Sentinel Trust Company

On Watch

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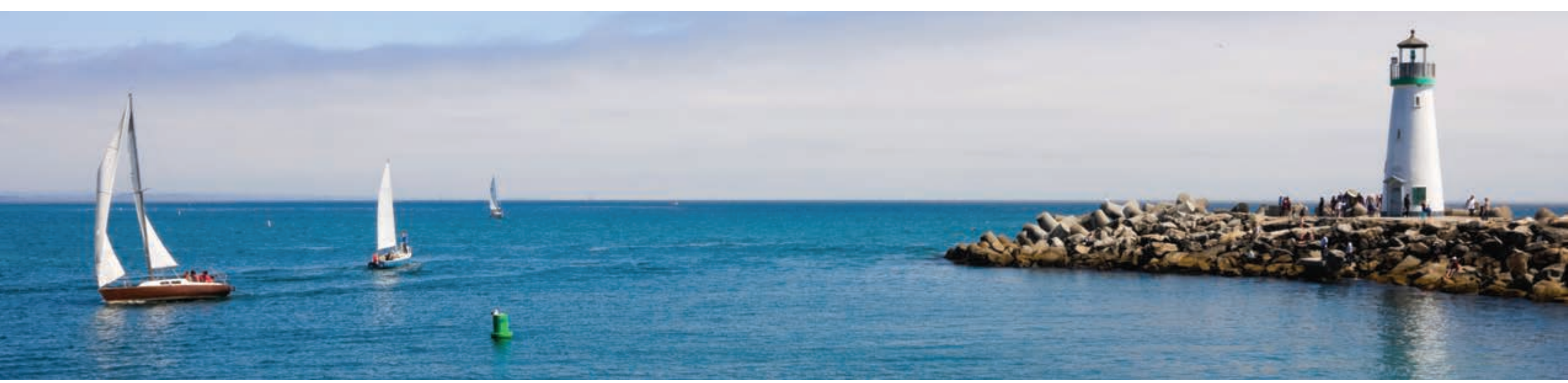

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10 Due Diligence Questions for Private Equity Investors

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SUCCESSFUL PRIVATE EQUITY (PE) investing requires thoughtful due diligence about the sponsor/manager (typically called the "general partner" or "GP"), both before making a capital commitment and during the course of the venture. This list of due diligence issues can be a useful guide for investors (typically called "limited partners" or "LPs") in analyzing potential GPs.

Story continued inside.

Due Diligence continued.

1 How's performance? Quite naturally, a GP wants to present his story in the best light possible; he is trying to raise money! There is a natural tendency to highlight:

- Returns from the good investments, while downplaying poor ones.
- Gross returns, which is how each investment performed on its own before fund expenses.
- Realized returns, which are from deals attractive enough to have been sold, while downplaying unrealized losses, which are attributable to investments for which buyers have not been found.

Yet LPs invest in the fund as a whole, so we must look at the entire track record; we cannot pick and choose our deals. Our interest is in what we can put in the bank after all losses, fees and expenses. The GP must be a good portfolio manager and efficient allocator of capital, not just a good dealmaker.

2 Great presentation, tons of interesting statistics, but where's performance? Investment professionals are analytical and want to see what works. Their first calculation is usually performance. The effort of analyzing underlying investment performance should match that of the total fund performance shown to you.

3 What if the track record shows deals only in the "new, improved" strategy? GPs evolve as they determine their strengths. Potential LPs should check the GP's entire track record. Selectively presenting past performance can be misleading. What past deals are being excluded and are all "new strategy" deals actually included? Ensure that the partners responsible for the best deals in the new strategy are still part of the team.

4 Is this a spin-off? The GP may make a compelling case that his team, sector, or track record is the best subset of the legacy firm from which the team came. Investors should ask what the remaining partners are doing, and whether they are co-located. Note whether the legacy firm is also raising a fund with a similar strategy. And check with the legacy manager to ensure that the departure was amicable.

We are pleased to announce that Sentinel Trust Company received the 2015 award for "Trust Company of the Year" at the 4th Annual Family Office Review (FOR) Awards held on January 29, 2015. Anthony DeToto attended the ceremony and accepted the award on behalf of the firm.

The FOR Awards recognizes individuals and firms that are the driving force behind the growth in family offices and the family wealth space nationally - with innovation, leadership and entrepreneurial creativity being key award themes.

We are honored to have been recognized by Family Office Review in this category.

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5 What if they're using the wrong vintage year or benchmark? LPs should use their own judgement in selecting the right vintage year and benchmark. In the PE world, funds are benchmarked by reference to their peers created in the same (or "vintage") year. For example, technology funds created early in the technology bubble of the 1990s have a much higher benchmark than those created in, say, 2001. The vintage year may differ if you use the year of first capital call or year of formation. The art comes when judging whether a December capital call should be for that calendar year or for the next year, or when a call for fees is made in one year but the first capital call for an investment is in another year. Taking a moment to look at the benchmark returns for the years before and after the supposed vintage year can be informative.

6 What if "so-and-so is in this fund, and they're a smart investor"? Investors in Bernie Madoff's fund were so awed by its reputation and by the big name investors in it that they ceded their own judgment to others. Each investor has his own criteria and constraints not shared by others and must make an independent decision.

7 How long have they been marketing the fund? The market judges funds, leading to new commitments or lack thereof. A successful fundraiser helps lead to a sustainable investment platform. Inability to raise capital suggests that the market judges the GP poorly.

8 Who does the talking – just the "key man" or everyone? LPs should seek to invest in a sustainable platform. Can the next level below the top partner(s) carry on seamlessly if the key people leave the firm?

9 Follow the money? While an LP should want a successful GP to benefit from the success of their investing, a GP's behind-the-scenes profit-generating activities may be detrimental to the LPs. Look at what the sponsors are getting out of a deal besides management fees and carry. For example, transaction fees that go to the GP, not the partnership, are a bad sign. Also, consider the role of any parent organization and any hidden involvement that it might have in the GP's or the fund's activities.

10 Does the public market offer a better return for the strategy? LPs analyzing funds only through a PE filter might blind themselves from better opportunities in the public market. Currently, for instance, yield-oriented investors may be better served with investing in publicly traded real estate investment trusts, master limited partnerships, and corporate bonds than in the PE world's private senior lending strategies, particularly when considering the illiquidity of PE investing.

When making private equity decisions, experience, knowledge and critical analysis can be the key in successful investing. It is important to challenge what is presented to you and continually question what you think you know.

Choosing Your Retirement State

If you are considering retiring, there are a number of factors to consider before selling your business and buying that house on the 18th hole.

No matter where you land, Uncle Sam will find you. While there is little control over the federal taxes you pay, there are choices you can make to protect income from state taxes. Seven states, including Alaska, Florida, Nevada, South Dakota, Washington, Wyoming, and Texas, do not have a state income tax. Two states also worth attention are New Hampshire and Tennessee, which tax dividend and interest income, but not wages. Twenty-eight states provide full exemption for Social Security income and others may partially or fully exclude distributions from 401Ks and IRAs. These states compensate through property and sales taxes, but you can still find savings.

Wallet-friendly states most often are considered by individuals and advisors as part of retirement planning. However, that planning can be useful for others as well. For example, changing residence can help beneficiaries, trusts, job seekers and families selling their businesses hold on to more of what they earn.

- Income distributions to trust beneficiaries are taxed by their home state.
- Income not distributed by a trust is taxed by the trust's home state. You may be able to change the trust's home state (called situs).
- If you choose between two jobs with the same salary – one in California, one in Washington, you could give yourself a 13.3% raise by choosing Washington.
- A family planning to sell its business or other major assets could establish residency in a new state prior to sale, thereby avoiding state tax on the gain.

While tax savings surely are not the only reason to move, it might help you decide between your top two choices if one has a lower rate than the other.

Moving has many non-financial considerations as well. Is moving closer to family a priority? Focus on climate and access to recreation if your primary interests are golf, hiking or skiing. Large metropolis or small community? Love of learning or the arts? Look for a college town or city with a rich culture. Look into access to healthcare, public transportation, crime rates and civic engagement.

While there is not one best place to live, the focus should be on the best life regardless of where it is lived.

If you are considering a move, talk to your advisors. They will 1) provide pros/cons from a financial perspective; 2) help determine if your trust(s) is eligible to change situs; and 3) set up a review of your investment portfolio to ensure tax-exempt investments chosen based on your current home state are not taxable in your new state.

Positioning yourself well now and in your retirement will allow you to do that which your heart desires and enhance the chances that all of your years are well, more golden years.

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(Data source: Each year Forbes, Kiplinger, and the Milken Institute publish lists of "The Best Places to Retire" which is helpful for non-retirees as well.)

Nurturing Family Togetherness

LEGACY PROPERTY OWNERSHIP CONSIDERATIONS

Many families want to ensure that future generations can enjoy a ranch, vacation home, retreat or other property to nurture deep family connections and great memories. Whether planning for an existing property or contemplating purchasing a new one, reflecting on potential future issues may be helpful.

What is your primary ownership motivation – investing for your own personal enjoyment or creating a place to keep the family together for generations to come? These things aren't necessarily mutually exclusive, but it's best to be honest about your priorities. For example, structuring for avoiding future estate taxes differs depending upon the objectives.

Considerations in All Cases

Although some don't think it through in the purchase decision, it should go without saying that the following should be considered whether or not you plan to keep the property through multiple generations:

- Understand net operating costs. There is a difference in the cost of owning and maintaining a pied-à-terre in a well-built building in Manhattan and a ranch in Texas.
- Understand income and expenses. If needed, can you generate income or qualify for tax-reduction programs to help offset expenses? If it's a farm or ranch land, are you willing to hire and manage people with the right expertise to maintain agricultural exemptions?
- Understand your property rights. Consider building permissions, zoning, deed restrictions, ecological constraints, water rights and potential historic building designations. Might you or future generations want to renovate, extend, build additional buildings, or generally alter the current footprint in ways that are not permitted by these restrictions? Think about future use and particularly future building. If you have a large parcel of land, can future generations subdivide it or sell off portions to help fund the core property?

Multi-Generational Considerations

If you truly want to enhance the chances that your family will enjoy the property for generations after you're gone, you should plan for the following common motivations for heirs to sell legacy properties after the senior generation is gone:

- Operating costs – They begin to feel expensive relative to the perceived value of the enjoyment received. Some family members may not be able to afford their shares of the costs to maintain the property.
- Accessibility – Whether the property is in the boonies and is too time-consuming for busy family members to access, or a family member lives far away and travel is too burdensome for use, ease of access can be an issue.
- Value is too high – The amount of capital (including appreciation) tied up in the property may seem high compared to individual family members' net worth. What if a family member wants to get "his" share of the value out of the property to use for other purposes?
- Hassle factor – Someone has to take care of the place (or at least manage those who will take care of it).
- Lack of interest – A descendant who does not like the beach might not want to spend time at a beach house.
- Bad memories – Individual members of a fourth generation family we know had wildly different memories of spending childhood time on the family ranch. Half remembered great times around the campfire with aunts and uncles singing and having a fun time. The other half viewed their time there with distaste as their aunts and uncles got drunk and acted rowdy.
- Estate taxes, especially if they have to be paid by each generation in the future.
- Lack of an agreement governing acceptable usage of the property, decision making, issue resolution, cost sharing, etc.

Overcoming these issues requires ongoing planning and communication among and throughout the generations. It requires effort by each generation to build and sustain the family members' desire to have an involvement with the property, whether that involvement is their time, their individual funds, "their share" of the capital or some combination thereof. It begins with your vision for the property, but that vision can only be sustained for generations if you and your descendants are willing to devote the necessary time, energy and resources.

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Sentinel Trust Company

Sentinel Trust Company provides custom integrated planning, investment, fiduciary and administrative solutions to affluent families and their closely held businesses and entities.

Founded in 1997 as the successor to two 40-year old, investment-focused family offices, today Sentinel offers the stability of an institutional firm, the entrepreneurial spirit of a young firm, the personal feel of a family office and the in-house technical skills of independent planning and investment management firms.

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For additional information about the topics presented in this newsletter, or to be placed on our mailing list for future editions, please contact Anthony DeToto at adetoto@sentineltrust.com or call 713.559.9578. You can find electronic copies of our past quarterly newsletters at www.sentineltrust.com/publications/on-watch/.

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