Orchestrating family firm transitions

MERRICK WEALTH

By Peter Merrick

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Often, financial advisors have corporate clients whose businesses are owned by multiple family members. Inevitably, the time will come when the older crowd of shareholders will want to pass the baton to the younger generation.

These older shareholders have put in many years of hard work and don't want to risk their future financial security on the ability of the younger generation to profitably manage the business. When they remove themselves from active involvement, they generally want to either be cashed out, or something close to it at the least. In these circumstances there is a very real need for clarity among the various shareholders, regarding the vision for the business and their role in it, since each will have a horse in the race when it comes time to make decisions on strategies and tactics.

Therefore, a discussion of specific planning strategies or tools is futile, unless it is done in the greater context of exactly what the shareholders desire to accomplish. Many of the tools, techniques, strategies and tactics used in estate and exit strategy planning involve irrevocable decisions that clients may not fully appreciate.

The importance of this clarity cannot be overstated. We are in a very tight credit environment. Family owned businesses usually don't carry enough retained earnings in the company to be able to 'cash out' the older generation. So, in a tight credit market and with insufficient retained earnings, other options need to be considered. One option is the use of a private equity partner.

Maintaining control of the family business and harmony among multiple generations of shareholders with divergent interests are major challenges confronting the owners of many such firms. Other issues, including the desire for asset diversification by all shareholders and ongoing capital demands of the business, can create additional obstacles to peaceful co-existence. Frequently, indebtedness incurred to buy out inactive shareholders severely restricts a company's ability to expand and, in times like now when credit is tight, can lead to its demise.

The presence of a restless bloc of shareholders precipitated the agreement to sell a substantial interest in Freedom Communications, Inc., a family owned media company started by founder R. C. Hoiles in 1935. Freedom's assets included eight television stations, 27 daily newspapers and 37 weeklies. Daily circulation was approximately 1.2 million subscribers.

Citing the company's underperformance in recent years, older family members demanded a buyout of their shares or an outright sale of the entire company. Another group of Hoiles' descendants, representing approximately 40 per cent of the company's voting stock, argued that the value of keeping the business in the family and protecting its unique philosophical heritage outweighed the financial rewards of selling out to a competing media concern.

This was clearly a case where clarity between the shareholders and their financial advisors about their true goals was required to arrive at an acceptable solution.

To address the conflicting objectives, the company's board of directors elected to partner with Blackstone Communications Partners and Providence Equity Partners to purchase the stock of the older family members under an agreement that enabled remaining shareholders to retain operating control of the family business. Funds provided by the equity firms and a JP Morgan Chase Bank debt facility were used to make the purchase. Competing bids submitted by three other companies could have resulted in a sale of the entire company upon approval by a majority of the shareholders.

Ultimately, these alternatives were discarded as inconsistent with the goals of the younger generation of shareholders – again, significant clarity of the goals and values of all shareholders was critical to this successful exit strategy.

Private equity transactions can take the form of leveraged acquisitions, buyouts or recapitalizations. There is substantial latitude in the structuring of each deal to accommodate the unique requirements and objectives of the various shareholders in the family business.

Prominent private equity groups continue to provide a flexible and dependable source of capital for established, family owned companies. Investors in these funds include public and private entity pension plans, major universities, insurance companies, investment banks, and high net worth individuals.

In the Freedom Communications transaction, for example, Provident and Blackstone purchased a substantial position in the company while leaving key family members in control.

After making an investment in a family business, private equity partners will seek to continue or accelerate its growth. Through a base of professional relationships, equity partners can create business development opportunities for the company. The group can offer financial expertise, access to strategic industry relationships and resources, and serve as a primary source for additional growth capital.

The investment in a family owned company by a prominent private equity firm provides additional credibility to the business and a solid foundation for its future expansion or sale.

Private equity firms are under increasing pressure from their limited partners and other capital sources to invest idle funds. It is estimates that the worldwide volume of private equity capital exceeds $1.4 trillion, and that $800 million of that is held by American private equity firms. This abundance of capital, combined with a relatively limited number of attractive target companies, has generated intense competition among private equity groups, hedge funds and corporate acquirers to consummate transactions.

As a result, valuations as reflected by multiples of EBITDA (earnings before interest, taxes, depreciation and amortization), are steadily increasing for well performing family owned businesses. Moreover, the private equity firms have become much more flexible in negotiating the terms and structures of their equity investments.

Although private equity firms are as diverse as the operating companies in which they seek to invest, there are many common characteristics that private equity investors find attractive in potential candidates.

In general, these investors look for well managed companies, which generate annual operating income in excess of $1 million. Many funds have significantly higher earnings thresholds. On the other hand, companies pursued as add-ons for an existing company within an equity fund's portfolio of businesses may be somewhat smaller.

Targeted businesses may compete in a broad spectrum of industries and supply a wide range of products and services through diverse distribution channels. Accordingly, successful manufacturing, wholesale, retail and service businesses are of interest to these seasoned investors.

What criteria do private equity firms consider when evaluating potential investment opportunities? They include:

- Consistent and growing businesses
- Stable revenue streams
- Expansion opportunities
- Predictable cash flows
- The current market position of a business within its industry
- The presence of meaningful barriers to entering the company's market segment or geographic region.

Finally, a private equity partner will seek assurances that remaining family members and operating managers will continue with the enterprise and endeavor to increase sales and profits to achieve maximum value for all shareholders. And most importantly you, as your clients' advisor, will remain a key member of the transition team.

— Charles L. Stanley, wealth manager with Capital Financial Advisors, and Lynn Ryder Mason, a principal with Global Capital Markets, Inc. assisted with this column.

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