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Family Retreat Governance

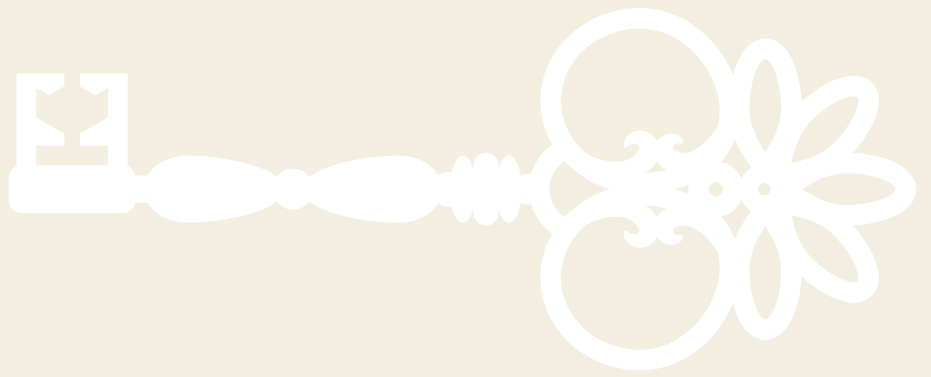
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SOME YEARS AGO, WE HAD THE PLEASURE OF WORKING WITH a loving, mutually respectful third through fifth generation family that owned a rather large ranch held in a trust created a few generations ago. It had a picture-perfect “big house” that family members used individually and in groups. But, there seemed to be tension within the family over the property.

It turned out that about half of the family loved the property and shared great memories of weekend nights with aunts and uncles around the campfire telling stories and having great times. The other half’s memories were of aunts and uncles getting drunk and obnoxious around the same campfire. Not surprisingly, half loved the property and wanted to preserve it for posterity, while the other half saw it as a waste of family financial resources.

Story continued inside.

Family Retreat continued.



... Our experience is that, regardless of ownership structure, long-term ownership and family harmony are enhanced through ongoing communication, well-understood rules and a relief-valve mechanism for a family member to cash out his or her interest.

A lake house, ski condo or mega-family retreat can be a great mechanism to solidify and maintain family connectedness across generations. Or, it can be a source of friction that tears the family apart. Inevitably, as the family grows, members will have differing objectives and interests. Some will live in other parts of the world, with little or no opportunity to use the property.

There are three types of rules that we recommend families establish as part of the plan for multi-generational use of a family property. Although families have different philosophies concerning rules, we believe they should be in writing and should be discussed periodically within the family. Larger families may create a governing council that is responsible for administering and enforcing the rules.

Use and Behavior

Rules should include scheduling of use, care and maintenance, payment for damages, alcohol and drug use, replenishment of supplies, reporting of maintenance and other issues, limitations on number of occupants, acceptable and unacceptable activities, cleaning of the property and linens, compliance with neighborhood restrictions, etc. Descriptions of consequences for violating the rules should be included. In essence, these rules should cover expectations that one might have in a short-term lease of a home to an unrelated person.

Sharing of Costs

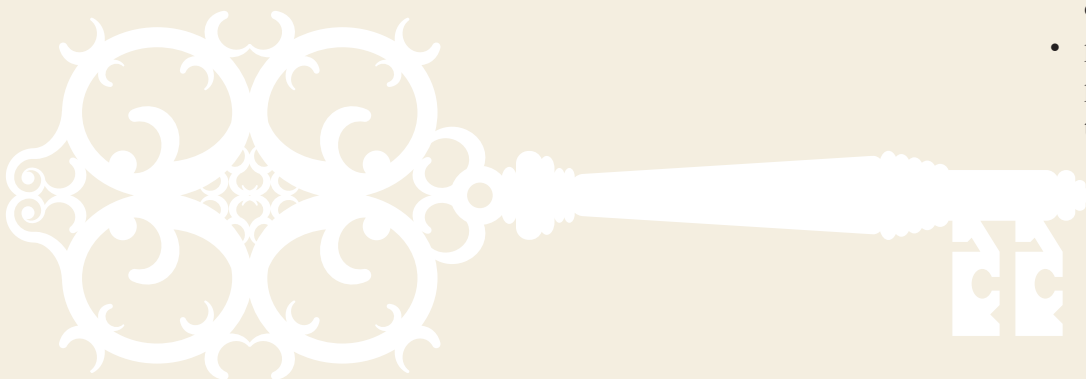
Typically, the senior generation that acquired the property funds operating costs. Some actually endow an entity (typically a trust or partnership) with sufficient liquid wealth to carry the operating costs of the property. However, after they are gone, at some point, costs must be shared by family members. How that is accomplished often depends upon the size of the family and the number of generations removed from the original owners. Possibilities range from proportionate sharing of costs by family line (common in the second generation) to a rent-type charge based upon actual use (common in later generations), or some combination of approaches. Consideration should be given to the creation of a fund to cover major renovations or other unexpected expenses.

Graceful Exit Rules

At some point, there will be one or more family members who either don't want to share in the costs or wish to redeploy their "share" of the capital that is tied up in the property. There may be differences of opinion over operation, governance and usage that begin to fray relationships. Whatever the reason, we believe it is important to provide a way out for those who do not wish to continue their ownership (whether direct or via a trust or other entity) of the property. Just as owners of a closely held business are well advised to have a buy/sell agreement, so should owners of a family retreat or other property.

Such agreements typically:

- limit permitted transferees (e.g., in the event of a death, divorce or creditor issues),
- provide a right of first refusal to purchase an interest that is being transferred outside the family,



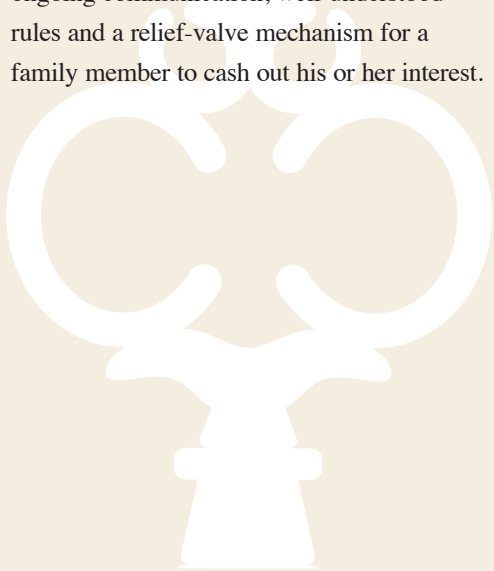
- incorporate a mechanism by which a family member may sell his or her interest to the other family members (including pricing and payment terms),
- specify the consequences of one or more family members bearing costs beyond the agreed method because other family members fail to pay their shares, and
- require the forced sale of the interest of a member who grossly violates rules or fails to carry his or her share of the operating expenses for an extended period of time.

The agreement also might include a mechanism for a sale of the entire property in the following types of situations:

- a vote by a specified percentage of owners
- a failure of non-selling members to buy the interests offered by selling members
- the inability or unwillingness of the owners to fund expenses

If a sale is triggered, there could be a mechanism to permit individual family members a right to purchase at fair market value the entire property and/or selected contents.

While it may be tempting to tie the property up in a trust that forces continued family ownership, our experience is that, regardless of ownership structure, long-term ownership and family harmony are enhanced through ongoing communication, well-understood rules and a relief-valve mechanism for a family member to cash out his or her interest.



PE:101

A Primer on Private Equity

Private equity (PE) is an asset class within the so-called “alternative investment” arena. It contributes to diversification when included in an investor’s overall portfolio. Expected investment returns are higher than public company portfolios, but those returns come with higher risk, lower liquidity and higher fees. It is important to understand the basics of PE before venturing into this investment space.

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PE FUNDS ARE

blind pools of capital structured as limited partnerships or limited liability companies to invest in multiple private companies. The PE fund investors typically are called “limited partners” (LPs). The fund sponsor is the general partner (GP) or managing member. The GP sources a portfolio of companies; structures the investments in those companies; provides operational, strategic and financial advice to the companies; and ultimately helps sell the companies to strategic buyers, other financial buyers, and/or to the public market in initial public offerings.

Fees

For its services, the GP typically charges the PE fund annually 1.5% to 2% of the capital committed by the LPs for the first 4 to 6 years, which subsequently changes to 1.5% to 2% of unreturned equity (net of write-offs). The GP normally receives 20% of the profits, often after the LPs receive some specified return on their investments (a “hurdle rate”). A PE fund’s life is contractually limited to the anticipated time needed to deploy all capital and ultimately dispose of all investments - typically 10 years with 2 one-year extensions.

The PE structure is used for a variety of investment strategies. The most common is buyouts. Bain Capital, a PE fund sponsor, is one buyout group recently in the news, and KKR first captured the attention of the broader public with its “Barbarians at the Gate” acquisition of RJR Nabisco. Venture capital funds invest in new and growing technology companies. “Special situations” funds use this structure for mezzanine lending, buying distressed debt for trading, or trying to take control of companies through debt-for-equity swaps. Even real estate funds use this structure, mainly for riskier strategies.

Additional Considerations

An LP cannot simply cash in his position at will. He might be able to sell it in the fragmented secondary market, but at a steep discount from underlying value. Capital is called from the LPs as needed for management fees and irregularly timed company purchases. While this sounds cash flow efficient, an investor must either reserve capital for the calls or risk potentially ill-timed sales of other assets to meet those commitments. PE offers investors different exposures from the stock market, such as new start-up companies, companies taken private and lending platforms.

Although GPs provide quarterly financial and portfolio company information, transparency is less than what is required of public securities managers. LPs delegate a lot of authority to the GP, which is why researching the manager to become comfortable with this delegation is critical.

J Curve

In the early years, the fund incurs costs, while the underlying investments need a few years to gain traction and increase in value. Consequently, expect negative investment returns at first, followed by increasing returns (for a successful fund) in later years. If illustrated on a graph, the annual values of the fund’s investments will look like a “J curve,” with declines initially (the base of the “J”), followed (hopefully) by annual increases over time. As portfolio companies are sold, most returns (other than for credit strategies) tend to be capital gains for tax purposes.

There is a much larger variation in managers’ results as compared to managers who invest in publicly traded stocks. Manager selection is key to success. Meeting with managers, reading industry literature and attending conferences with GPs and LPs are invaluable ways to get a flavor of the strategies and fund terms to better understand the asset class and how it fits in your portfolio. A consultant can be a useful guide.

Diversification Difficulties

PE typically should be a modest percentage of an investor’s portfolio. The investor should diversify managers, strategies, geographies, market sectors, etc. to reduce risk. Plus, commitments should be paced over several years (“vintage years”) as a form of timing diversification for market cycles. Unfortunately, most sponsors require a minimum investment of \$1.5 million or more, making diversification difficult for all but the wealthiest investors. The result is that most investors must turn to “feeder funds” or funds of funds, which have lower minimums. Unfortunately, these come with an additional layer of fees, thereby reducing returns.

Private equity offers a great way to enhance returns in a portfolio, but it is not for the inexperienced or short-term investor. Understanding the asset class and seeking input from experienced investors and advisors can increase the chances of success and reduce the overall risk of a portfolio by offering diversification into investments not available through the public markets.

CONSIDERING LIFE AFTER THE



SALE

When considering a business sale or transition, the first questions on an entrepreneur's mind usually concern valuation, timing, the right team of advisors and an appropriate suitor or successor. These are all important considerations, to be sure. However, having walked this path with many highly successful entrepreneurs, including some whose businesses are household names, we find it is important to not only structure the most beneficial transaction possible, but also to help them plan for a successful transition into retirement.

In my experience, successful entrepreneurs, post-business sale or exit fall into seven general categories:

1 | The Serial Entrepreneur realizes, usually within 12-24 months, he can't stay out of the game. So he returns, often to the same or similar industry from which he retired, to start a new business. It's important to ask, however, whether he really wants to head back into the frenetic work-a-day world or whether he just doesn't know how else to fill his time. It's also useful to weigh how much money he is willing and able to risk versus preserving his capital. Does he want to risk it all again and will he have the discipline to stop pouring money into it when its needs threaten his financial security?

2 | The Investor puts his business acumen, political connections and financial might to work behind the scenes with venture capital and private equity dollars. I've seen clients both win, but more often lose, huge fortunes by funding new businesses that they may not fully understand

or control. The key here is to limit investment dollars to an appropriate portion of the existing portfolio in order to limit downside risk.

3 | The Philanthropist was likely engaged in charitable missions well before retirement, but this "second chance" allows for a new level of commitment – both in terms of time and dollars. The Philanthropist needs to choose his commitments wisely or he will quickly become overburdened time-wise, if not financially.

4 | The Advisor/Consultant returns to the market as a board member, consultant, speaker or guru. Prior to retirement this person was probably an excellent teacher, scholar and coach. During retirement they hone these skills on boards and as consultants or guest lecturers. While it may not garner much in the way of money, it usually proves to be very fulfilling work.

5 | The Hobbyist ignites another passion – such as sailing, collecting or farming – at which they become extremely proficient, often experiencing dominance akin to that which they experienced in their business. Alas, I remind my Hobbyist clients that some passions can become quite expensive – art collecting and horse racing to name good examples. So, if wealth preservation is a goal, make a budget and stick to it.

6 | The Family Man was always a family man – even during the 70 hour work weeks. Retirement, however, allows him to travel to see the grandkids and spend even more time with his cherished spouse (if she will have him).

7 | The Recluse does not find his new groove after retirement. Usually he battles issues of identity loss, marital discord, loneliness and depression.

It is critical for any entrepreneur to begin imagining retirement long before the business sale proceeds clear the bank. What essential parts of his current life would he like to see continued long after the business is gone? Perhaps Popeye said it best "I yam what I yam." I urge clients to reflect on who they are and what they truly, not theoretically, enjoy when thinking about life post business.

New skills and hobbies (whether family man, philanthropist or whatever) are like muscles that must be worked, like any new routine. In the early days, I urge clients to put 2-3 fixed activities – whether social gatherings, or business or board meetings – on their calendar a day, providing both a framework for activity and plenty of room for experimentation. Identifying and practicing these new skills and interests before retirement can prevent disappointments and potential financial disasters after the business is sold.

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