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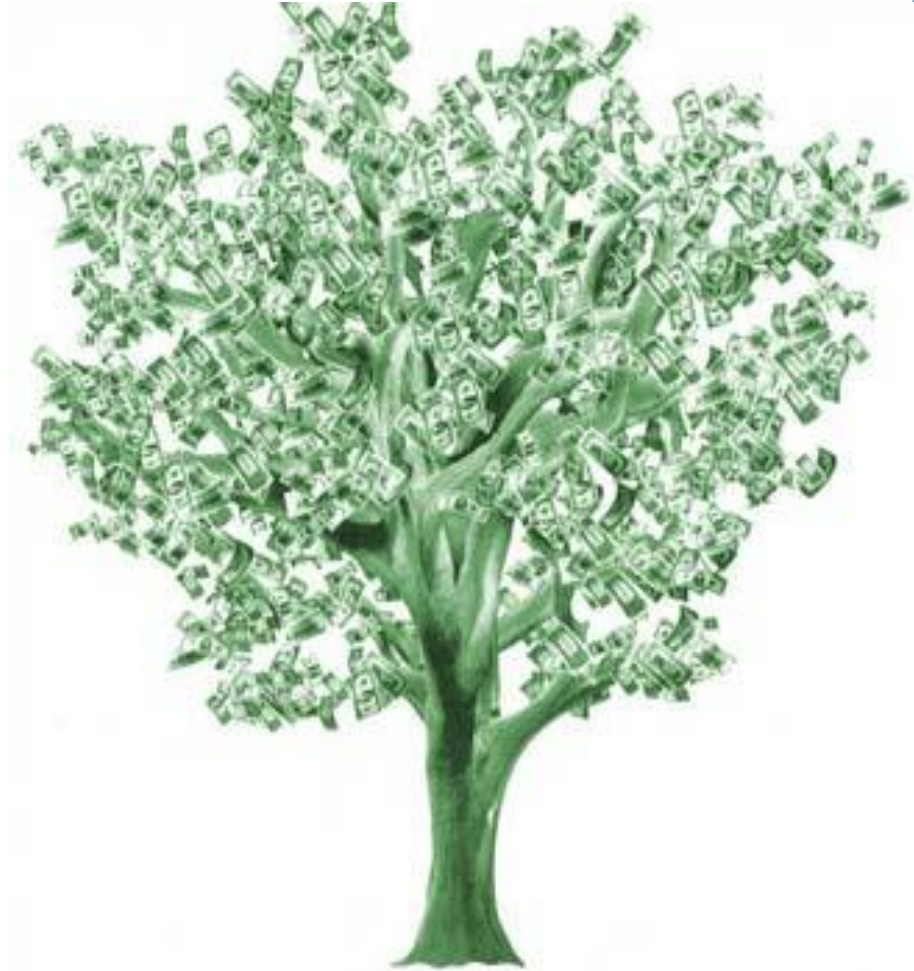
LOS ANGELES



The Family Business Consulting Group, Inc.®

www.familybusiness.com

Managing Capital and Liquidity in a Risky World



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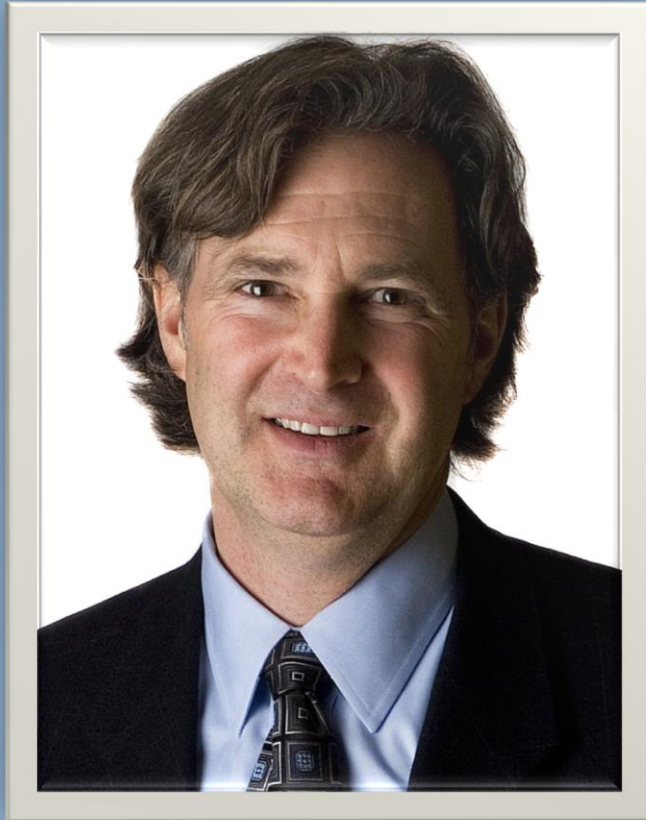
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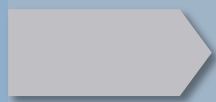
TORONTO

Today's Presenter

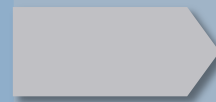


Gregory G. Greenleaf
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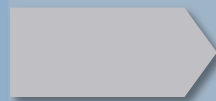
Today's Outline



Theory



Real Life Examples



Opportunity for Q & A

Goal for today's presentation

Review why it is essential for the **stakeholders** in family businesses to understand the competing needs for **capital** in the business and **liquidity** for shareholders



Goal for today's presentation

- Explain why *balancing* **Capital, Liquidity** and **Family Control** is critical for long-term success of a family business
- Offer *suggestions* and *approaches* for **liquidity** options

Why is this topic important for both family businesses and their trusted advisors?

- Helps families to avoid:
 - deep resentments and fissures that can destroy a family
 - collapse or failure of the business
- Helps families to achieve:
 - success in their family
 - success in their business

Family business have three types of capital

Human capital

Family business have three types of capital

Intellectual capital →



Focus of today

Financial Capital



Perspective

- **30%** of all family businesses make it through the second generation into the third generation
- **10-15%** make it through the third generation
- **3-5%** make it to the fourth generation
- Thus the expression “shirtsleeves to shirtsleeves in three generations”



Why Do Family Businesses Fail ?



Lack of succession planning

Poor business performance

Inadequate estate planning

Family Dynamics

Why Do Family Businesses Fail ?

Family businesses are constantly walking a tightrope. On one side is the need for **capital to grow** the family business.



On the other side is a need for **shareholder liquidity**. Shift too far one way or the other and it's a long way down – sometimes without a net

Why Do Family Businesses Fail ?

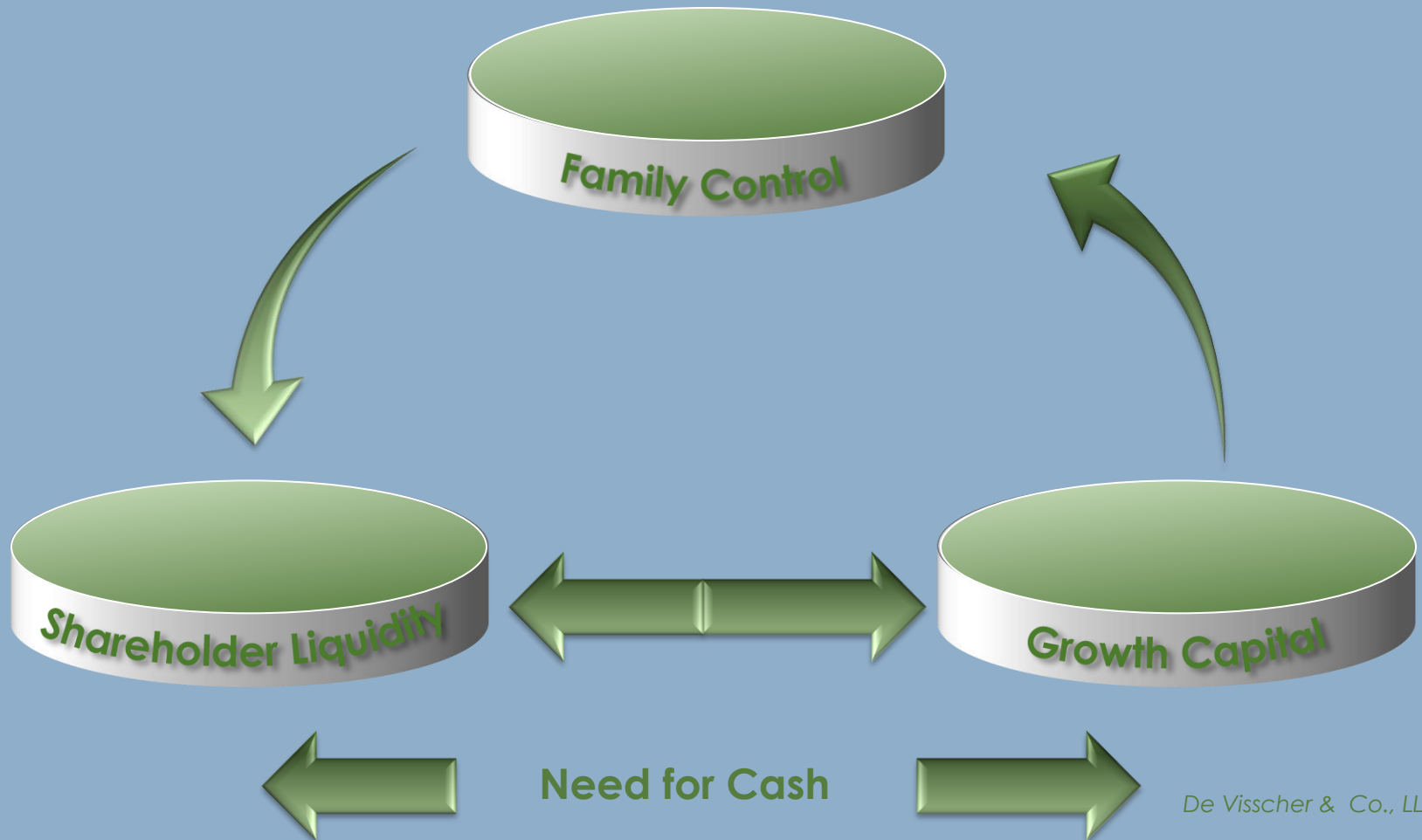
A man in a dark suit is running through heavy rain. He is looking down and to his right, with his right hand raised to his forehead as if shielding his eyes. The background is dark and filled with streaks of rain. A bright lightning bolt strikes down from the top left corner of the frame.

Lacking balance between these three aspects of the family business

- **Liquidity** needs for shareholders
- Continuous **growth** of the company
- Maintaining **control** of the business

The Family Business Triangle™

Balancing three needs in a family business system



De Visscher & Co., LLC©

Balancing Capital and Liquidity Needs

How well one balances these competing needs will determine the health of both the **business** and the **family !!**



What is “Liquidity”?

- Speed at which an asset may be converted to cash
- Being “in cash” or easily convertible to cash; debt paying ability
- Distribution or dividends



What is "Control"?

- Power to direct or determine; "under my control"
- The activity of managing or exerting direction over something



What is “Financial Capital”?

- Assets available for use in the production of further assets
- Wealth in the form of money or property owned by a person or business



Definition:

“Patient capital” is equity provided by family business owners who are willing to balance the current return on their business investment with the merits of a well-crafted, long-term strategy and continuation of the family tradition and heritage.

Attributes of “Patient Capital”

Stability of capital structure

Long-term investment strategy

Tangible and intangible return on equity

Commitment to all stakeholders

Presence of family values

Drawbacks of “Patient Capital”

Strategic immobility

Commingling of family business and business of the family

Increasing cost of patient capital with every generation

Few companies can match the family business's potential for investor cohesiveness.

However, this cohesiveness must be constantly nurtured.



Family businesses that have successfully transitioned “Patient Capital” from generation to generation share these attributes:

They have a performing family business that is creating value for shareholders

They have effective liquidity programs for shareholders, allowing them adequate return, freedom of choice of their investment in the family company and the assessment of its value. In other words, patient capital is not trapped capital.

They invest in the family effect and in strong family governance to reinforce the values, commitment and family heritage.

Family Control Needs

- Shareholders must be cohesive, motivated and committed enough to take risks and build the business for the future
- This **unity** among shareholders is called “**The Family Effect**”



How to Maximize the Family Effect:

1. Schedule regular family gatherings
2. Develop shareholder education programs
3. Review business results together
4. Talk about business trends and strategy
5. Review trends in shareholder value
6. Discuss the responsibility of the business to its stakeholders
7. Prepare a family mission statement

How to Maximize the Family Effect:

8. Develop a statement of family values
9. Discuss how family values are manifested in the business
10. Research and write a family history
11. Hold celebrations such as a Founder's day picnic
12. Work together for a charitable cause
13. Organize a family foundation

Fact

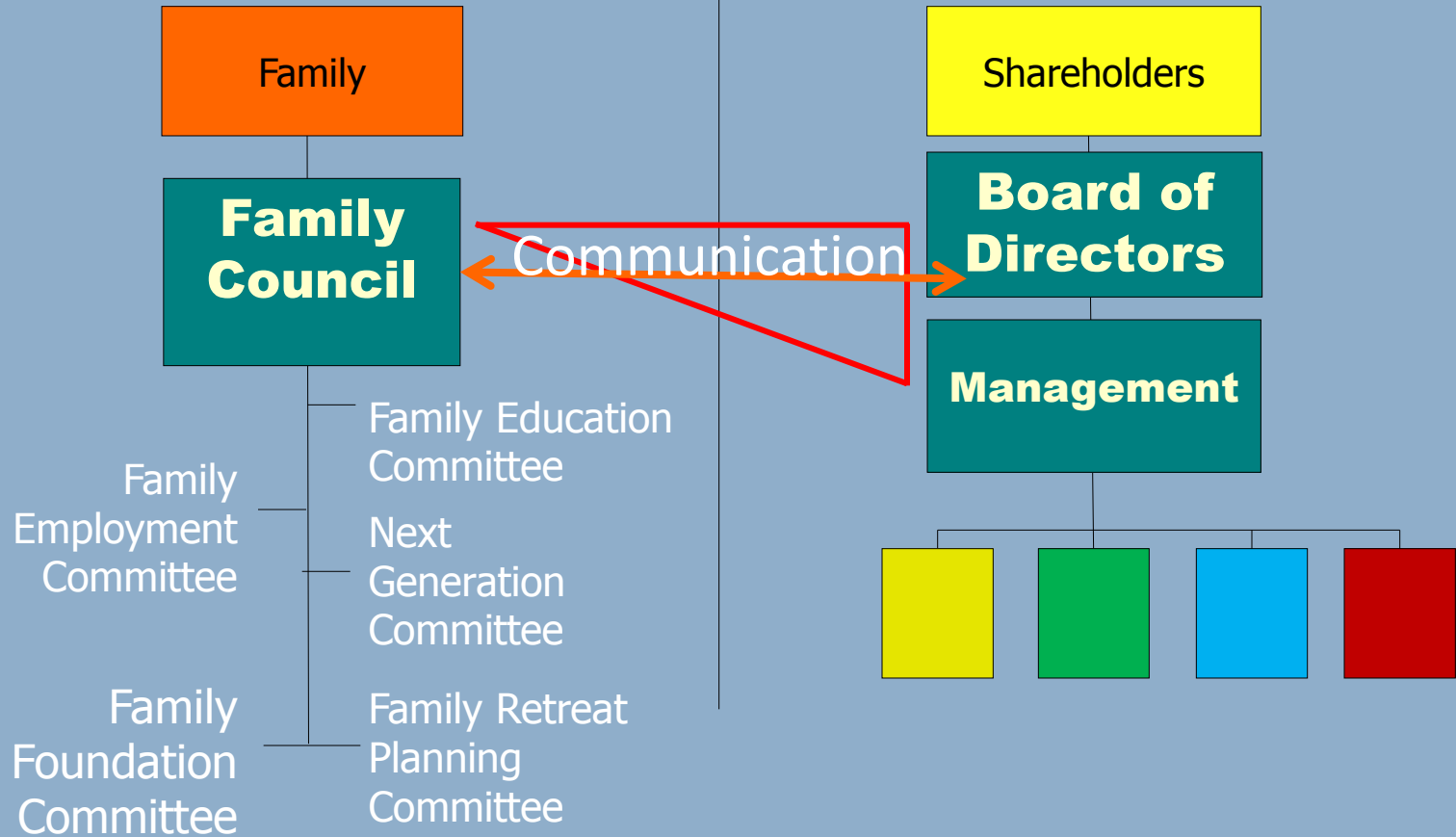
Good governance is key to maintaining the “Family Effect”

Governing the Family and the Company

	Family Governance	Corporate Governance
Vision and Mission	Family values, wealth objectives	Strategic directions, risk level, target markets
Structures	Family assembly, family council or family office	Board of directors and its audit, nominating and compensation committees
Policies	Family business ownership, code of conduct, communication, liquidity opportunities, representation to the family business board of directors, employment rules of entry, family perks, conflict resolution	Oversight of financial reporting and auditing, executive sign-off on financial statements, strategic planning, whistleblower protection, executive compensation and perks

Business of the Family

Business of the Business



Evolution Of Family Control Needs

Generation	Owner/Manager Stage I	Sibling/Partnership Stage II	Cousin/Collaborative Stage III
Ownership Structure	Concentrated ownership among founder or founders.	Emergence of inactive shareholders	Advent of minority shareholder class; transition from ownership to family control
Liquidity Sources	Owner's compensation	Dividends and limited internal redemptions	Dividends, internal redemptions and outside capital
Capital Sources	Primarily business cash flow	Business cash flow and some external debt or equity financing	Capital needs of the business far exceed the means of the family, requiring a search for outside capital
Causes of Financial Conflict	Cash flow allocation between business and personal use	Dividends to all shareholders vs. salary and benefits to active shareholders	Tension between goals of business growth vs. shareholder desire for current return; differences over adequate return on equity

Many family businesses die because **capital** and **liquidity** problems erode their “Patient Capital”, which prevents them from surviving, generational, strategic or ownership transitions



CLOSED

Death of a
shareholder

Divorce of a
shareholder

Personal
financial
bankruptcy

Business
ventures

Other personal
financial crises

Occasional Factors

Factors that tend to increase family business
shareholder demands for liquidity

Weakening
of family
cohesiveness
and
commitment

Limited
recognition of
inactive
shareholders
to business
success

Conflicts
between
active and
inactive
shareholders

Heavy
dependency
by shareholders
on income from
the business

Concentration
of shareholders
in the same
age groups

Family Factors

Factors that tend to increase family business
shareholder demands for liquidity

Shareholder
disappointment
in current
returns

Lack of
shareholder
access to
appreciation

Lackluster total
return on
equity
(dividends plus
appreciation)

Shareholder
need to
diversify
investment

Reinvestment
opportunities
elsewhere for
shareholders
wealth

Financial Factors

Factors that tend to increase family business
shareholder demands for liquidity

Liquidity options

Increased dividend

Increase dividend payout rate to maximize shareholders income, thus extracting liquidity over time.

Leveraged distribution

Incur borrowings (senior debt or a combination of senior and subordinated debt) to facilitate a one time dividend or share buyback.

ESOP

Incur borrowings (senior debt) to provide ESOP trust with funds to purchase shares from selling shareholders.

Recapitalization

Raise combination of external debt and private equity to effect a buyout in conjunction with family, management or broader base of employees.

100% sale

Sales of the Company, ideally to a strategic player best able to pay a premium.

Increased dividend

Benefits include:

Shareholders retain control and ownership.

Secures all of the future upside for shareholders.

Business “legacy” continues.

Drawbacks include:

Amount of liquidity limited to company’s ability to pay dividends.

Liquidity paid out over time (time value of money).

Management may become disenchanted if company operated as “cash cow”.

Company can stagnate with no re-investment.

Increased dividend

Tax Considerations:

C Corp earnings subject to double tax.

No basis offset if C Corp has earnings and profits.

S. Corp distribution may be tax-free if shareholder has basis in the S Corp shares.

Foreign shareholders may be subject to withholding.

Leveraged distribution or buyback

Benefits include:

Provides partial liquidity to selling shareholders.

Continuing shareholders retain control and ownership.

Secures substantially all of the future upside for continuing shareholders.

Business “legacy” continues.

Drawbacks include:

Amount of liquidity limited to debt capacity.

Reduces financial and operation flexibility, cash flow consumed by debt repayment.

Expansion prospects somewhat curtailed.

Out of favor in current debt market.

Leveraged distribution or buyback

Tax Considerations:

A redemption (i.e., a stock buyback) may or may not be a dividend.

A plan of redemption may create phantom income to non-redeeming shareholders.

Ability to deduct interest at corporate level may be limited.

Net operating losses (“NOLs”) generated by interest deductions may not be carried back.

NOLs may be limited due to ownership change.

Leveraged Employee Stock Ownership Plan

Benefits include:

Provides partial liquidity to selling shareholders.

Offers significant tax benefits to company and shareholders if structured properly.

Provides ownership opportunity for broad base of employees.

Business “legacy” continues.

Drawbacks include:

Selling shareholders can't participate in ESOP.

Amount of liquidity limited to debt capacity.

Reduces financial and operating flexibility, cash flow consumed by debt repayment.

Employee buy back provisions can create cash drain.

Leveraged Employee Stock Ownership Plan

Tax Considerations:

Proceeds may be received and reinvested tax-free.

Company gets deduction for distributions made to ESOP Trust to cover acquisition debt repayment.

Recapitalization

Benefits include:

Received “fair” value for the company.

Immediate liquidity to selling shareholders.

2nd bite of the apple for continuing shareholders.

Platform for growth, opportunity for employees.

Business “legacy” continues.

Drawbacks include:

Potential shift in strategy, including pressure for aggressive growth.

Shares upside with the investors.

Requires company to operate with increased financial leverage.

100% sales of the company

Benefits include:

Potential to receive strategic premium.

Provides full to liquidity to all classes of shareholders immediately .

“Clean break”

Drawbacks include:

Sale process/execution risk.

Strong possibility of changes to the business “legacy.”

Strong possibility of management/employee changes.

Recapitalization and 100% Sales of the Company

Tax Considerations:

Can be structured as taxable or tax-free transaction.

May have different results (taxable versus tax-free) for different shareholders.

Sale of stock or assets is not the only way to generate value (e.g., non-complete and employee agreements).

Fact:

Shareholders who lack emotional attachment to the family or whose family relationships are troubled are more likely to pressure the business for cash

Real Life Example

- U.S. based manufacturing company
- Founded by three brothers
- Third generation – ten cousins have ownership
- Fourth generation – six adult family members have ownership (so far)
- Historically one male family member from each branch worked in the business

Poor Family Relationships

- Non-working family members told “take your checks and stay out of our business”
- Family managers increased distributions to keep shareholders from asking questions

On The Verge Of A Train Wreck

- No annual shareholders meetings
- No formal board meetings
- No independent directors
- Nearly 100% of profits after taxes distributed annually for years
- A generation of disengaged, uninformed owners

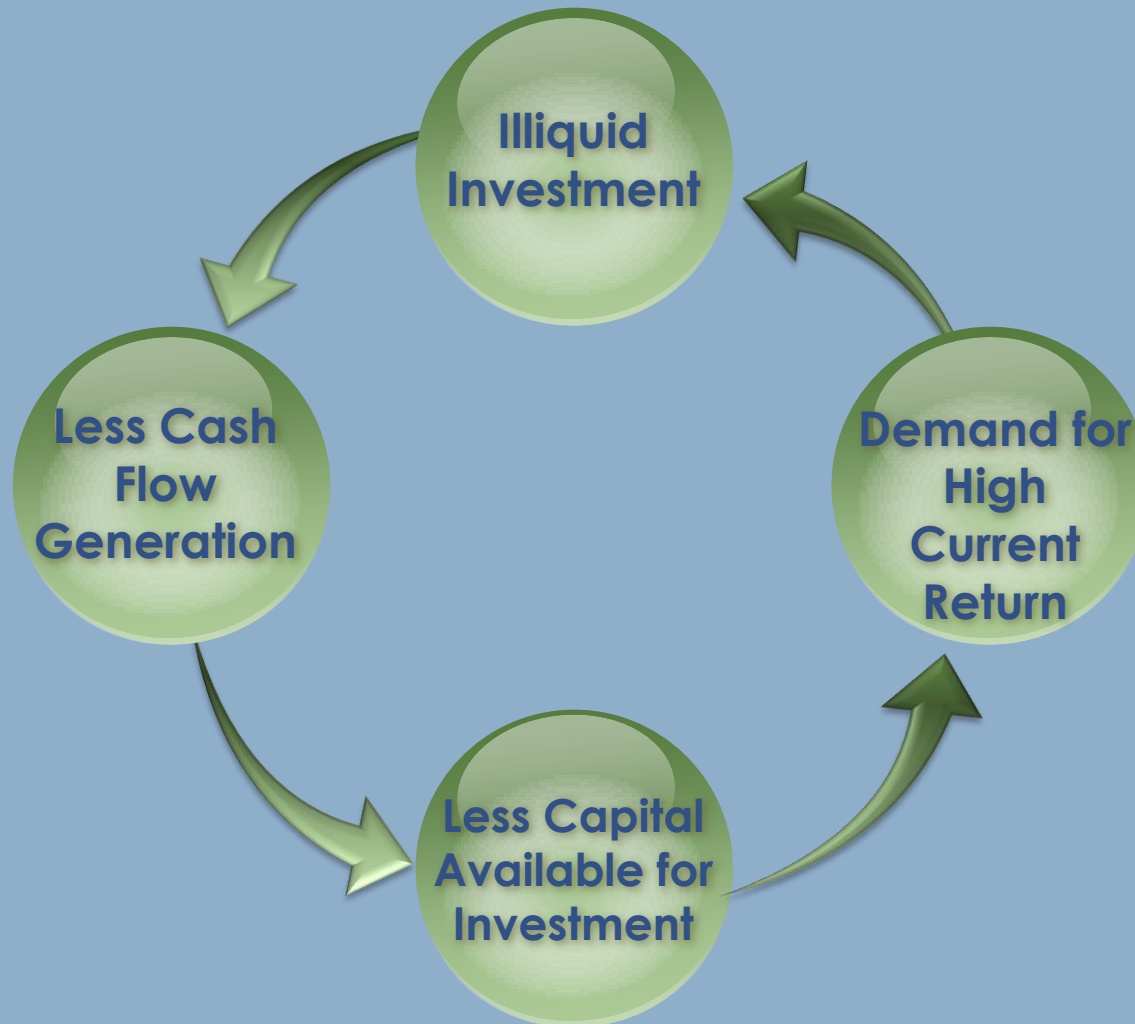
On The Verge Of A Train Wreck

- Without new product development the company is falling behind competitors
- Profit margins are being squeezed
- Difficulty recruiting new talent to company
- Managers recommend that dividends be slashed so they can reinvest in new products

Crisis

- Shareholders who are dependent on distributions for sole source of income are furious
- Several non-working shareholders want to sell “before it’s too late”
- Family working in the business fear they will be without a job if company is sold
- Family is being torn apart

The Downward Liquidity Spiral



Solution:

- Family agreed to bring in a family business advisor to address issues of conflict
- After many shareholder meetings consensus was reached to keep the business and fix the family
- Shareholders agreed to bring four independent directors onto the board

Solution:

- Distributions were reduced by 40% with plans to scale back further over time
- Reinvested proceeds into R & D and into beefing up existing products
- Shareholder redemption plan was put in place

Solution:

- Several family members have sold off assets to replace their lost income
- Two have gone back to work part time
- Family is meeting on a regular basis to prepare the next generation to become “good owners” or stewards of the family business

Reality

Sometimes the best thing to do is sell the family business

Weighing a sale of the family business

Why some families choose to retain their business

Potential of family business as a wealth-creation vehicle

Family pride in ownership

Competitive advantage of staying private

Business ownership as a valuable component of family heritage

Desire to pass on opportunities to children

Role of business in keeping family together

Fear that passive wealth could harm family values and work ethic

Concern that investing in new areas is more risky than maintaining business

Weighing a sale of the family business

Why some families choose to sell their business

Lack of capable successors

Lack of capital to grow business

Threat from large, well-financed competitors

Shareholder liquidity demands

Estate tax burden

Lure of high sale prices from private or public markets

Promise of greater wealth by reinvesting assets

Shareholder desire to diversify investment for higher return

Lack Of Capital to Grow the Business

- **The Device Company**
- Manufacture of products for the aerospace and off road vehicle industry
- Mr. Smith is second generation CEO
- Five daughters, three work in the business
- Four son-in-laws, all work in the business
- Mr. Smith is sole owner
- Business has grown rapidly over the previous ten years

Lack Of Capital to Grow the Business

- Very capital intensive business
- Ability to grow was limited by lack of liquidity
- No distributions beyond what was required for taxes
- Company did not qualify for additional credit
- The business model was changing with much longer payout periods.

Lack Of Capital to Grow the Business

- Life insurance for estate planning had become unaffordable
- CEO & father - “I don’t see how my children can afford the estate tax”
- “Should I sell all or some of the businesses?”
- Family met for over thirty, full day meetings
- Family meetings included owner, wife, daughters and son-in-laws

Lots of Questions!

- Family weighed their options:
 - Did they want to bring in outside investors?
 - How would this impact their control of the business?
 - How would they continue to compete against well financed global competitors?

Lots of Questions!

- What were the benefits of selling?
- Would they still have to work?
- What other careers would the family pursue if they needed to work after selling the family business?

Decision

- The family unanimously decided to sell their aerospace company and keep the off road vehicle parts company
- Consulted with expert advisors:
 - Estate tax attorney
 - Business broker
 - Wealth management firm

Success

- Agreed on who would stay on with the new business and what the other family members would do:
 - one pursued dream of being a professional golfer,
 - another opened a Yoga studio

Success

- Sold their business at market high
- The sale of the company assured liquidity for future generations
- Proceeds from sale funded capital growth of the remaining business

Success

CEO – father:

“We were a close family before all this, we are even closer now”

Reality

In order to keep your
“Patient Capital” - patient,
you need to provide
timely shareholder liquidity

Real Life Example

- Large Catholic family
- Second generation has eleven siblings ages 48-66
- One son passed away leaving five men, six women
- Four of the remaining five men work in the business
- Family committed to keeping the business in the family

Real Life Example

- Two operating companies
 - Mining
 - Manufacturing
- No distributions made beyond what is needed for taxes
- All profits reinvested
- No formal board of directors
- Annual shareholder meeting

Real Life Example

- Company is well capitalized
- Very little or no debt
- Control of company is maintained in the family
- Very little estate planning is in place
- Family members begin to worry how do I pass this onto my children?

Trapped in the Family Business

- Only way to receive benefit from ownership
 - Work in the business
 - Sell your shares back to the company
- Annual shareholder redemption plan worked reasonably well but.....

Challenge

- Only way for non-working shareholders to maintain current lifestyle (and retire) is to sell out completely
- Family realizes they will need to use all of the company's cash flow and/or borrow to buy out the non-working shareholders
- The cost of capital will dramatically increase over time

Challenge

- Business risks loosing their complete advantage
- Family members realize they can't pass the business onto their children if they sell all their stock
- They can't honor their fathers wish that the business be there for future generations

Solution

- Board called a meeting to discuss the issues
- Board agreed to issue a one time major distribution to give shareholders liquidity to stop or slow down shareholder redemption
- Distribution policy developed that would allow for ongoing liquidity
- Financial & estate planners consulted

Challenge

- Good example of a company that was well capitalized, and had maintained family control of their business, but over time was going to loose their **patient capital** and their **family unity**

Summary

- The business' need for **capital** and shareholders need for **liquidity** must be kept in equilibrium

Summary

- It is essential for shareholders to understand and manage the cost of capital
 - Cultivating shareholder unity and a solid understanding of the business is an important part of keeping capital costs low

Summary

- Satisfied, confident shareholders tend not to demand high current returns because they believe in the business' and the family's long term potential
- All of these support the “**Family Effect**”

- One of the critical hurdles facing all family businesses is to need to pass on a family **heritage**, not just a family business

Family businesses that have successfully transitioned “Patient Capital” from generation to generation share these attributes:

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The Family Effect:

The Core Competitive Advantage of a Family Business



Four Principals To Enhance The Family Effect

Enhance family communication

Cultivate shared interests

Educate shareholders

Foster an awareness of shared values

Remember:

As a family business matures, balancing the competing needs of **Capital** and **Liquidity** become a greater challenge



Few companies can match the family business's potential for investor cohesiveness

However, this cohesiveness must be constantly nurtured.

Good family relationships are like money in the bank!!!!



Questions?

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Additional Questions?

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Thank you

