Family Business
THE GUIDE FOR FAMILY COMPANIES
www.familybusinessmagazine.com
20TH ANNIVERSARY

Though much has changed, core strengths are constant

In later generations, family firms' financing needs and funding sources evolve. But key factors remain the same.

BY FRANÇOIS DE VISSCHER

Over the last two decades, family businesses have undergone significant transformations, with regard to family composition as well as the challenges faced by these enterprises.

In the late 1980s, most family businesses were still dominated by World War II generation leaders who were generally autocratic and self-assured. The reference book for that generation of business owners was Léon Danco's masterpiece, *Beyond Survival*. In the book Danco described the loneliness of the war-generation leaders and their trepidations about bringing the baby boom generation on board. Recalling their childhood experiences during the Great Depression, these leaders maintained conservative balance sheets; they relied mostly on the founder's savings and family loans to bootstrap their business.

Founders and their families took personal risks. As collateral, they pledged personal assets, such as their home. To fund expansion of their fledgling enterprise, they plowed internal cash flow back into the business. Along the way, they called on their neighborhood banker for some short-term financing and occasionally turned to a group of their wealthier friends for "angel" equity capital. When the young baby boom generation joined their parents in the management of the family business, their youthful energy was substantially tamed by the lack of financial flexibility; plans were limited and depended on the company's resources. Navigating the often-stormy waters of generational transitions was the most difficult challenge faced by family businesses at the end of the 20th century.

The acceleration of globalization during the last two decades has caused many family businesses that used to compete locally to be increasingly confronted by well-capitalized global competitors.

The last two decades were marked by three distinct phenomena that have had a significant impact on the state of family businesses today.

On the business side, we witnessed the fast acceleration of globalization and information flow. Family businesses that used to compete locally increasingly confronted well-capitalized global competitors. Global companies' access to capital and markets were well above the financial and managerial means of these very conservatively capitalized family businesses. At the same time, customers came to expect companies to meet their global needs, and suppliers began to favor global sourcing. For the first time, many family businesses needed access to outside capital and outside global management teams to stay competitive and to grow. The alternative was to sell out or seek a global partner.

The late '80s witnessed the liberalization of financial markets across the globe. As private wealth increased, the wealth management industry arose, giving family businesses access to new sources of capital, such as private equity funds, private trust companies and non-public equity. Private equity would be deemed very attractive for family businesses as an alternative to selling the company or going public.

Finally, advising family businesses became a distinct profession of its own. The Family Firm Institute (www.ffi.org) was formed in 1986 along with many other networking and educational organizations and programs. Family business owners and their advisers now had plenty of opportunities to learn from professionals and from their counterparts in other family enterprises.

Global, multigenerational family business owners

In the first decade of the 21st century, it is not unusual to find family businesses with ownership spread among three or more generations. Most of these extended families no longer live in the same town—they may not all live in the same country, or even on the same continent. This diversity among family members creates significant dichotomies in the various shareholders' control and liquidity goals.

The founder or second-generation owners, now grandparents in their 70s or 80s, are more interested in golf than in growth. They need dividends or a full or partial buyout to allow them to retire in comfort. The next generation, in their 50s and 60s, are often still active in the company, but their biggest personal expenses are behind them. (Their homes are mostly paid off; their kids have graduated from college or are nearing that milestone.) But the boomer generation's kids—in their 20s, 30s or 40s—have those expenses in front of them, and are ready to leap into new technology and new global markets to help the company grow enough to meet their future needs. Smart family businesses in this situation create ongoing liquidity programs to match the diverging needs of owners in each generation.

Globalization—of families as well as businesses—has substantially changed the role of the family owners in the management of their companies. The better-educated family members in the baby boom generation and beyond have taken on the role of global managers. If global managerial talent cannot be found in the family, the owners seek professional teams to fill the gap. The role of the family in such instances shifts from owners/managers to "responsible shareholders" whose role is to develop strategies and policies to guide management in enhancing the shareholder value creation process.

As family members assume this new role of shareholders rather than managers, the family must develop its own governance structure. Family councils and family offices were born from global families' need to govern the wealth creation process. The challenge now is to maintain the family's "patient capital" by recruiting the best management teams to lead the business, providing liquidity to those family members who want to exit and maintaining strong family and corporate governance structures.

Developing new financing

The globalization and liberalization of the financial markets have had a very positive impact on family businesses by opening new avenues for financing growth capital needs of the business and liquidity needs of the shareholders.

In the late 20th century, family businesses relied mostly on community banks and savings and loan contacts for outside financing. Gradually they began turning more and more toward money-center banks, and then they increasingly accessed global sources of capital. Mergers between U.S. banks and international institutions, now a common phenomenon, have made it easier for local entrepreneurs to develop relationships with loan officers in other countries.

Family businesses used to rely on short-term working capital in the form of lines of credit backed by receivables or inventory. Today they more commonly take out longer-term debt, not necessarily backed by assets but based on the strength of their cash flow. Family businesses are also bolder about tapping alternative sources of financing providing long-term debt or cash-flow lending such as mezzanine debt, angel and venture backers, and institutional sources such as insurance companies.

Over the past ten years, private equity increasingly targeted family businesses. However, many private equity financings were leveraged and not strategic in nature. So even before the current economic crisis, the short-term orientation of many private equity funds began to clash with the long-term goals of family companies. Recently, family offices and high-net-worth individuals have been infusing more patient capital into family companies. In addition, strategic partners from all over the world have emerged to take a minority interest in companies—for example, where they can share technology.

The rise of private equity, particularly the "patient" private equity provided by family offices and high-net-worth investors, has reduced many family businesses' need to tap the public equity markets. That is a great thing for family businesses, because the public equity markets' reporting requirements and short-term orientation are not very attractive for companies seeking stable long-term partners or investors.

What has not changed

Despite these fairly significant changes, family businesses remain conservative compared with other companies, in terms of their determined approach to react to global trends and opportunities as well as their unwillingness to burden their balance sheets with debt.

Family companies' resistance to the excesses that were available in the financing market means that few of them have grown beyond their means. They have not over-leveraged, as so many other companies have done. As a result, they have entered the financial crisis in better financial shape than companies with riskier balance sheets. Thus, many family companies are well positioned to ride out the current financial storm.

My crystal ball

What's in store for family firms in the future? The mismatch between private equity and family businesses' long-term goals is likely to grow. To bridge that gap, the family office market will increase its infusion of patient capital into family businesses.

Corporate and family governance will continue to become more effective and sophisticated. More family enterprises will recruit outside board members and institute committees of the board, and meetings will become more rigorous. Twenty years ago, board meetings might have lasted half an hour and be convened primarily to ratify measures presented by management. A corporate council would rubber-stamp all resolutions for dividends without much review. Family councils, family forums and family offices are expected to be more rigorous in training the next generation, communicating across and among generations, and establishing a better balance of power between family owners and family managers.

Much has changed over the past two decades, and the evolution is continuing. But the core strengths of family businesses—their conservative financial management and patient capital—increase the likelihood that they will survive for many more generations. FB

__François de Visscher__ is founder and partner at de Visscher & Co., a Greenwich, Conn., financial consulting and investment banking firm for closely held and family companies (francois@devisscher.com).