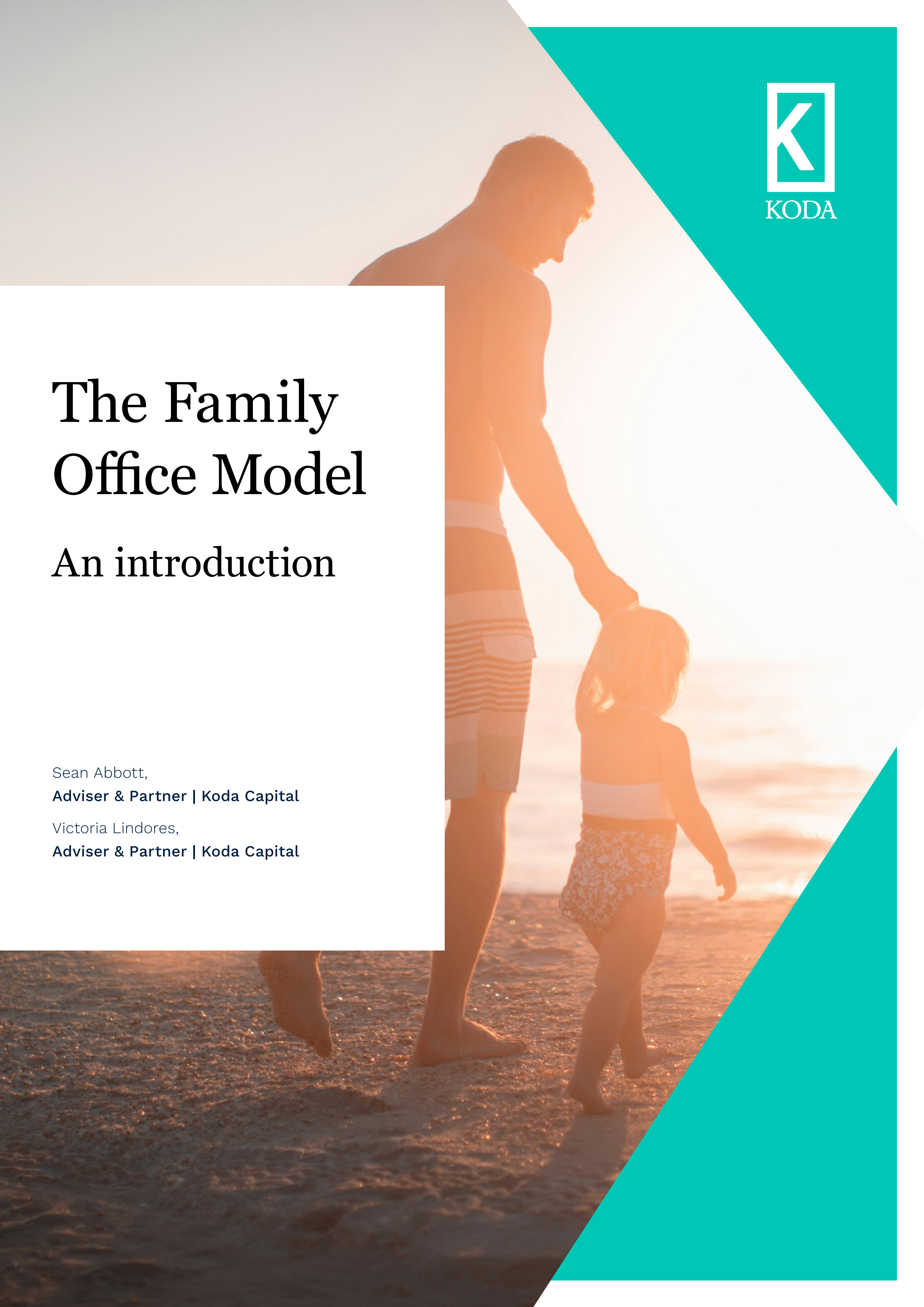

The Family Office Model

An introduction

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The first question is not “How should we be investing?” That is skipping to the end.

The first question is “What do I want to do?” followed by “Do I have the right foundations?”

It is fundamental to get the governance right as you need that framework regardless of where and how you invest.

CEO of a Leading Australian Family Office

Contents

Executive Summary

This paper is relevant to people who are looking to:

a) understand the purpose and core functions of a family office;

b) understand which version of a family office may be appropriate to their particular circumstances.

The term family office itself is rarely well defined and can have different constructs for different people. The sophistication and functions of the Australian family office market today varies by family office. In simple terms, the intention of a family office is to manage the family capital like one would a business.

Through interviews with founders and family office executives in this paper, we uncover the learnings from successful family offices. We provide an explanation of the core functions of a family office and the various ways in which those functions can be insourced and outsourced.

The biggest mistake identified was rushing into big decisions. The best advice was to set up sound governance first. *But how?*

Each family will travel their own journey as to which family office framework best suits their circumstances. From experience, we know this will change across generations. Consistent throughout and no different to running an operating business, the family will need a trusted support network to provide the expertise that supports their specific needs to deliver on the family's vision.

Key Insights

In writing this paper we interviewed three market leaders who run three distinct family office models. While approximately 70% of the functions are consistent across all three models, the differences highlight the importance of setting the foundations to reflect the capacity, capability and aspirations of the family.

Our panel included:

1. a fifth generation fully insourced option where a family member is the CEO;
2. a family office where the CEO is an employed, experienced executive and;
3. a service provider model where the CFO and CIO roles have been outsourced.

All agreed that the family office should be designed as a steward of wealth through generations. The four key insights provided by our panel were:

1. Understand the why

Setting up a family office is expensive. Attracting great talent is difficult. It is therefore important to be clear on why you would set up a family office and that the economics make sense.

2. Never hide from emotions

Money is different between families, but the emotions are the same.

3. The concept of the family office model *spectrum*

The appropriate family office infrastructure can be split between what is insourced versus outsourced. This framework changes with the family, over time. It is a journey.

4. The Firewall

The single greatest cause of family office collapse is a lack of discipline. An undisciplined investment strategy will have long term impacts on both the family's wealth and relationships. Professional advisers can construct and operate the mechanism that protects the family from 'every good idea on the street'.

"Basically, pause, catch your breath, learn what it feels like to have a 6, 7, 8% return as a baseline from a diversified portfolio and then you can spice it up as you desire"

Family Office Family Member

What exactly is a family office?

A family office is an entity established by one or a small group of related wealthy individuals to manage wealth. It seeks to offer a full suite of financial services to family members as well as play a role in building capacity and capability in the next generation.

The role, size and sophistication level of a family office can differ greatly depending on the needs of its members, which will depend on the complexity and magnitude of their wealth as well as the diversity of their objectives. Another important consideration is the desire to employ in house specialists or preference to outsource certain functions.

Running smoothly, a family office should give effect to a structured framework that handles financial and wealth management with the primary goal of growing, sustaining and transferring wealth across generations.

Importantly, it is critical that a family office has:

- clarity as to purpose and vision
- a documented business and investment strategy
- a transparent transition to the next generation

When are family offices created?

Family offices are often established after the sale of a family business or any form of meaningful 'liquidity event'. However, they may also operate alongside a business as a means of creating a diversified asset base to better manage concentration risk. Likeminded families can also come together to pool resources and establish a family office.

Family offices are as varied – in scope, strategy, structure, staff, size and source of capital – as the individuals who establish them. At its core, the intention of a family office should be to manage the family capital like you would a business.

What a family office might consider

SCOPE

- Budget and cash flow planning
- Financial accounting
- Investment management
- Portfolio administration and reporting
- Risk management
- Tax and compliance services
- Estate planning
- Succession planning
- Lifestyle concierge
- Philanthropy

STRATEGY

- Grow capital for future family members
- Sustain capital for increasing number of family members
- Maintain capital for existing family members
- Generate income to meet lifestyle objectives
- Deliver philanthropic objectives

STRUCTURE

- Single family
- Multi family, related
- Multi family, unrelated
- Virtual family office

STAFF

- Family members
- Professional staff
- External advisers

SIZE

Typically an investable asset base of $100 million and over

SOURCE OF CAPITAL

- Sale of a business (a liquidity event)
- Cashflow from ongoing operational business

Key Insight 1 – Understand the *why*

Establishing a family office framework is driven by recognising that governance and risk management safeguard one's life's work, leading to long-term financial peace of mind.

When well-constructed, it delivers superior efficiency, oversight, strategy coordination, and centralised support for continuation of wealth across multiple generations, surpassing individual efforts.

Too often, however, a family office is established as a:

- ✓ place to receive advice, and act only on pieces of it;
- ✓ means to find a purpose; or
- ✓ very expensive bookkeeping operation.

For many families with significant wealth, a family office may be the right choice. However, it is rarely a path mapped with precision. Too many founders start with no goal in mind, and a misunderstanding of their own motivations.

While the founding of a family office is an important step in taking control of a family's future, be wary that it does not also concentrate power in one source.

> "We interviewed 50 family offices globally and the SINGLE most consistent piece of advice was, don't go out and buy something else. You are going to feel like you need to because you have always been business owners and you are going to feel naked; and you are going to feel like you are not working properly if you don't own a business. Every single person, without exception, who did that said, "I tell you that because we went and did that and it was a mistake."
>
> **CEO of a Leading Australian Family Office**

Transition your thinking - from entrepreneur to family office

Pause and catch your breath. If you have recently sold a business, people will ask you what you are doing next, and it is ok to say "I don't know" or "I'm exploring".

Moving from an entrepreneur and business builder to an investor of patient capital requires some perseverance, as founders need time to readjust their thinking. While there are many translatable skills – including relationship building and operational rigour – it is unlikely that family office founders will already possess the professional experience required to manage an investment portfolio.

Creating wealth is considerably different to maintaining wealth. This is where the Family Office structure supports that important shift in thinking. Placing trusted professionals on your side of the table will give you the best chance at success. And just like business, you should *hire slowly and fire quickly*, as in the microcosm of a family office poor performance and bad behaviour can undermine key relationships.

If the family office does intend to engage in both an investment portfolio and active businesses, then ambidextrous leadership is key to success. This scenario is where many founders settle on a hybrid model which allows them to follow their natural entrepreneurial instinct – or allow for their children to do so – and manage risk through a diversified balance sheet.

There are good reasons and bad reasons to start a family office

Reason	Good	Bad
Risk Management	A well-conceived family office framework is **best practice** for governance and risk management. The more personally aware individuals recognise their role in creating the wealth doesn't always translate to managing wealth, the more likely they will seek out the expertise they need.	**Ego** can get in the way of seeking out the right expertise and create barriers to learning.
Legacy & Continuity	Desire for an ongoing legacy driven by a purpose for the wealth, and set up properly with a **clear transition plan**. Involving children with independent board members/advisers generally leads to better engagement from the next generation. Some founders believe that keeping the wealth together is more impactful, while others will find that keeping the family together is more important.	The concentration of **power** can create a lack of accountability, discourage diverse points of view and generate tension.
The Economics Make Sense	A small family office will have four to six employees and costs anywhere from $1 million to $1.5 million to operate each year (requiring $100m minimum in investable capital for an in house model.)	The fact that you have the scale to establish a family office, is only a part of the reasons you should. **Poor execution** at scale can be disastrous.
Human Dynamics	To set up a family office requires energy and focus. It works well when there is someone in the family with the **capability and skills** to champion and drive a core function.	**Part time relationships** and passing or coerced levels of interest will end badly.

"Best practice suggests that you should start off with outsourced. Irrespective of how much direct investing is done, very few families do end up going 100% direct. Most families retain a portion of third party. If you are a family office with say $300m, and you outsource 33%, that is still $100m outsourced, so it pays early on to get the outsourced model right. So devote time to it and get it right. Get the right relationships, choose the wealth manager, get this aspect working correctly first. Once that is done, then you can decide how much you want to insource..."

CEO of a Leading Australian Family Office

Key Insight 2 – Never hide from emotions

Culture clashes between first generation wealth creators and the next generation who have grown and developed as a product of that wealth are common.

For example:

- values around presenteeism versus value created
- attitude towards debt and spending habits
- favouritism directed to certain personality types or career choices
- willingness to take large risks over a slow and steady approach
- restrictive age and gender stereotypes
- timeout for career, travel or family

These issues can be the source of misunderstandings and disappointments for both sides. While the attitude to wealth is different between founders, the emotions are mostly the same. Accordingly **time needs to be spent on the human dynamics of the family** where difficult conversations are addressed. Expertise can be brought in to facilitate this key step.

Engagement and enhancing family relationships

A family office should enhance relationships across and amongst family generations. Without transparency and fairness, however, many founders risk damaging and splintering relationships that are difficult to recover.

It is for this reason that education and engagement of the next generation are important issues that must form part of the long-term strategic plan.

- Who can work in the family office?
- How are they remunerated?
- How is performance measured?
- How is transparency achieved?
- How is fairness measured?

Clarity on purpose and timeframes, as well as capacity building, are key issues to be addressed by founders to ensure a successful succession.

Thinking across generations

Similarly, with a long-term mindset founders can first focus on preservation of capital and strengthening relationships, then consider how they may grow. The operational framework must be responsive to changing capabilities and capacities amongst family members, whereas reliance on one key family member may cause frustration amongst others.

Common sense processes around how decisions will be made and how information will be disseminated help the family talk about the wealth in a practical and logical (and not emotional) way. Providing a safe forum for family members to explore, validate and develop new ideas teaches not only valuable commercial skills but also an appreciation of life values. Philanthropy is often a powerful and engaging first step.

Capital must grow to meet the increasing needs of a growing family across generations, yet expectations may also need to be tempered. Taking a long-term approach and focusing on the sustainability of both the capital and family office framework first will avoid the unsatisfactory outcome of splitting wealth on the passing of the founder.

> "...With the children taking over, if they have been guided and have a good team around them, then chances are they will lean on those people when [the founders] are not around."
>
> **External CFO** – Service Provider

Key Insight 3 – One size does not fit all

> “It took us 10 years to get the right structures in place and to have the office running smoothly with all family members engaged.”
>
> **5th Generation Family Member and Family Office CEO**

Personal motivation and human dynamics will ultimately determine the most suitable structure for a family office, with capital available for investment and services a secondary deciding factor. For the most successful family offices, the foundational decisions around structure and governance come down to an analysis of cost versus benefit.

Key questions:

1. What are my unique skills and experience?
2. How actively involved do I want to be? (Or, what other things do I want to do?)
3. Do I want to employ people? Who will be responsible for managing their performance?
4. Should I make decisions on my own? Do I have that level of expertise?

A family office is unlikely to insource all the professional expertise it needs. In interviews with successful family offices, one message was very clear: **Get the outsourced model working first.**

It will take time to get the insourced roles and responsibilities clear, and you should make some room for trial and error in that journey.

What is governance

- **Financial Charter**
- **Financial Education**
- **Family Board**
  - Independent directors
  - Skills matrix
  - Decision making

> "There is often no governance in a family office and there is one decision maker – the founder. Therefore, they need a trusted sounding board from whom they can tap expertise, and one that they will listen to."
>
> **External CFO** – Service Provider

Family Office Roles

When considering the cost / benefit equation, founders will look to insource or outsource key functions. Each family office will need to fill the following roles.

Role	Insource	Outsource
Governance & Decision Making	CEO or Founder	Unlikely to outsource
Accounting	Chief Financial Officer Financial accountant	Outsourced CFO Service Accounting practice
Audit (Internal & External)	-	Critical to avoid malpractice
Banking	-	Align with a trusted banker
Legal	Employed solicitor with expertise in property, M&A, tax, asset protection, estate planning and family law	One or several specialist legal practises
Reporting	Employed Bookkeeper	Services offered through online platforms and software
Custody	-	
Communication to Family Stakeholders	CEO or Founder	Outsourced CFO chairs regular Family Meetings
Asset Allocation	Chief Investment Officer	Investment consultants and wealth management firms bring a wide range of experience and expertise.
Idea Discovery & Investment Selection	CIO with team of asset class specialists	
Performance Monitoring	Employed data analyst	Wealth management firm
Philanthropy	Employed grants specialist	Community foundations with granting expertise or philanthropy consultants

Keep in mind: A family office managing $300m of wealth is similar in size to an ASX listed small cap company. It should be managed with a comparable level of rigour.

With insourced roles, attracting and retaining quality candidates will only be a problem if you are unwilling to remunerate appropriately. Equity and participation in value added (carry), as well as the varied nature of the role, will be attractive to dynamic executives. However, be wary not to create part-time roles for critical positions. Continuity in a small team is critical.

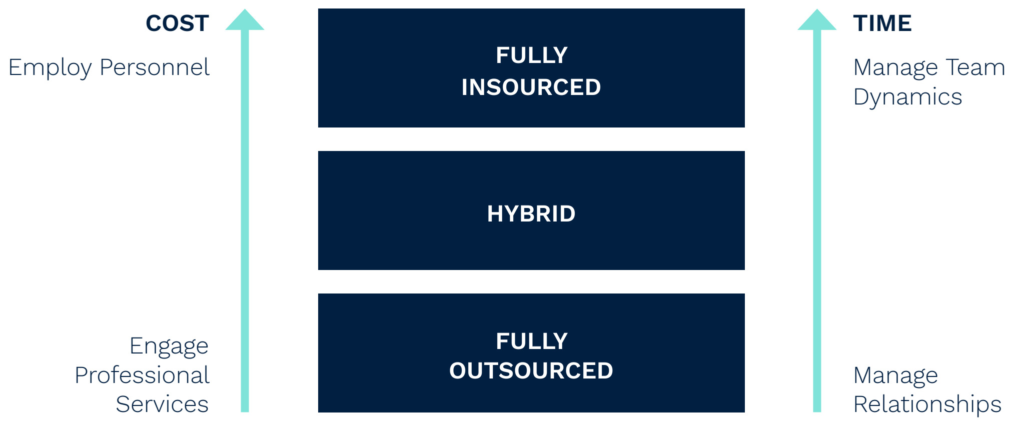
It is also important to have a range of legal, accounting and banking specialists ready to move quickly on investment opportunities.

Investing directly with an in-house team works as long as you have the networks to source opportunities and expertise to analyse them.

To manage risk, it is critical that your investments remain diversified across a range of asset types, geographies, capital structure and liquidity. For this reason, many of the family offices we interviewed consider a hybrid model as a part of their successful journey. Being able to outsource the investment related decisions in specific areas meant they could focus on building the expertise in-house for others.

Organisational Spectrum for Family Offices

No matter where you land on the organisational spectrum, you will need to be ready to manage people.



Consider

- ✓ expense, skills and time required to manage a team of talented individuals.
- ✓ alternative option of managing a number of professional service relationships.
- ✓ hybrid option where founders can focus on what they are good at and outsource where there is a need for additional expertise.

If you can only afford to insource one person, each family office interviewed highlighted the CFO as the critical capability. Other key roles – such as Chief Investment officer (CIO) and legal – would be outsourced roles that function as a family board to set an agreed on strategy and investment approach.

> "The sweet spot for families to outsource to a family office is $50m to $1b. It is not a hard and fast rule but below $50m the sophistication needs are unlikely to add value.
>
> If insourcing executive roles like CEO, CFO and CIO, families must have $1b of wealth and a person within the family with the capability and skills to champion and drive the group."
>
> **External CFO** – Service Provider

Key Insight 4 – The Firewall

> "...People can think family offices lack sophistication in decision making. The question we always ask ourselves is, "Why is this deal in front of us?"
>
> **CEO of a Leading Australian Family Office**

Assessing investment opportunities

You will quickly find that people seeking capital will come and find you. Ask yourself:

1. Why is this investment deal being presented to me? Why hasn't someone else taken it up yet?
2. Do I have an edge to understand this deal?
3. Am I sufficiently personally aware to seek the expertise when I need it?
4. Is this the best deal in this class, or the lesser of many I don't yet know about?

Having a standardised assessment process will help to avoid unnecessary risk and disappointing investment returns. Nonetheless, first implementing a firewall to savvy salespeople through professional advisers will also save you time and energy.

Remember that it would be unimaginable to have run your business without a core team of executives with different skills, so an investment committee can offer a similar outcome and result in better decision making.

We have already discussed that the single greatest cause of family office failures is a lack of discipline and self-control. High net wealth families are targeted by investment firms constantly with new ideas and there are a lot of terrible ideas and terrible investments out there. It only adds to the complexity when friends or extended family are putting forward these 'opportunities'.

The presence of experienced advisers serves as a protective firewall to bad deals without closing your door to new opportunities. It also becomes the adviser's role to unemotionally explain to the offeror/vendor why the family office is not proceeding with an opportunity.

Advice from 5th Generation Family Office CEO

- ✓ A structured decision-making process limits emotional influence from parent/child relationships in decisions to invest that are promoted by the next generation.
- ✓ Being actively involved in every decision isn't necessary. Working with other professionals leads to better decisions, while remaining flexible and agile.
- ✓ Do you want to manage the human dynamics of saying 'no', or is that best left to a third party?
- ✓ Be aware that the family's desire for privacy might limit the quantity and quality of investment deals being presented.

Building the firewall

With panel feedback identifying a lack of **discipline** as **the most dominant reason behind the failure of family offices**, the concept of the presence of process and an investment firewall is very important. A firewall ensures that as deals are presented, they go through a triage process.

Limited investments should get through the firewall if the correct advice process and experience is in place. The investments, once approved, should then be sized appropriately.

Entrepreneurs often fall into the trap of ignoring their personal balance sheet and focus solely on return. In doing so, they ignore the need to appropriately match assets with liabilities (liquidity, income generation) and accumulate a range of investments that have no specific role in the overall strategy.

The firewall also acts as a method of distancing the family from personal network approaches to ensure a commercial approach is applied to decision making.

With an effective investment committee and professional firewall in place, all potential investments go through a triage process before proceeding to deep and time consuming due diligence. This should include considerations around risk, return, liquidity, contribution to the existing portfolio, price, correlations and the macroeconomic outlook.

Each opportunity is assessed under an initial simple framework with four potential outputs:

- ✓ Outright no
- ✓ Yes, but not at this price
- ✓ Yes, but we need to discuss the parts we don't like
- ✓ Yes, proceed to full due diligence

The benefit of this framework is not simply avoiding poor investment decisions, but also avoiding wasting time and energy on investigating in unsuitable and/or bad ideas.

Well governed family offices have an investment policy run by an investment committee based on clarity around the strategic plan for the capital. The whole portfolio reflects the risk profile of the family.

How advisers can help

> "The characteristics of a good outsourced provider is someone who can sit across the entire picture (in a business model that supports that). Even if they don't manage all of it, they need to be across all of it."
>
> **External CFO** – Service Provider

If an outsourced advisory team is across the whole picture, the team is in a great position to advise the family how to assess the investment opportunity properly and apply the appropriate due diligence to ensure it aligns with the objectives of the family capital.

The CFO and CIO functions in an outsourced model are needed like a family board to sit at a strategic level representing the two disciplines of finance and investment.

Working collaboratively the two functions can build out an appropriate level of governance, common sense processes around how things will be done and how decisions will be made and how information will be disseminated – **the basic professionalising of processes.**

Conclusion

Through our interviews with successful family offices and our experience as an outsourced provider, we have observed the following best practice approach and common mistakes.

Best practice : A stepped approach

1. **Decide on the purpose for the wealth and how actively involved you wish to be.**
   The second decision largely drives what form of family office is appropriate.
2. **Set the foundations.**
   Regardless of the insource/outsource combination, embed the two disciplines of finance and investment with a clear strategy for ongoing governance and disseminating information to the family.
3. **Build the outsourced investment model first.**
   Devote time to it. Get the right relationships in place. Get it working.
4. **Decide on what is insourced and work out the direct model.**
   Typically families will directly invest in areas that the individual/family has expertise or an 'X factor' in.
5. **Be aware that the family office needs will change with time.**
   Have the right team around you to support that change over the journey.

Common mistakes

1. **Hiring a team before deciding a strategy**
   The wealth that was generated to place the family in the position of considering a family office construct was generated in a professional manner. Similarly, there is the need to assemble a high quality team that can provide the appropriate expertise over the ensuing journey. Acting in isolation has been shown to both elevate risk and limit sources of return.
2. **A lack of discipline**
   The most common reason why generations of wealth is lost is due to a lack of discipline. Rigour is critical. Don't do every deal that hits your desk.
3. **Ending up with a portfolio of good ideas as opposed to a good portfolio**
   Investing in an ongoing list of investments without these investments aligning to the purpose of the capital leads to sub optimal outcomes.
4. **Poor communication to family members - *especially the less involved members*.**
   It is incredibly important from a relationship perspective to have a structured and transparent method of communicating to all adult family members and involving and educating children, at the appropriate time. Poor or no communication generally erodes trust. Many founders have trouble pulling together the picture and articulating it in a way that makes sense to the next generation.
5. **A model where the economics of running the office don't make sense**
   With annual personnel costs of c $1m - $1.5m alone, to fund a high calibre inhouse CIO and CFO, a c $100 million capital base is the minimum threshold for running an inhouse model.

The way wealth is managed is a personal decision. It is very important to take time to reflect and decide on whether the individual views the family office as a business venture or are the objectives different to this. Personal reflection is required and consideration should include, 'What is important to you? What are you wanting to achieve? What do you hope for? What is the wealth for? What is keeping you up at night? Is it now time to have fun? What is fun?

As said by one panel member in describing a client's thought process:

> "Why the hell would we want to run our own operation if we just want to know wealth is preserved and the family is looked after?"
>
> **Retired Entrepreneur**

Our Message

This white paper was designed to provide an initial overview as to the family office ecosystem including an outline of the various functions and how they may be sourced.

The key message that has emerged from the research process is that the family office model can be constructed across a spectrum of services some of which are insourced and some of which are outsourced. There is no one single right or wrong or superior model. While there are best practice principles that should apply to any family's office construction, **the customisation beyond that point should align with each family's circumstances, their purpose for the capital and how actively they wish to be involved.**

Koda is an Indigenous word which translates to friend or ally. Consistent with this theme, Koda's role is to assist in these preliminary conversations, build a plan and guide our clients on their journey.

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Sean Abbott is an adviser and partner of Koda Capital. He has been a financial adviser since 1998. He holds a Bachelor of Business, Finance Major (UTS), and a Graduate Diploma in Financial Planning (SIA), and holds the Financial Planning Association peak international certification of Certified Financial Planner.

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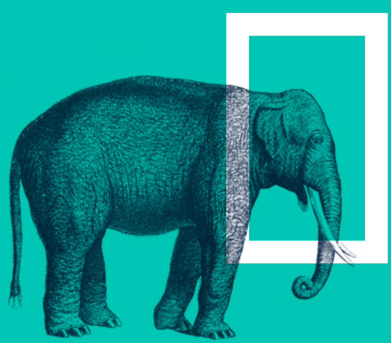

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