REDEEMING THE FAMILY BUSINESS

A share redemption fund can improve communication with all shareholders and ease family tensions. That can be good news for the next generation, too. **Francois de Visscher** explains

The lack of liquidity options is the most frequently cited source of unhappiness among family shareholders, particularly those who are not involved in the management of the family business. The demands of these "passive" shareholders frequently escalate in later generations at just about the time when larger family businesses have opportunities to expand or a need to diversify and require infusions of capital. At precisely the time when third- and fourth-generation shareholders are coalescing as a force to be reckoned with, management resists their demands for liquidity, setting the stage for family conflict. All shareholders in family companies want a clear idea of what their investment is worth, how it compares with other, alternative investments, and how it can be liquefied, if necessary. Succeeding generations are increasingly well educated and financially savvy. Family businesses need a formal mechanism for valuing and liquefying privately held stock on a continuing basis, and intelligently factoring in the capital needs of the business so that conflicting claims for finite amounts of cash are minimised. The managers can also reap substantial benefits by establishing ongoing liquidity programmes for stockholders who want to diversify their investments or get their hands on cash for personal uses.

However, creating liquidity options for shareholders doesn't mean there will be a mass exodus of shareholders. In fact, the very presence of a liquidity programme may mollify shareholders. I've identified five facts that might be surprising to some family business owners.

First, not all shareholders in family companies have the same liquidity needs. Therefore, liquidity programmes need to be tailored to many different family members.

Second, the more liquidity is offered, the less shareholders tend to want it. In fact, many liquidity programs to provide liquidity flexibility are never used. It seems that once shareholders know they have liquidity flexibility, that releases the pressure valve. They many not be so eager to sell once they have the option to sell. So the beauty of setting up a liquidity programme is that you end up with a much more unified shareholder base.

Third, when providing liquidity to shareholders, absolute value is less important than appreciation potential. Once a company's value has been determined, shareholders tend to focus on perceived future appreciation of that value as a factor for deciding whether they will hold their stock or sell it.

Fourth, fairness is a relative notion. Some shareholders may perceive fairness in value differently than other shareholders. However, in the tasks of providing liquidity to exiting family shareholders, it pays in the long run to be slightly more generous than in other business situations. This will avoid many headaches in the future.

Fifth, providing periodic opportunities for liquidity is more important than a one-time liquidity event. Predictable and flexible liquidity programs are attractive to family shareholders.

What kind of liquidity programme is right for your business? There are three common ways of providing ongoing liquidity to shareholders: a structured dividend policy (by far the most popular method); an internal recapitalisation; and redemption of shares.

THE DOWNSIDE OF DIVIDENDS

Dividends, while useful and popular, contain several pitfalls for family firms. One pitfall is that regular payment of dividends can lead to unrealistic shareholder expectations. Once shareholders begin to depend on a stream of dividend income to support themselves, any decrease in dividends can have serious repercussions for the family business and for healthy family functioning. Shareholders will be quick to express their discontent. They may bring pressure on the company to maintain a level of dividend payments long after such dividends can be justified by the company's financial performance.

Increasing demands for dividends can also strain cash flow and prevent the company from reinvesting profits in future growth,as well as in badly needed capital improvements. This can lead to an illiquidity spiral which limits cash flow growth and hence hinders the company's ability to pay dividends in the future. In terms of allocation of financial resources, dividends may not be the most productive way of meeting shareholders' return-on-equity objectives. If

Assessing liquidity: Formula price for a business in the steel industry is dependent on free cash flow.

one dollar of cash flow reinvested in the business will reap a higher return on investment than the same dollar paid out as a dividend and reinvested outside the family business, why not give the shareholders the benefit of this differential return?

Another downside to dividends: they are a blunt instrument for rewarding shareholders with diverse liquidity needs. Every share of the class of dividend-paying stock receives the same return, whether or not the shareholder needs or desires liquidity. For example, members who are drawing salaries will receive the same dividend per share as inactive shareholders who may depend on dividends to meet their income needs. While this non-discriminatory policy honours the principle of equal rewards for equal ownership, it makes dividends a less precise liquidity tool than other options.

THE RECAPITALISATION METHOD

In families where different family members have different liquidity needs and objectives, an internal recapitalisation may be a useful solution. Under an internal recapitalisation, the company would create different classes of stock for different shareholders. Most commonly, when shareholders are reaching retirement age, they may want to exchange their common stock with a preferred stock that provides them with higher current income but limited appreciation of their holdings. Concurrently, younger shareholders fully invested in the business may seek to realise the fruits of their work by owning common stock that will capture a greater proportion of the appreciation.

Let us take the example of a family trucking company in generational transition with three family shareholders active in the business (father and two sons) and one inactive shareholder (daughter). An internal recapitalisation could accomplish multiple objectives by allowing the retiring patriarch to exchange his common stock for a non-voting preferred stock with a 7% dividend. Simultaneously the inactive daughter could meet her need for liquidity and diversification by selling her stake, leaving all the common stock in the hands of the two sons operating the business.

CREATING LIQUIDITY OPTIONS FOR SHAREHOLDERS DOESN'T MEAN THERE WILL BE A MASS EXODUS OF SHAREHOLDERS

REDEMPTIONS – IN THEORY

Redemption programmes have been used by multi-generation families in many different forms such as buy/sell agreements, a company clearing house programmes and even stock put programmes. In our experience, one of the most effective types of programs to provide liquidity flexibility is the annual redemption fund programme (ARFP), which periodically allows shareholders to sell their stock to other family members or, if they cannot find such buyers, to the company at a fixed, formula price. The company creates a pool of funds out of available cash flow to buy back stock during a predetermined period every year.

There are three key elements involved in any redemption programme. First is the size and structure of the redemption fund, dictated by how much liquidity will be needed by how many shareholders and what the company can afford. Next is the issue of timing. Redemptions may be offered annually or even bi-annually. The important aspect of timing is that all redemptions should occur during the same finite period to encourage greater intra-shareholder transactions. Finally valuation is a critical part of the process. What metrics will be used to value company shares that will be seen as fair to all parties involved?

One of the most difficult steps is the selection of valuation methodology and a funding mechanism tailored to the particular company and the dynamics of its industry. It is wise to engage experienced advisers to design the formula and reassure all shareholders of its objectivity and fairness.

The annual formula price is typically derived from standard valuation criteria, including income approaches, comparisons with values of comparable public firms, and data from previous arms-length sales. The formula differs slightly from standard valuation criteria, however, in its emphasis on available cash flow and borrowing capacity – since these are the primary sources of funds for stock redemptions.

The formula price and buyback fund must be responsive to changes in the operating business and the industry. For a slow-growth, highly capital intensive industry such as the steel industry, the most appropriate yardstick is often free cash flow, adjusted for annual capital investment. For high-growth industries, such as broadcasting, communications and food processing, after-tax earnings is frequently emphasised: cash flow as measured by earnings before interest, taxes, depreciation and amortisation (Ebitda). Because of the operating leverage in their franchises or brand names, companies in these industries are often driven and valued by cash flow, for which Ebitda is an approximation.

A formula price allows managers to demonstrate the degree to which their efforts have benefited shareholders. It becomes a benchmarking tool with which to project stock values that might be achiev-

able under a business plan with certain assumptions. Pursuing a particular investment opportunity might temporarily lower the price, for example, but management could show how much value the investment might add over the long term. Thus shareholders will have a more reasonable basis for making an informed decision on whether to hold on to their stock or sell some of it.

A formula also focuses shareholder attention on the factors that determine value in the business. For example, one of the components of the formula may take into account real estate values, which shareholders might believe fluctuate less than the earnings component. By following the trend in the formula price, shareholders might learn that real estate values were not always constant, particularly when interest rates are rising. The inclusion of supply-and-demand considerations, as well as tax costs, are likely to lessen shareholders'desires to liquidate their portfolio.

If more shareholders want to redeem shares than the annual redemption fund is able to accommodate, the redemption fund amount can be allocated in proportion to the number of shares for sale by the sellers. In the case of excess buyers where the number of shares available for purchase does not meet the demand of shareholders seeking to increase their holdings, available shares can be allocated to buyers on the basis of orders received to purchase shares. Treasury stock purchased by the company through the redemption fund may also be sold to shareholders who wish to purchase shares the following year. Finally, most ARFPs include special provisions for redemption of large blocks of stock, for instance from a single estate. As is the case for internal recapitalisation, we would strongly urge you to consult your financial and tax adviser before implementing any redemption programme.

REDEMPTIONS – IN PRACTICE

At one building materials manufacturing company, an outside valuation firm used a combination of methods – comparable company, comparable transactions and discounted cash flow – to determine that the common equity was $180m, or $30 per share. We suggested they set aside a redemption fund of up to $5m, based on a liquidity-needs survey of the company's ten equal shareholders, half of whom do not work in the company. Therefore, each year, if all shareholders were to sell stock, each shareholder could sell up to $500,000 of shares – to the company. The company now has to ability to target liquidity to those that need it.

The process of setting up the redemption fund can improve communication with all shareholders and ease family tensions. Dissatisfied shareholders may come to feel that their concerns are finally being recognised and acted upon by management. By shifting more ownership to the shareholders who were most interested in the growth of the family business and preserving its heritage the leaders can increase the prospect of a successful transfer of the company to the next generation. ■

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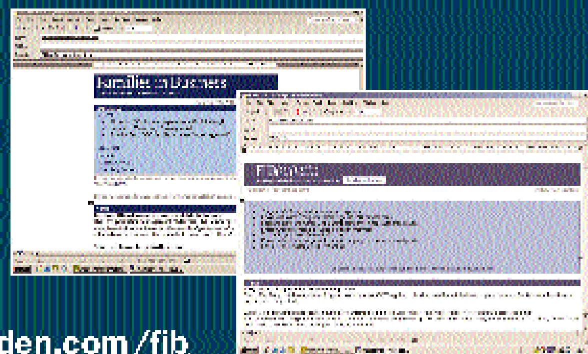

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