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In uncertain times, taking a counterintuitive leap of faith

Today's economic turmoil may offer opportunities for healthy family businesses.

BY FRANÇOIS DE VISSCHER

True or false?

- Most commercial banks are no longer interested in lending capital, having eroded their capital base with losses on subprime-related loans.
- The private equity market has little or no interest in making new investments, since financial leverage is no longer available from the banking sector.
- With the current economic turmoil, now is not the time for a family business to strengthen its global competitive position, let alone make new investments.

It may seem counterintuitive, but all three statements above are *false*.

We are clearly living in a period of extraordinary uncertainty. The events that are unfolding and will continue to unfold in front of our eyes will undoubtedly alter forever the economic models of the U.S. and most likely the rest of the world.

Yet today's economic turmoil may very well offer opportunities for healthy family businesses with strong core competencies, healthy balance sheets and ample cash flow. Much of the business world feels paralyzed as they wait and see what will happen next. But strong, smart and bold family businesses are continuing to access capital from commercial banks and private equity funds to finance investments and acquisitions that would strengthen their global competitive position.

Banks are lending—selectively

Even in the midst of the current liquidity crisis, banks and financial institutions continue to extend credit—on a selective basis. In fact, the chairman of a very healthy and prosperous family business in North Carolina recently related to me that his chief financial officer has never fielded as many unsolicited calls from commercial banks as he's received since the start of the financial crisis. While this may sound counterintuitive given the recent losses in the capital base of many commercial banks, the essence of the banking business model is to pay (short-term) interest on clients' deposits and collect (long-term) interest on money that is lent out. Without making loans (and, of course, assuming they continue to receive deposits), banks cannot survive.

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It is sad that many banks over the last decade have lost track of their most traditional form of business, instead following what seemed to be very lucrative, but obviously not always wise, lending and investment practices in subprime mortgages and other highly leveraged opportunities. To the extent their capital base permits, commercial banks must go back to traditional practices of lending to healthy corporations that have demonstrated strong cash flow and the ability to repay the loans.

No wonder my client's sound, financially stable family business has so many bankers calling. Family companies like his are prime targets for commercial banks in today's environment. Of course, the cost of credit has significantly increased in this tight liquidity environment. So one must evaluate the wisdom of taking on bank credit in light of the return the company expects to generate with the bank proceeds.

Private equity is still available

Although recent financial events make it difficult to raise fresh capital, many middle-market private equity funds have ample liquidity capital available for investments. The contraction in the banking market has made it all but impossible for private equity funds to generate high returns from leveraged transactions. They will use their liquidity first to support their existing portfolio companies or make new investments in these firms. Next they will look at new investments that generate attractive returns without exposing the funds to high leverage, which today would not be available from banks and financial institutions.

The lack of debt financing available, coupled with lower valuations in the public markets, have caused many private equity investors to consider longer-term investments in the form of joint ventures and non-control deals that require only a minority position. Isn't this a great time for a healthy family business to seek more patient capital from the private equity market, to either gain liquidity or make new investments?

In the third quarter of 2008, a 100-year-old family business in Georgia took advantage of these market conditions and sold a 35% stake in the company to a private equity investor to provide some liquidity to a member of the senior generation and to acquire one of the company's main competitors in California. The New York-based private equity group invested in the form of preferred stock over 12 years, requiring only three of the company's ten board seats. Various provisions were included to protect the rights of the minority private equity investors yet limiting their ability to control the ongoing management of the company. With those provisions, the interests of the investor and of the family would be totally aligned.

Grow stronger, not bigger

Another client recently complained, "With the weak dollar, it is difficult these days to bargain-shop for overseas acquisitions in Europe or Asia. And foreign banks don't seem so eager to lend to U.S. borrowers, either for lack of confidence or because they may want to keep their lending power to support their domestic banking clients." That may be true, but we advised this client to seek U.S.-based investments and acquisitions that would strengthen the company's long-term global competitive position. Instead of growing horizontally to increase global market share, we recommended he consider vertical acquisitions that will make the company stronger in its niche. The idea is not to get bigger, but to become stronger. Which technologies, know-how or capabilities does the company lack today that would make it more competitive globally in the long run?

The global slowdown and the financial crisis have significantly reduced competition for deals in the U.S. Among overseas investors, only those with an existing U.S. base may consider U.S. acquisitions. Even Chinese investors mentioned to me during a recent trip to Beijing that their main focus of new investment is Chinese companies, despite the strength of the yuan. On the other hand, as mentioned earlier, private equity investors would rather partner with an existing family business for new investments than singlehandedly structure acquisitions.

This reduction in deal competition in the U.S. (and a lowering of sellers' price expectations owing to economic uncertainties) has brought down price multiples in U.S. mergers and acquisitions. The U.S.—not Asia, not Europe—should be the focus of investments and acquisitions in times of economic uncertainty, global turmoil and a weak U.S. dollar. Let's shop at Wal-Mart in Arkansas ... not at Harrods in London!

One client, a well-capitalized CEO of an electronic component manufacturing firm in the Northeast, gathered his CFO; a few board members; and his technology, manufacturing and sales/marketing teams for a brainstorming session on how to grow globally. The teams first took inventory of the company's core global competencies, its most dangerous global competitors, and what the company would require in the next five years to respond to demanding customers' growing needs. The group identified several technologies, manufacturing processes and products that would enhance quality of its products, improve operating efficiency and, as a result, enable the company to anticipate as-yet-unidentified customer needs.

After the meeting, the CFO and his staff, with the company's financial advisers, undertook to identify U.S.-based acquisition candidates specifically responding to the needs the group uncovered. They found two private companies worth approaching. With the help of a private equity fund and some bank financing, the company completed one acquisition in 2008 and is now pursuing the second one.

Smart companies are refocusing their niches and investing in strengthening their competencies in a way that will deepen their product or service offering.

While in the past, companies' global strategy consisted of running off and buying businesses in the countries where they wanted to expand, today smart companies are refocusing their niches and investing in strengthening their competencies in a way that will deepen their product or service offering. In the "flat world" of Thomas Friedman, people's mobility and information technology make most global markets readily accessible.

Competitiveness is defined not in terms of size or market coverage, but in terms of depth of product and service content. This makes a company the most advanced and efficient in its niche, no matter how small it may be. Therefore, one should define acquisitions criteria vertically, focusing on a niche strategy rather than market expansion.

Being the best

What would happen, you may wisely wonder, if the dollar were to strengthen in the near future? This strategy would likely hold up much better than efforts to expand market share. Being the best in the world at what you do, instead of the biggest, is a much more defendable position whether the dollar strengthens or remains weak.

Just as Warren Buffett has maintained a phenomenal investment track record by buying into undervalued companies with solid fundamentals—especially during cyclical downturns and periods of economic chaos—the current financial fallout contains many opportunities for solid and bold family firms. FB

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