies.

3. Do we want a controlling position?
Direct private investments can enable a family office to shape the future of the target company. This demands both desire and expertise. Some of our clients wish to apply their experience to a new or growing venture. Others seek steady cash flow and capital growth ahead of a potential IPO. Whether or not active involvement is wanted will determine whether control is sought.

4. Do we have the resources to do direct investments?
Direct investing requires additional resources and expertise compared to privately managed strategies. Doing due diligence on potential investments is an intricate activity, demanding a family office either have in-house professionals or subcontract the work to a specialist external firm. A family office that is unwilling or unable to do this will prefer managed strategies for its private investment exposure.

5. Which sectors do we want to invest in?
A direct investor can be highly selective about the target companies. Some of our clients scout for well-run, EBITDA-positive[3], middle-market companies in economically resilient sectors. Others aspire to invest in the next technology "unicorn." The former requires patience, with perhaps one deal every two or three years. The latter may be more efficiently accomplished via a well-established private equity strategy or participating as a minority investor in a pre-IPO raise.

6. How can we monitor diversification in our private holdings?
Especially for family offices starting out in private investing, overlooking the degree of diversification of their holdings is a common pitfall. In other words, it may be easier to assemble a collection of attractive companies than to understand their individual and collective risk exposures. This task is more challenging with private investments than with public market assets.

The same goes for the reporting and management of associated capital calls, required liquidity and periodic assessment of mark-to-market value. Our clients have often expressed frustration at using rudimentary tools and manual processes to track and manage a private portfolio that has grown over time.

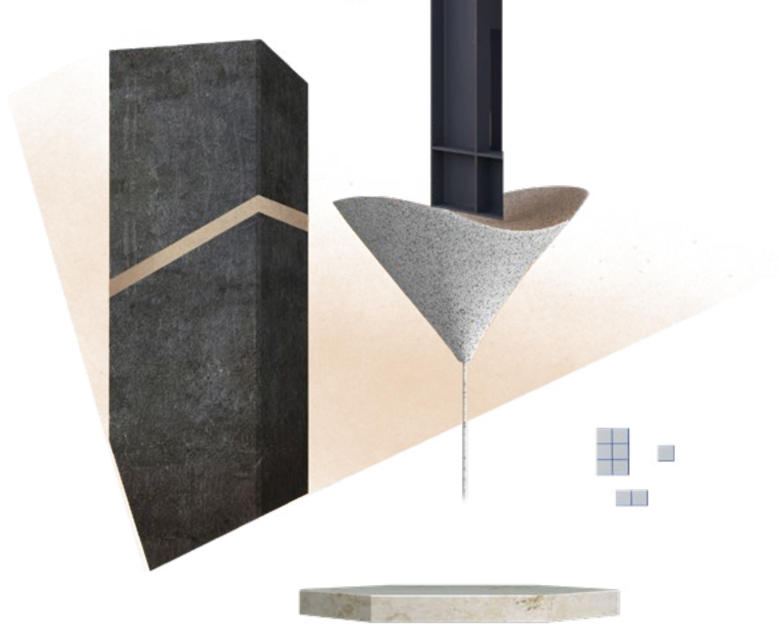
[3] EBITDA: Earnings before interest, taxes, depreciation and amortization.

Private investing – Funds or direct?

While the chart below may seem an over-simplification of the complex considerations behind any private investing decision, we believe it can serve as a guide and framework for decision making. We have further sub-divided direct investments into majority and minority stake holdings to further refine the discussion.

FAMILY OFFICE CONSIDERATION	PRIVATE EQUITY AND REAL ESTATE FUNDS	DIRECT EQUITY INVESTMENTS MAJORITY STAKE	DIRECT EQUITY INVESTMENTS MINORITY STAKE	DIRECT REAL ESTATE INVESTMENTS
MANAGEMENT OF DUE DILIGENCE	Limited to firm and fund	High	High	High
CORPORATE MANAGEMENT AND EXECUTIVE DECISION MAKING EXPERTISE	Not required	Required	Not required	Required
LIQUIDITY	Generally illiquid within the commitment period	Illiquid	Illiquid	More liquid than others depending on the asset
INTERIM CASH INFLOWS	None	Possible dividends from EBITDA-positive companies	Generally not a consideration, but dividends are possible	High potential for continual cash flow
INDUSTRY AND SECTOR CHOICE	May provide wide-ranging, global opportunities, including in growth sectors like tech, space, AI, biotech, etc.	Often considered for middle market opportunities	Varies	Wide variety of sub-sectors are available
TICKET SIZE / CAPITAL OUTLAY PER OPPORTUNITY	Generally $0.5–25m or more	Generally $5–25m	Generally $1–10m	Generally $5m+

Source: Global Family Office Group, Citi Private Bank, as of Jun 2023.
Currencies are shown in US dollars.



Section 1: Direct investments in private companies

When evaluating and then overseeing investments, most family offices operate like other institutions, having processes, procedures and controls. For direct investments, additional resources and expertise are vital. Many family offices are thus investing in their capacity here, hiring professionals with private equity expertise. They are also seeking to develop their in-house investment infrastructure and expand operational teams.

Rigorous due diligence of potential direct investments in target companies is as critical as it is complicated. Below are eight key considerations for every family office when approaching this process.

Before even beginning due diligence, family offices should run various checks. This should begin with the investment term sheet. The term sheet is a non-binding agreement outlining key terms and conditions for the investment. It provides a high-level understanding of the deal dynamics including company valuation, liquidation preference, voting rights and so on. The term sheet thus provides a framework for negotiations without excessive time and expense and can help indicate investors' commitment.

Some of the most common investor mistakes at this stage are shown in opposite.

Only once the term sheet is fully dissected should the formal due diligence process begin.

COMMON INVESTOR MISTAKES AT THE TERM SHEET STAGE

Partial understanding. Some investors don't take in the entire term sheet, skimming parts of it or failing to consider others.

Exclusive focus on valuation. While valuation is important, so too are governance, management structure and exit strategies. But these can get overlooked.

Ignoring downside risk management. Liquidation preferences or anti-dilution provisions can help manage risk for investors in the event of a downturn or business failure.

Lack of focus on management. The management team is critical to private equity success. Sometimes, too few questions get asked about their competency to execute the business plan.

Exit strategy mismatch. Ensuring that the proposed exit strategy aligns to the investors' desired timeline is vital.

Failure to negotiate. Term sheets are typically non-binding, so investors should seek to negotiate more favorable terms where possible.

Before family offices can invest in any company or asset, they need to estimate its potential worth. This valuation might involve comparing the investment to other comparable public or private companies and/or performing a discounted cash flow analysis. Valuation is determined by the lead sponsor and is generally included in the term sheet.

Thereafter, the following elements need assessment:

- **Transaction timeline**

  Early on, the prospective investor will receive a teaser, a typically succinct document presenting some of the highlights of the potential opportunity but without naming it.

  If the investor is interested, they will then sign a non-disclosure agreement and have initial calls with the management team.

  Given the speed at which the process occurs, the investor needs to be well prepared for each step.

- **Lead sponsor details**

  Lead sponsors "anchor" the fundraising round, including by establishing the term sheet.

  Family offices may look to invest behind sponsors with a robust track record and relevant industry and sector expertise to enhance their own due diligence process.

- **Competitive landscape analysis**

  By assessing the market in which the target company operates, investors will gain a picture of some of the risks and opportunities involved. The value of the total addressable market is an important data point for quantifying the revenue potential for the company's product or service. The protection of the company's intellectual property (IP) from rivals is also important.

- **Background of offer and details of existing investors**

  Key questions on why, where and how the private investing deal has reached the eyes and ears of the family office and how trusted it is. The questions should lead to the understanding of the total raise, the allocation available and if there are any minimums/maximums when determining their commitment. Additional considerations include what existing shareholders are participating in the round, whether there is right of first refusal (ROFR) and whether there will be any secondary opportunities.

  The identities of the existing shareholders is vital, as they can add strategic value to the company through their industry expertise and network.

- **Capitalization table**

  The capitalization or "cap" table displays the equity ownership of a company. The size of shareholdings and the type of shares involved will determine an individual investor's ability to influence or guide the company.

  Key elements include:

  - **Preferred versus common equity:** Preferred stock confers no voting rights upon shareholders unlike common stock. But preferred shareholders receive dividends before common shareholders do.

  - **Convertible preferred equity:** These are preferred shares that include an option for the investor to convert their holding into a fixed number of common shares after a predetermined date.

  - **Ratchets:** Ratchets primarily operate as anti-dilution provisions for founders and early investors in the event of subsequent fundraising at lower entry prices.

- **Key assumptions for the return profile**

  Family offices may conduct a scenario analysis to evaluate potential upside and downside scenarios. Where possible, it is worth engaging with the lead sponsor to help determine key assumptions for each scenario.

- **Comparative analysis**

  The operating and financial performance of relevant competitors can also shed light on the target company's prospects. An examination begins with identifying similar growth-stage companies from the same industry. The next step is comparative analysis of their business and financial metrics.

- **Exit strategy**

  What might the financial end game be for a private investment? Strategic options include an initial public offering (IPO), sale to a competitor or a management, or private equity buyout. Prevailing market conditions in the desired period for a sale can clearly have a huge bearing on the execution.

These considerations are far from exhaustive. However, it is vital to address these and other issues before making any commitment to a direct private investment. This typically involves engaging with specialists to validate assumptions and to assess an opportunity's fit with a family office's investment objectives.

Section 2: Direct investments in real estate

Many family offices have a long history of directly owning commercial real estate, such as office buildings, retail centers, warehousing, mixed-use and multi-family properties. Direct real estate ownership is typically active, requiring expertise and presence in the markets where the investments are located.

Given the wide variety of property types, geographies and ownership structures, a tailored approach to each opportunity is critical. Nevertheless, there are common steps that should be taken in almost every case.

MARKET ANALYSIS

The market analysis provides vital insights into trends and forms the basis for an objective and quantifiable financial forecast based on market data. Sometimes called commercial real estate ("CRE") analysis, it addresses a wide variety of economic, social and demographic factors affecting a subsector.

For example, an assessment of a multi-family or rental apartment complex would likely include indicators such as local employment rates, housing vacancies, market rents and the median cost of housing, etc.

While each market is unique, net migration/population growth, area median income, projected job growth, ease to do business, diversity in demographics as well as economic activity, weather, access to major airports, universities and supply/demand are important considerations in most cases.

FINANCIAL ANALYSIS

Having identified a target market and property type, the next step is typically a broad search to choose several potential investments that meet their general criteria. Financial analysis of the most viable candidates comes next within the diligence process.

A property's cash flow projection over a defined holding period is central to almost every commercial real estate transaction. Commonly known as a commercial real estate pro forma, it typically contains sections on income, expenses and debt service. Each is estimated from a combination of historical operating data, growth assumptions and current market information that was part of the market analysis.

Net operating income (NOI) is the amount of gross rent revenue less all expenses, such as maintenance expenses, property taxes and insurance. NOI is one of the most widely discussed metrics in real estate investing. It serves as an input in a property's estimated valuation and a key driver of the cap rate calculation, or NOI divided by asset value.

Additionally, buyers generally calculate internal rate of return (IRR) as well as cash-on-cash return to evaluate potential over the entire holding period and for each investment year respectively.

Key considerations when creating the financial analysis or pro forma include income/expense growth, occupancy levels, lease renewal rates, capital expenditures and any other property tax/levies, etc.

PROPERTY DUE DILIGENCE

Assuming the identified property passes the financial analysis stage, a purchase agreement and then a good faith deposit to a title and escrow company may ensue.

The process at this stage generally starts with a review of the seller's documents including any current tenant information, lease contracts, surveys or inspection, title insurance, notice of pending litigation or local government action, special assessments, environmental conditions, zoning information, construction plans/warranties and insurance coverage, etc.

This is followed by an independent review and inspection with the help of an experienced real estate agent and attorney. The type and extent of title insurance, standard or extended coverage and any endorsements need scrutiny.

Surveys provide a clear understanding of any encroachments or easements that may burden the real estate. The type of survey needed is generally driven by the type of property and nature of the transaction.

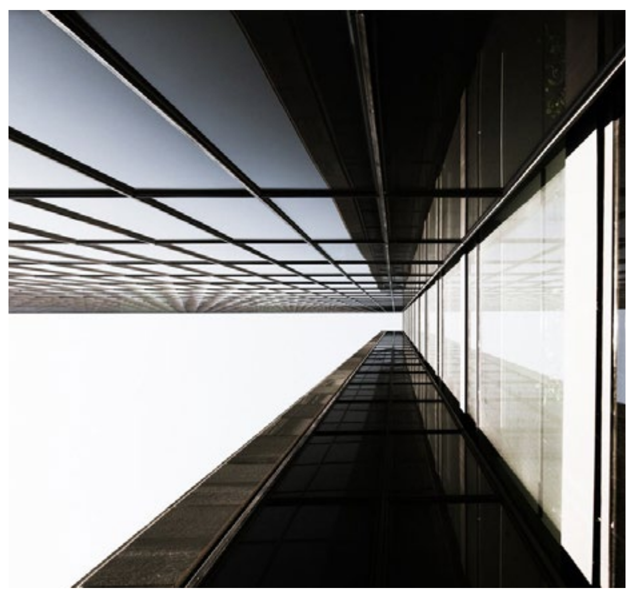
Building inspections by certified third-party inspectors provide insight into any statutory violations of local municipal or county codes.

Zoning designation and confirmation are critical to ensure allowed uses. A review of pending zoning changes may also be helpful to avoid any surprises post-purchase.

Environmental reviews and their scope will be driven by past, present and potential uses of the real estate.

Independent appraisals are required when lender financing is part of the transaction. An experienced private bank can help guide buyers and sellers through all stages of the transaction to close.

Finally, other considerations include decisions on staffing or outsourcing ongoing tenant management and maintenance of the property.



Section 3: Private equity and real estate funds

While many family offices are interested in private investing, the direct route will not be suitable for them all. Likewise, some family offices may opt for a mix of managed strategies and direct investments. To do so, they need to be able to scrutinize investment managers' investment approach, operational capabilities and the ability of their infrastructure to support the execution of their strategy.

This raises the topic of governance and its exploration as part of risk mitigation attempts.

Citi Private Bank's Global Investment and Operational Due Diligence team follows a rigorous process outlined below, before onboarding private equity funds and managers on to our platforms.

A. INVESTMENT DUE DILIGENCE

Investment due diligence includes a detailed qualitative and quantitative analysis of an investment. The key factors for each sub-step are outlined below.

Qualitative analysis covers a review of:

- key terms and conditions
- market opportunity
- investment strategy and focus
- investment team's experience and continuity
- compensation/carry as an alignment of interests
- investment process – sourcing, acquisition, internal processes, asset management, monitoring
- performance attribution analysis
- key risk factors and merits
- reference checks with portfolio companies, co-investors and investors
- organizational changes – departures, hires, personnel changes
- competitive landscape
- regulatory analysis
- other ad-hoc items

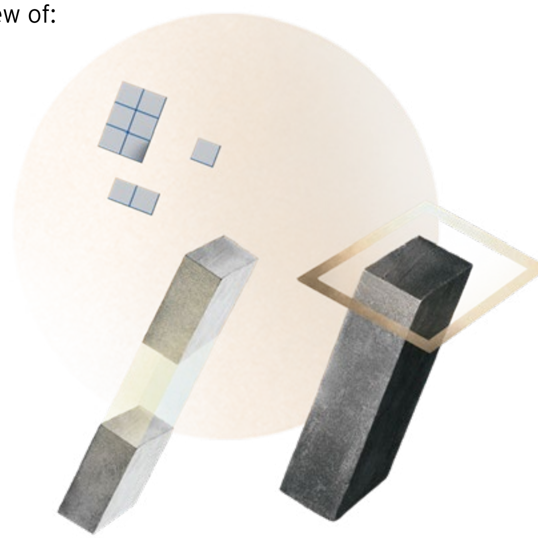
Quantitative analysis includes two sub-steps and covers a review of:

Fund analysis – detailed track record analysis, including a review of:

- individual evaluation of cash flow data for all historical investments
- attribution analysis by size, sector, geography, partner, source and other factors relevant to the opportunity
- realized investments – impact of multiple expansion, EBITDA growth and leverage on returns; sensitivity analysis
- unrealized investments – capital structure, sensitivity analysis and independent valuation of material unrealized positions

Individual deals – detailed track record analysis, including a review of:

- investment forecasts
- discounted cash flow analysis
- sensitivity analysis
- capital structure
- value creation plan
- exit strategy



B. OPERATIONAL DUE DILIGENCE

A separate analysis of an investment manager's operational capabilities and the ability for their infrastructure to support execution of their investment thesis. While less widely understood than investment risk, operational risk has frequently been a source of losses for investors in private equity and other alternative asset classes.

The key steps involved in operational due diligence include:

- Implementation of a combination of quantitative and qualitative risk assessments with procedural rigor
- Conduct background and onsite assessments of investment managers
- Review fund governing docs, audited financial statements and regulatory filings
- Take a risk-based approach in performing enhanced monitoring on designated "higher risk" managers
- Perform periodic reassessments and provide ongoing, in-person reviews with managers

Family offices may choose to create an in-house due diligence team. But as we have noted, due diligence needs to be comprehensive and may require substantial allocation of resources and cost.

Family offices can choose to outsource this function and allow for an unbiased third-party assessment of the manager, founders and investment itself. While this may be a cost-effective strategy, it still requires a full understanding of the scope of work delegated. The family office ultimately is responsible for the outcomes. Alternatively, family offices can opt to invest through the private equity funds platforms offered by institutions like Citi Private Bank based on their track record, performance and robust due diligence.

Section 4: Co-Investment and Continuation Fund ("GP-Led Secondaries") Strategies

General Partner (GP) and Limited Partner (LP) secondary markets are private markets transacting in resale interests of private equity partnership stakes and asset continuation vehicles.

The two main secondary market transaction types are as follows:

- **GP-Led Continuation Vehicles (single or multi-asset)**
  A continuation vehicle is structured by a General Partner to transfer assets from its fund to a segregated vehicle or new fund vintage. These vehicles help a GP to (i) provide liquidity to its LPs and (ii) maintain control of quality assets through the remainder of their value creation periods.

- **LP Portfolio Sales**
  Limited Partners of private equity, real estate, and venture capital firms seek to sell their partnership interests in fund(s) to another investor who takes on any obligation (e.g., unfunded commitment) of the position. Most commonly, these investor sales are a series of fund positions sold together for the purposes of (i) crystallizing returns, (ii) portfolio construction, (iii) liquidity, or (iv) GP consolidation purposes within a broader asset allocation context. Transactions often trade at a discount to reported Net Asset Value (NAV) as incentivization for the investor to take on the portfolio.

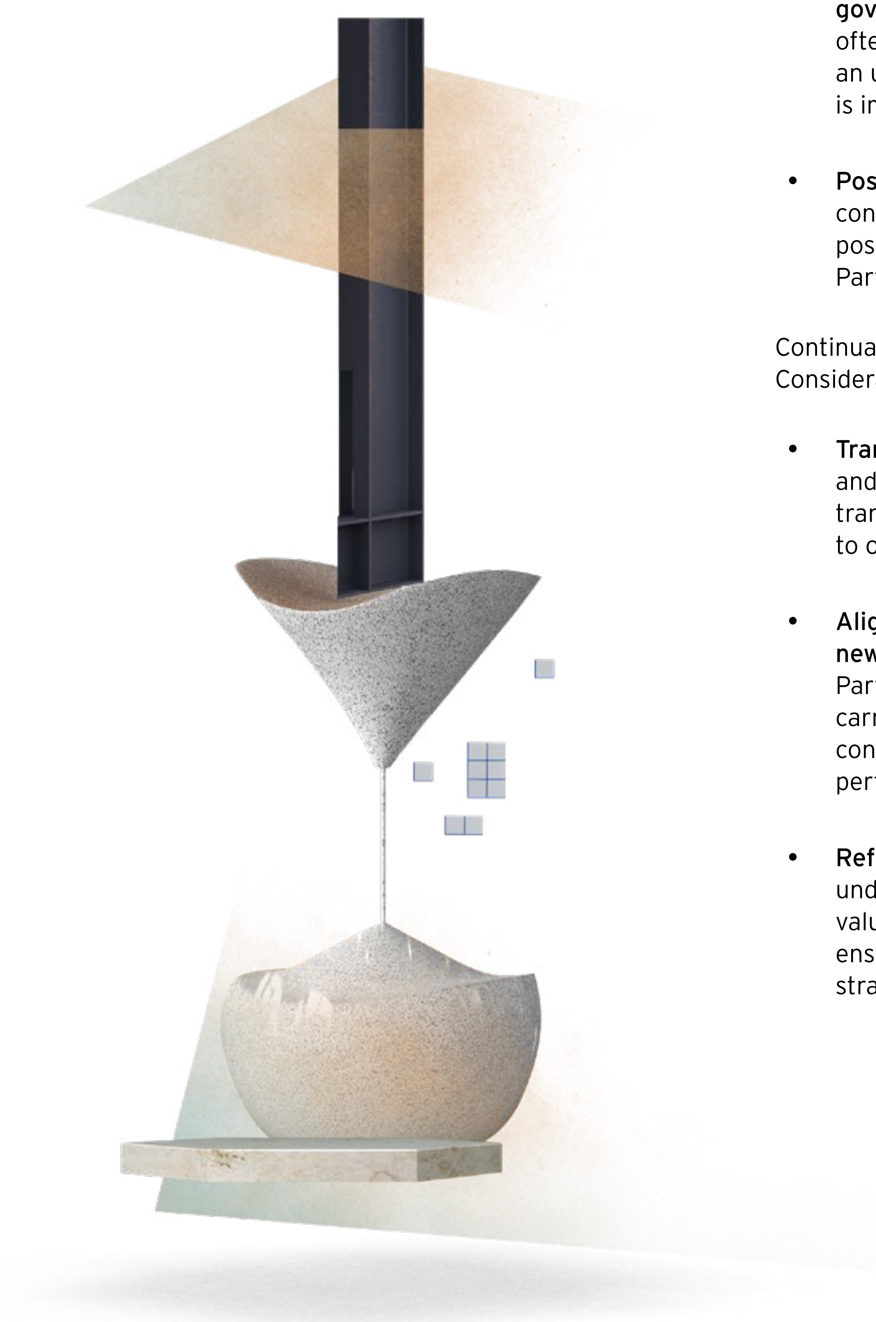
When evaluating co-investments or single-asset continuation funds, family offices should review both the sponsor and target company. Co-investments come with a variety of nuanced considerations and family offices should leverage private equity fund due diligence checklists - **see Section 3** - to confirm the sponsor's track record and value-add expertise in the target segment. Families could also look to better understand:

Co-Investment Vehicle Considerations:

- **The purpose and use of co-investment capital in a transaction:** Investors should ensure alignment of the co-investment vehicle and investment rights with the main fund.

- **Exposure to the main fund investing in the transaction:** It is important to understand an investor's incremental exposure's impact on (i) overall fees and economics for the co-investment and (ii) overall exposure to a single transaction or General Partner ("GP") as a result of the increased commitment.

- **Alignment of exit considerations and other decision making between the main fund and co-investment vehicle:** Differences in the Limited Partner makeup of the main fund versus the co-investment vehicle could impact alignment of interests.



- **Understanding of the co-investment vehicle Limited Partner Advisory Committee (LPAC) or governance framework:** Co-investment vehicles often default to the main fund's framework; an understanding of that investor makeup is important.

- **Post-IPO distribution or exit clauses:** Exit considerations such as set distribution timelines post-IPO versus at the discretion of the General Partner should be reviewed.

Continuation Funds / GP-Led Secondaries Considerations:

- **Transaction motives:** Understand the purpose and driving factors for the asset transfer and the transacting parties' incentives for the transfer to occur.

- **Alignment of interests between the GP and new LPs:** Ensure alignment with the General Partner including material rollover of crystallized carried interest as a GP commitment to the continuation vehicle and upside from investment performance.

- **Refreshed underwriting and due diligence:** Re-underwrite the investment thesis and go-forward value-creation plan of the underlying asset to ensure the new underwriting case meets the strategy's objectives.

Conclusion

Due diligence of direct investments – be it in real estate or operating companies – is critical but can be an onerous task for family offices. It requires an appropriate level of staffing or access to adequate external resources with the right expertise to navigate through the process in a timely way. Depending on the type of investments, ongoing management and oversight needs should also be considered.

Alternatively, family offices may consider private equity and real estate funds. This path involves selecting a reliable financial institution that follows a disciplined process to conduct both investment and operational due diligence of all funds and can assist you in making suitable decisions for your family office's portfolio.

Finally, such decisions are not always made solely based on investment reasons. When they sell the operating business that generated their wealth, some families worry that they might lose the "glue" that kept their family together. Therefore, they sometimes turn to direct investments to continue to deploy their operating experience and to engage the next generation.

No matter the approach, family offices should establish a long-term asset allocation plan and consider exposure to private investments, if appropriate.

About the Global Family Office Group

Citi Private Bank's Global Family Office Group serves single family offices, private investment companies and private holding companies, including family-owned enterprises and foundations, around the world.

We offer clients comprehensive private banking and family office advisory services, institutional access to global opportunities and connections to a community of like-minded peers.

For more information, please contact your Private Banker or the group head in your region.

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· lack of liquidity in that there may be no secondary market for the fund and none is expected to develop;
· volatility of returns;
· restrictions on transferring interests in the fund;
· potential lack of diversification and resulting higher risk due to concentration of trading authority when a single advisor is utilized;
· absence of information regarding valuations and pricing;
· complex tax structures and delays in tax reporting;
· less regulation and higher fees than mutual funds; and
· manager risk. Individual funds will have specific risks related to their investment programs that will vary from fund to fund

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