Sentinel Trust Company

# On Watch

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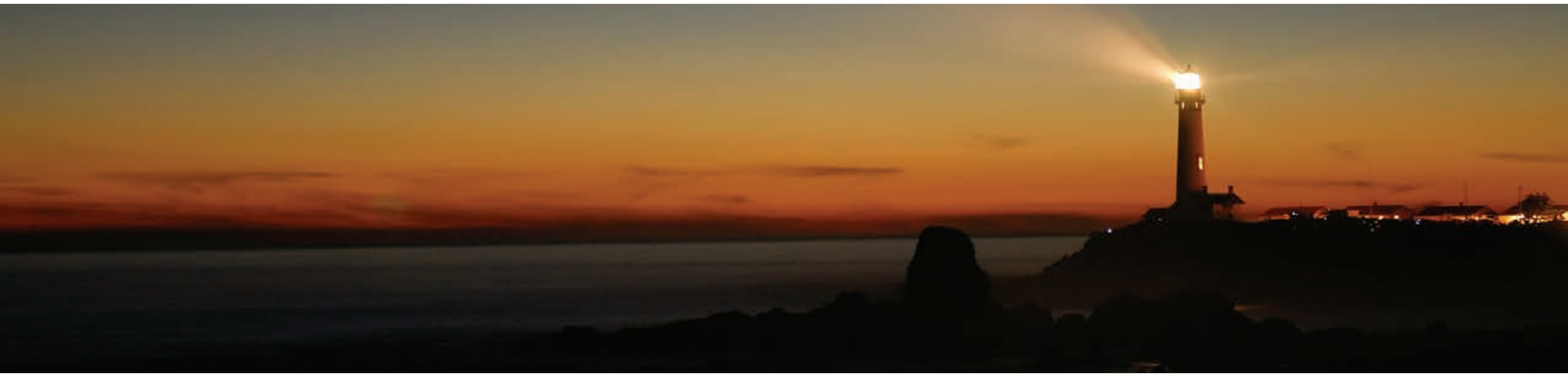

# Have I Got a Great (Direct) Deal for You!

D. FORT FLOWERS, JR., CFA
*President and CEO*

## In This Issue:



Most wealthy people are approached by friends and acquaintances offering opportunities to make direct investments in start-up businesses, real estate developments, or similar high-risk/high-return opportunities. Some politely decline all such offers, while others enjoy the opportunity to be close to the action.

Obviously, early-stage direct deals should be evaluated very closely on the merits as well as the risks. Each opportunity is different and all require unique in-depth due diligence, but there are some general questions that should *always* be asked, including:

### 1 Why me?

Every successful investor evaluates opportunities with a healthy dose of skepticism. That skepticism is especially important when considering direct deals. Are you being asked to invest because you have expertise in the field and your participation will encourage others to participate? Or, are you being shown the opportunity because the deal or its terms are not attractive to investors with more knowledge or experience?

Story continued inside ...

Story continued from front ...

## 2 | What value do I bring to the investment other than cash?

We all have heard stories of investors who have earned tremendous returns investing very early in a company that later turns out to be hugely successful. Unfortunately, for every big success there are thousands of companies where early investors lose most or all of their money. For non-professionals, success often depends a lot more on luck than skill. As an amateur the odds are almost always against you.

Unless ...

Your presence in the deal brings significant value in addition to the cash you invest. If your knowledge, experience, and network of connections bring value (assuming that you are willing to devote the time and reputation risk to the opportunity), then your participation may create more value for yourself and all the other investors. This may be sufficient to tilt the odds in your favor. We typically advise clients that if they don't bring something more than cash to the deal, they should not invest.

## 3 | How should I decide the size of my investment?

The size of the initial investment is typically a very difficult decision. By the time the analysis has been done, an investor is excited about the prospects and has devoted a great deal of time. This often leads to a willingness to invest much more than is prudent. We often advise clients who are considering direct investments of $1 million or more that they really should be considering something more like $50,000 to $100,000.

When deciding on size, consider the following:

- *How much can I afford to lose?* Since many direct deals fail, invest no more than you can afford to lose. Also, consider "afford" in the broader context of the amount of anxiety and emotional pain that you will feel if the company fails.

- *How will this investment compare in size to similar investments in my portfolio?* Because investments of this type have such a high failure rate, it's important to have very diversified exposure. We suggest that clients look at the size of their exposure to similar investments on a look-through basis. For example, if they have a $2 million commitment to a private equity fund that will make 20 investments, their average exposure (at cost) to each company in the fund will be $100,000. The investment in any direct deal should not be significantly larger than this amount.

- *How many follow-on investment rounds are there likely to be?* Successful startup companies typically require multiple rounds of financing before investors realize any profit. Investors need to consider how much more they may have to invest in these subsequent rounds in order to protect themselves from dilution. If you don't have capital to invest in a "down round" (where shares are priced well below earlier rounds), your returns may effectively disappear through dilution.

## 4 | Should I insist upon participation by an independent professional?

The answer is almost always yes. Investment by an experienced private equity fund or other independent professional investor offers many benefits, including:

- You gain comfort that someone with significant experience evaluating direct deals views the opportunity as compelling.

- You also gain comfort that the investment terms negotiated on behalf of the investors are "market."

- You will benefit from the presence of an independent professional on the board.

- If the idea turns out to be a good one, but management is unable to perform, the professional investor will have experience making timely changes.

- Professional investors are likely to recognize earlier than you that it's time to pull the plug and stop throwing good money into a losing situation.

## 5 | Are my interests aligned with everyone else?

It is important to understand the interests of everyone participating in a venture so that you can evaluate conflicts that may arise. Consider:

- Ensure that management's potential for wealth creation is sufficiently tied to the investors. Beware of situations where cash compensation will ensure that management is successful whether or not the investors realize a decent return.

- Investment terms should either be the same for all investors or, if some investors have preferential rights (typically because of the size of their investment), the terms should give sufficient protection to the smaller investors.

- Everyone's "pain tolerance" should be similar. You want to be invested with others who have the capacity to proportionately inject more funds in the deal as long as it remains promising. If others have a lower pain tolerance, you can be put in the difficult position of either increasing your funding above what you planned or letting the deal fail despite continuing promise.

*This article is based on a presentation Fort Flowers made at the Thunderbird School of Global Management in October 2011.*


IT'S LIKE TAKING A TRIP.

IF YOU DON'T KNOW WHERE
YOU WANT TO GO,
YOU WILL BE SURPRISED
WHEN YOU GET THERE.

*(Odds are that it won't be a good surprise.)*

# Should You Make Gifts?

Pressure to make large gifts is rising thanks to Congress' two-year increase in the lifetime gift exemption from $1 million to $5 million. Of course, no one knows whether Congress will extend its largess beyond 2012 (indeed there are rumors of an imminent reduction), so advisors are recommending that you use it or lose it. But, you're not so sure that beating the IRS out of some gift or estate tax is sufficiently compelling for you to make gifts.

Why are you hesitating? I've known incredibly wealthy people who lack confidence that they will have enough to live on for the rest of their lives. You might be comfortable parting with a chunk, but maybe don't want the kids to get their grubby little hands on it, fearing it might screw up their work ethic and moral and social values. Or, they might fight over and destroy it.

Truth be told, you would like to suspend your wealth somewhere out of the kids' reach, where you can control it, access it for investment purposes, and perhaps use it if chaos descends on the world. Well, more chaos than there is already.

Unfortunately, sitting tight and doing nothing is not the right answer. You must take some type of action to change things for the better.

An 82-year-old business owner once told me that his son wasn't quite ready to take the helm of the family business. "How old is he?" I asked. "About 55," he replied. Well, who's fooling who? If the kids aren't quite ready for the responsibility, what's going to change them?

I am not telling you to make gifts to spendthrift children or to give control to those who are incapable of handling the responsibility. Long ago, a client told me that my great estate planning technique would just make his kids richer rather than just rich. It would give them twice as much to fight over and squander. At least Uncle Sam takes his share and goes away happy.

Life is full of uncertainties. The best way to deal with them is to honestly assess the cards you have been dealt. More wealth than you can possibly spend; or maybe not given the state of the economy? How can you think this through rationally? Kids aren't quite ready? How will you teach them? Too much financial risk? What steps will you take to reduce that risk? Don't want to retire? OK, but I guarantee you will be retired one day. Who will take over then and aren't there some things you should do to prepare them and the company for that day?

Once you've assessed the situation, you need to determine your objectives. It's like taking a trip. If you don't know where you want to go, you will be surprised when you get there. Odds are that it won't be a good surprise. Then, develop a plan. Include your spouse and advisors in this process. If they can't help or don't understand, get rid of them (I mean the advisors!) and find some who can. By the way, with thoughtful planning, it is possible to part with a chunk of wealth, continue to control it, retain access to it, keep it away from the kids, and keep Uncle Sam away – all at the same time. Your advisors can help you, but they need to understand your objectives and concerns to develop a plan that you might actually execute.

An incredibly philanthropic client once told me that he wasn't interested in leaving wealth to charity when he dies. "I want to give it away while I'm alive so that I can enjoy seeing the charities use it wisely and maybe guide them in doing so." Wouldn't that make sense with family, too? Whether to charity or kids, don't just write a check. Give them the education and guidance that they need to handle the responsibilities. Then, test them. Hopefully, the result will give you great pleasure. If they don't handle it well, adjust your plans accordingly.

You better hurry. You'll have a lot to do and it takes time. Maybe you can get comfortable with the idea of making big gifts before the December 2012 deadline. Maybe not. But, making headway in resolving your concerns and accomplishing your objectives will make the process well worthwhile even if you don't take advantage of an expiring tax opportunity.

ROSS W. NAGER, CPA
***Of Counsel***

*Ross' title recently changed to "Of Counsel" in recognition of his reduced time commitment to Sentinel. Although he has given up internal management responsibilities, he will continue to serve our clients and friends. His contact information remains the same and he will retain his Sentinel office. We are pleased that this change enables Ross to pursue teaching and other activities of interest to him.*

# What Are The Important Papers?

**No matter the circumstances, an evacuation is a stressful situation, but knowing what to bring can help alleviate that stress.**


It was an interesting summer. Our clients evacuated their homes in the northeast to escape flood waters, were shaken by a rare earthquake in Virginia and fled from the paths of wildfires in Texas. In these types of events, the public is told, “Take your important papers with you.” But what is important enough to grab when you have only a few minutes to pack precious belongings? How can you be better prepared to respond to an emergency and what is truly irreplaceable?

Of course, family and pets take first priority; be sure you have everyone’s medications, eyeglasses, car keys and cell phones (with chargers). Gather those up and then address documents that you have stored in your home. (Those in a bank vault should be secure.)

The most important documents to take with you are government issued identification such as your passport, driver’s license and social security card. With those, you can easily replace credit cards, deed records, birth certificates, medical records, car titles, bank records and insurance policies that you might fail to take with you.

If you have retained your original will, medical directive or power of attorney, bring them with you. Your lawyer may have a copy, but probating a copy of a will is cumbersome and generally more expensive. (Those original legal documents are best left in the hands of a professional and not in a safe deposit box or drawer at home, but that is a topic for another day.) Also bring any foreign birth records, unrecorded deeds or titles, original stock certificates, bearer bonds and cash. Many of those items are difficult or impossible to replace.

Take the information that you need to start the recovery process, including the name, phone and policy numbers for your home, flood and car insurance policies. Your medical insurance card and checkbook will be much more useful than last year’s payment records. Don’t worry too much about your tax returns, bank, trust and investment account records since they can be reconstructed, but account numbers and contact information will be useful. (If you believe that strangers might enter your home before you return, place sensitive papers in a locked drawer.)

You should have an inventory of the contents of your home and if a copy hasn’t already been stored somewhere else, bring it with you. Don’t have one? You can hire a videographer to walk through the home with the camera rolling, describing art, antiques and other valuables to create a complete record of contents. Lacking that, take your cell phone, stand in the middle of each room and snap a picture in each direction. Even if the photo quality is poor, it will help you remember what was there if you have to file a claim.

If you have your home inventory, valuable documents, irreplaceable digital photos, etc. on your computer and don’t routinely back up your hard drive to a website or other offsite location, grab the computer or remove the hard drive and take it with you.

Finally, bring your address book in whatever format you use – computerized or an old fashioned rolodex. Imagine what it would be like to lose the addresses and phone numbers for your dentist, veterinarian, tailor, college buddies, and your cousin in Ohio all at the same time.

No matter the circumstances, an evacuation is a stressful situation, but knowing what to bring can help alleviate that stress. Fortunately, the vast majority of people who must evacuate in a disaster return to a home that is unscathed.

LESLIE KIEFER AMANN, J.D.
*Senior Vice President – Lead Fiduciary Officer*

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.

**For further information**, please contact Anthony DeToto, Senior Vice President, at adetoto@sentineltrust.com or 713.559.9578.

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**Contributing to this issue:**
Leslie Kiefer Amann, J.D.
Anthony J. DeToto
D. Fort Flowers, Jr., CFA
Ross W. Nager, CPA

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.

2001 Kirby Drive, Suite 1200
Houston, Texas 77019-6081
713.529.3729

**www.sentineltrust.com**