Achieving growth via the perfect capital structure

Imagine Saddam Hussein, Karl Marx and Thomas Jefferson as co-owners of a family business. What might that company look like? And how would it function? François M de Visscher explains how it might just resemble the family business of the future ...

Traditionally, banks and financial institutions have provided the majority of external capital for family companies. However, in an increasingly global environment, those asset-based lenders have fallen short of enabling the family business to grow while providing liquidity for shareholders. Family businesses must therefore access a much more diverse array of capital.

Although private equity is currently grabbing all the headlines among the many possible investors who are flush in today's market, any such source of capital may place conflicting demands on the business and on family control. As such, there are three very different types of stakeholders that family businesses can look to:

- Private equity investors (the "dictators") who require a significant stake and involvement in the business and generally invest for the short-term while looking for high returns.
- Professional, non-family managers (the "socialists") who expect to share communally in ownership of the business and with whom family members will be expected to treat as co-owners and share financial information.
- Family investors (the "democrats") who provide long-term capital and usually wish to uphold family ownership and traditions.

How can these diverse stakeholders – dictators, socialists and democrats – co-exist in the family? In part, the answer lies in determining just the right mix of capital. The other part involves focusing each of these stakeholders and their sources of capital on a common goal: the pursuit of sustainable, profitable growth.

This focus represents a departure for family businesses that concern themselves with preserving capital, maintaining a low-risk profile and seeking liquidity. With new sources of outside capital, the mentality must shift to accept riskier activities that will enhance long-term profitable growth and value. This shift may occur naturally and organically in some families, along with the shift in generations. However, many large, extended families tend to fragment as a result of divorce and relocation over the generations. To stay on their growth trajectory, family owners may need to impose significant changes in the family's control structure.

BALANCING CONTROL

Pursuing sustainable, profitable growth for a family company is a long-term wealth-building objective. The family's "patient" capital will always be more long-term than any other source of capital. However, each one of those alternative sources fulfils an important role in growing the company and achieving shareholder liquidity.

Families have transitions, not transactions. Dictators, those private equity investors, have transactions, not transitions. They are generally willing to invest for five to seven years after which they will expect to exit the business. However, Their insistence on sharing control has a significant upside: they can bring financial discipline, industry expertise and management systems, which can help the family business achieve that next level of growth.

Socialists, who represent non-family managers, are individually motivated without having to take substantial risk. Most do not "buy" equity; rather it is part of their compensation package. Their investment horizon is as short-term as their employment – they need to see short-term returns and will exit if the value of their shares fails to rise in accordance with their efforts. To keep such managers focused on long-term, profitable growth, compensation packages must hinge on growth. Management equity is also an important attractor of private equity and other investors. While the timing of a manager's exit is difficult to plan, it's important to be prepared for it as the company will need cash to buy them out.

Democrats are family investors who provide long-term patient capital. They are willing to balance the current return on their business investment with the merits of a long-term strategy and continuation of the family heritage. However, some of that patient capital is beginning to fray. Their desire for short-term rewards has reduced what's known as the "family effect" – the combined value of the firm's ownership, heritage and stewardship. "What have you done for me lately?" is a common question at family business shareholder meetings.

Over time, two conflicting forces tend to impact the family democrats: the need for individuality and the need for collective identity. In the first case, as a growing family acquires different interests over the generations, keeping patient capital in place will require sustainable, profitable growth and returns. The business's capital structure will increasingly diversify as the family effect deteriorates, resulting in a greater financial return expectation on the part of family shareholders. On the other hand, as the family grows, more and more members end up with smaller individual ownership. The financial rewards on their investment in the family company become less important than the attributes of their family ownership. The notion of belonging to a business family, of being part of the heritage, will be a lot more important than the value of shares that represent less and less of each member's net worth. That trend will have an impact on patient capital.

To balance control and allow liquidity for transitional shareholders, the family must develop effective governance systems to allow the patient capital of the family to survive such transitions. Therefore, a family office will play an increasing role in many family businesses as they mature, providing a forum to unite the increasingly disparate views of the increasingly extended family. Through the family office, family members will have a say in the decision process, so that management or private equity will not completely take over the direction of the company's strategy.

With each type of capital having different objectives and shareholder value expectations, it can be tricky making sure they work together smoothly. If you let a dictator's short-term focus determine your strategy, your ability to obtain long-term sustainable, profitable growth may be hampered.

Sustainable, profitable growth is the crucial connection between all sources of capital. It is important for managers to understand the link between the company's growth and their rewards, and for family shareholders to understand that growth is the key to meeting future liquidity needs. They also need to understand that using outside sources of capital will help the company achieve growth that will enable the it to achieve the returns needed to buy out those investors.

Most companies should not plan their strategy on the basis of five-year exiting capital, but some have no choice. My company's private-equity fund, for example, invested in a family company that had outgrown its management team. One condition of our investment was that they exited the business after five years. The family agreed because they realised they could not take the company to the next level with its existing capital and management. They'll help us increase the value of the business, then they – not we – will exit with enough of a return to form their own family office and redirect their business activities to managing the cash they realise.

BALANCING EXPECTATIONS

Determining the ideal capital structure depends largely on its unique circumstances. To achieve the best balance between long-term patient capital, outside managers pushing for medium-term return and private equity looking for high return in the very short-term, the following variables should guide family businesses: control objectives of the family; liquidity needs of the family; family management capability; and the company's size and growth trajectory.

Many shareholders look at private equity as evil usurpers of control. But family owners should keep in mind that, in the long run, they will benefit because the patient capital of the family will outlast both democrats and socialists.

Therefore, there's no reason for them to fear giving up temporary control to private equity investors as long as the family has carefully planned their exit. Similarly, giving up equity to non-family management is not an evil as long as the managers' incentives are tied to growth of the business and the family has the ability to redeem their equity upon their retirement.

So while Saddam Hussein, Karl Marx and Thomas Jefferson may have very different personalities and perspectives, their successful co-existence may depend on finding a common stake. In a family company, that common stake is the pursuit of sustainable, profitable growth, which will ultimately enhance the value of the company for all stakeholders. ●

Francois M de Visscher is founder and president of de Visscher & Co, a Greenwich, Connecticut, US-based worldwide financial advisor to business-owning families.