



## Ongoing liquidity programs can keep relatives on board

*Offering family shareholders a chance to redeem some of their shares can enhance your relationship as business partners.*

**I**N ONE FAMILY BUSINESS I know, the family managers wanted to buy out a group of family board members who were not involved in management. But the managers feared that recapitalizing the business to raise debt capital would impede future growth. Instead of a buyout, they created an ongoing redemption program that allowed shareholders to sell some of their stock each year at a preset valuation and within certain redemption guidelines. The share price would be determined by an annual valuation.

They instituted this program five years ago, yet to this day no shares have been sold. By offering liquidity to the shareholders on an annu-

what may start as a family buyout actually can evolve into a more friendly shareholder redemption program.

### Preventing future conflicts

In the case of a buyout, the value of the shares being repurchased is often determined either by contractual arrangement, as may be the case in a buy-sell agreement, or through negotiation between the company (the buyer) and the selling shareholders. In the latter case, the valuation will be influenced by the friendliness—or the hostility—of the negotiations.

A buyout terminates the relationship with the selling shareholders. As in an M&A transaction, each

the company as well as those of the shareholders who wish to redeem some of their shares.

### Pricing complications

Three variables determine the effectiveness of an ongoing redemption program: how it's structured, how it's funded and the valuation method used to price the shares. The thorniest variable is how the shares are valued. One reason is that pricing is subjective and depends on the purpose of the valuation. It is more art than science and may depend on how the family defines fairness. Some redemption programs are set at a very low value to discourage family shareholders from selling and to establish a low company value for estate tax purposes. Other redemption programs are set at a high value to encourage minority shareholders to sell and eventually reduce the number of shareholders.

Another pricing complication concerns the amount of liquidity available. The more liquidity the company has, the greater the extent to which it can fund the program. But ample liquidity will increase the value of the shares by reducing the amount of the discount. If the family is large, with many buyers and sellers, the value of the company will also be affected.

The valuation must be fair to the sellers as well as to those who stay in. Because most valuation programs involve a partial, rather than full, shareholder buyout, the company must be able to defend its valuation to both sides of the family. Even if

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al basis, they alleviated pent-up demand for capital and united the family.

There are two types of redemption programs. One involves buying out family members; the other, commonly called an ongoing liquidity program, offers regularly scheduled opportunities for shareholders to redeem some of their shares.

Many family business leaders considering setting up an ongoing liquidity program are concerned that family redemptions might drain the company's financial resources and create splits in the family. However, as occurred at the company above,

party wants to get the best price. But in family companies, the parties will continue their family connections after their business relationship is dissolved, so it's important that the negotiations be friendly. Including buyout provisions in the shareholder agreement will help prevent future family conflicts.

In an ongoing redemption program, the purpose is not to terminate the business relationship but to enhance it by providing some or all of the shareholders an opportunity to cash in on appreciation in their holdings. Therefore, such programs must take into account the objectives of

there is a set of “obvious” sellers at the outset, that might change over time.

A liquidity program should not be designed as one-time event. When shareholders have an ongoing ability to sell, the company will have an easier time coming up with a valuation that’s interpreted as fair—because in any year any shareholder may be a buyer or seller. Thus there’s less trouble finding a middle-ground valuation that’s fair for both buyers and sellers with ongoing liquidity programs.

Because the valuation used in a redemption program will have some tax and accounting consequences, it’s wise to settle any unresolved estate issues before creating a liquidity program. In most countries, estate tax value will depend not on whether there’s a program in place, but whether the program has been used.

### Valuation methodologies

Three different valuation methodologies can be used in ongoing redemption programs. Each method has advantages and disadvantages.

**1. Valuation formula.** The family has agreed on a predetermined formula, such as a book value, a percent of book value or cash flow multiples.

*Advantages:* This method is very predictable and stable year after year and is not subject to outside market conditions. It is also very transparent to potential selling shareholders in the ongoing liquidity program, and easy to communicate to them. Another advantage lies in the method’s simplicity; annual computations are unnecessary.

*Disadvantages:* The formula may be out of sync with the actual market value. When the industry is hot and the market is trading at twice book value, shareholders are not likely to want to sell at book value.

**2. Market valuation.** A trusted family adviser performs a valuation of the stock every year based on up-to-date valuation multiples and parameters. Discounts to public-mar-

ket values for lack of liquidity and marketability may be applied.

*Advantages:* Because the price will be close to the market, it should be easier to agree on a fair price. Participation in the redemption program may be higher than it would be if a valuation formula were used.

*Disadvantages:* Because the price is likely to fluctuate year to year, it is difficult for shareholders to do

shares he or she is willing to sell at specific price levels. The company then fills sell orders, starting with the lowest price, until its set number of shares or dollar amount has been fulfilled.

For example, if shareholder A is willing to sell for \$50 a share, Shareholder B will sell for \$75 and Shareholder C will sell for \$100, the company will use its available cash to

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long-term planning. If they decide to sell stock today vs. two years from now, they must take into account what they think the market will do. Shareholders who use a fixed value need worry only about how well the company will do in terms of book value. Determining whether this is the right time to sell requires a greater level of shareholder sophistication—how educated they are, and how well the company’s governance structure has informed them about the opportunities.

Another disadvantage is that this form of valuation is often subject to interpretation of the “right” amount of discount to the market. Discussions of this topic can be contentious, so we recommend that shareholders agree to use a fixed discount of market value when they set up the program.

**3. Dutch auction.** This method—named after the Dutch tulip auctions—involves no valuation and no predetermined formula. Each selling shareholder establishes his or her own valuation within parameters set by the company.

The company first determines how many shares it will be purchasing or how many dollars it will allocate for the Dutch auction. Within set price parameters, each selling shareholder informs the company how many

purchase A’s stock first. (Shareholders could set different prices for different stock quantities.)

*Advantage:* The major advantage of a Dutch auction is that it avoids any discussions regarding the amount of discount for liquidity and marketability used in the valuation.

*Disadvantages:* This method puts the valuation burden on the selling shareholders, therefore requiring even more shareholder education than market and fixed valuation methods. Shareholders must be aware of what the valuation is under current market conditions and what it might be under possible future conditions.

There’s also a little bit of a poker factor in Dutch auctions. As a seller, you must predict how the rest of the shareholders will react. If you feel you’re the only seller (that is, if other shareholders don’t seem to want to sell), you can set your value pretty high. But if you really need your liquidity this year and a lot of other shareholders are seeking to sell, you should set your price low. FB

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Reprinted from Family Business® Winter 2008

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1845 Walnut Street, Suite 900 • Philadelphia, PA 19103

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