

## A Closer Look

# Liquidity Alternatives for Family Businesses



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### In Brief

- For family business owners, balancing the capital requirements of the business with the personal wealth objectives of the family presents one of the great challenges to building and maintaining a family business legacy.
- While negotiating trade-offs between company and family is never easy, the variety of available liquidity alternatives allows for a thoughtful approach tailored to the profitability of the company and the personal financial goals of the family business owners.
- Holding the family business in a trust with a corporate trustee can help family business owners maintain a long-term perspective, prioritize goals, and choose the most appropriate liquidity alternative.
- In this *A Closer Look*, we survey the liquidity alternatives available to family business owners, focusing on the advantages and disadvantages of each and examples of business and family situations that can make one approach preferable to another.

Most family business owners know how challenging it can be to balance the capital requirements of their company with the personal wealth objectives of their family.

Unfortunately, they aren't always aware of the wide array of liquidity alternatives available to them — alternatives that can help to provide the capital they need to manage their business as well as cash to make distributions to their family.

Depending upon the company's profitability and the family's financial aspirations, an approach can be crafted that goes a long way to overcoming these serious challenges to building and maintaining a family business legacy.

## Balancing the Interests of the Business and the Family

A successful family business must generate free cash flow and also have access to external capital. Once early-stage investments have been made, ongoing capital expenditures are required to fund expansion and maintain the company's competitive edge. Then with growth comes the need for more capital, often involving banking relationships for credit facilities and perhaps long-term debt. If significant investments are required or substantial strategic initiatives are being pursued, selling equity may have to be considered.

Balancing competing interests comes into play here because family business owners often depend on the company for income to pursue their lifestyle of

choice. This is true whether the family members are employed in the business or are just shareholders who receive periodic distributions from the company. Since compensation arrangements for employees can be generous with perks — such as a company car — the non-employee family shareholders are often the most concerned about distributions.

In the case of multigenerational family business owners, personal needs can also tend to be disparate and sometimes conflicting. The elder generation, for instance, has often accumulated significant wealth and may prefer to reinvest the cash flow in the business, while younger family members tend to have expenses — such as mortgages and private school tuition — that require healthy distributions.

### A Note on Liquidity and Estate Planning

Broader liquidity issues can arise relating to estate planning for family business owners. Frequently, family wealth is concentrated in the illiquid private company stock when diversification into a broader portfolio of assets would be more prudent.

One of the main concerns? If a family member with significant equity dies with inadequate estate planning, the result could be a large tax bill and the forced sale of an otherwise healthy and attractive part of a family legacy.

One potential solution for families with a commitment to the long term is placing the family business in a trust with a corporate co-trustee providing fiduciary guidance to enhance and preserve the family legacy.

In addition to providing estate planning advice, a corporate trustee can monitor the operating performance of the company and management's succession planning to ensure that longer-term strategies and adequate liquidity are prioritized.

This fiduciary oversight can be particularly valuable if professional managers are running the business instead of family members.

The bottom line? Successfully resolving these competing liquidity demands is a critical factor in determining whether the business will thrive as a family legacy or face internal strife and pressures to sell.

### Using Cash Flow for Liquidity

One conservative approach to sourcing liquidity is to focus on the cash flow generated from the company's operations.

Ideally, as the company progresses beyond the start-up stage and increases its scale of operations, a degree of stability is achieved with revenues consistently exceeding expenses. Growth is financed with free cash flow.

At this stage, the family business owner can consider several low-risk liquidity alternatives:

1. **Dividend Distributions:** Providing cash dividends to shareholders out of earnings is the most straightforward method of funding distributions. The size of the dividend depends upon the judgment of the owners or board of directors regarding the

sustainability of earnings balanced by the cash required by operations for capital expenditures and strategic initiatives.

The payout ratio for healthy companies in similar industries is usually comparable, but it is often lower for private companies with limited access to capital than it is for companies listed on a stock exchange with easier access to the public markets.

The payout ratio is also influenced by the need to balance the interests of family members working at the company with those who are not — and who are often more reliant on distributions for their income. Striking the right balance can mean the difference between family harmony and family conflict with possible litigation.

A special dividend is another option. Often the result of strong earnings, the realization of a windfall profit, or the accumulation of excess cash on the balance sheet, special dividends are usually much larger than regularly scheduled dividends. They are either paid infrequently or viewed as one-time events.

In certain cases, a special dividend may also be paid to provide greater liquidity to family members not employed by the company to address wealth disparities and maintain family harmony.

2. **Share Buybacks and Redemption Programs:** Share buybacks and redemption programs provide targeted liquidity opportunities for shareholders. Public companies implement buyback programs to support the share price of their listed securities. Private family businesses, however, use share buybacks and redemption programs primarily to offer liquidity to shareholders, regardless of the value of the shares. Such programs may be the only source of shareholder liquidity available, since active secondary markets for shares of private family businesses are rare, and often the sale of shares to non-family members is restricted by the company.

Share buybacks are offers by the company to repurchase a specific number of shares outstanding. The price is usually determined in advance and set pursuant to a third-party valuation. Share buybacks are generally scheduled intermittently, at times when the family business is in a stable position financially.

In contrast, redemption programs are often scheduled annually for family business shareholders. The rationale is to ensure that shareholders have regularly scheduled liquidity opportunities for some of their equity — generally averaging 3% to 5% per year, an amount that likely would not restrict management’s ability to execute its business plan. The price at which the shares are redeemed is usually the fair market value, as determined through an annual valuation by a third-party expert. The valuation is often discounted due to the lack of marketability of the shares and other relevant factors, such as the size of the family business. (See “Strategic Advisory and Increased Distributions” Case in Point.)

## Leveraging the Balance Sheet for Liquidity

Borrowing funds from a bank or raising debt capital in the private markets are liquidity alternatives that involve greater risk as the balance sheet is leveraged. Although modern corporate finance theory asserts that a prudent amount of debt in a company’s capital structure enhances the value of the business, many family business owners prefer a debt-free balance sheet. This is due primarily to their low tolerance for risk, attributable in part to the more limited financing alternatives available to private companies. Accepting a reasonable degree of leverage, however, can often help fund the growth of the family business and distributions for shareholders.

1. **Different Classes of Stock:** It is typical for family businesses to be capitalized with common stock that has one vote per share and participates equally in the payment of dividends. Several variations, however, provide greater flexibility to accommodate different priorities among family business owners. As an example, for family members who founded and work in the business, voting control may be a higher priority than the dividend yield. For other family members not employed in the business and unfamiliar with its strategy, maximizing current income may be more important than voting rights.

Under such circumstances, it may be a reasonable trade-off for the founding family members to have voting control through the ownership of a class of common stock with super voting rights. In exchange

## Case in Point: Strategic Advisory and Increased Distributions

A multigenerational family business in the building materials industry had recently transitioned to a new CEO to revitalize the company. The prior management team had pursued a vertical integration strategy with an investment into raw materials that had proven to be ill-advised. The CEO asked Bessemer to help him streamline operations and raise capital for future investments by divesting the non-core assets.

Given the extensive domestic and potential international interest for the assets, we organized an interview process for the CEO with leading middle market investment banks. Key issues addressed included industry expertise, the target valuation range, and the proposed fees. The bank selected following this “beauty contest” ran a comprehensive and efficient auction process culminating with the sale of the assets at an attractive price.

Family issues arose quickly, however, when the CEO announced his intention to invest the sale proceeds in the future growth of the business, including selected acquisitions. Shareholders had not been receiving significant distributions for some time, so many expressed their interest in sharing directly in the benefits of the sale, perhaps through distribution of a special dividend. The members of the younger generation, in particular, were disappointed, as the financial requirements of their lifestyle were at odds with the company’s more conservative financial management.

With Bessemer’s assistance, a balancing of business and family interests was achieved by dedicating a portion of the proceeds to the CEO’s growth plan and implementing a two-pronged strategy to provide more liquidity to shareholders. Current income was provided through a meaningful increase in the quarterly dividend, which had been stagnant for many years. A second, more significant liquidity alternative was introduced with an annual share redemption program for up to 4% of each family member’s shares.

Bessemer was asked to provide supporting market analysis to ensure that the proposed dividend and annual redemption price were appropriate. Bessemer analyzed the dividend payout ratios for our client’s public company peer group to determine the target payout range and dividend yield, as adjusted for a private company. Bessemer also initiated an annual valuation analysis supporting the redemption program to determine the company’s fair market value and ensure that family members selling their shares would be treated fairly.

Bessemer’s financial analysis supported the important enhancements to the shareholders’ liquidity alternatives, while reserving sufficient capital for the CEO to pursue his strategic initiatives. This balancing of interests helped ensure the continuation of the family business legacy.

for surrendering voting control, the other family members could own a class of common stock that is entitled to meaningfully larger dividend distributions than the super vote shares receive.

- 2. Dividend Recapitalizations:** Traditionally, dividends are paid to shareholders out of the company's current earnings. At times, however, it may be necessary or desirable to fund dividends partially from the proceeds of borrowings. A more aggressive means of providing liquidity to shareholders is a leveraged dividend recapitalization in which the company borrows for the specific purpose of distributing the proceeds to shareholders in a large special dividend.

For family business owners, the increased financial risk of leveraging the company's balance sheet can be offset by the benefits of enjoying a significant liquidity event. That said, dividend recapitalizations are extraordinary measures that are utilized only when the liquidity needs of family business owners justify the increased risk of leveraging the balance sheet.

## Selling Equity to Generate Liquidity

Selling equity is often a last resort for family business owners, but situations can develop where it must be considered. The reasons vary, but they may include operational difficulties, seizing a substantial strategic opportunity, or the need for wealth diversification and retirement planning. Two of the most significant issues involve selecting the buyer and determining whether to sell control.

- 1. Sale to an Employee Stock Ownership Plan (ESOP):** The sale of equity to an ESOP can be attractive to family business owners. Importantly, it achieves an alignment of interests with the employees, who become shareholders. This provides an incentive for employees to act as owners and focus on building the business. The formation and management of an ESOP, however, is subject to comprehensive regulatory guidelines under the Employee Retirement Income Security Act of 1974 (ERISA), which combines carefully structured inducements to the family business owner with protections for the employee shareholders. The costs of establishing an ESOP and the ongoing compliance requirements are significant.

A central feature of ESOPs is that the shares are sold to the employees at fair market value, as determined by a valuation or appraisal firm. This prevents family business owners from achieving a premium

### Case in Point: Minority Sale for Liquidity

The patriarch of a family-owned industrial products business passed away and ownership of the company was inherited primarily by his two sons. The eldest son, who had been working at the company for many years, became CEO and expressed his commitment to continue the family business legacy. The younger brother, who had only worked in the business briefly, preferred to sell the company to fund venture investments in tech and new media.

As tension between the brothers over the future of the business escalated, a private equity firm offered to buy the company. The brothers believed the price was attractive, but they asked Bessemer for an objective valuation analysis. The industrial products industry was in the midst of a significant consolidation, so our analysis focused on comparable acquisitions in the industry. It revealed that the offer was 35% to 40% below its current market value, so the brothers agreed to turn down the offer. Undeterred, the private equity firm quickly increased its offer by 25%, which led to a major disagreement about how to respond.

The compromise solution was for Bessemer to find a minority capital partner with a longer-term investment horizon who would buy out the younger brother and help the CEO with strategic issues to promote future growth. Pricing was a major consideration, since the selling brother did not want his minority stake sold at a significant discount to fair market value. Following a detailed negotiation, it was agreed that his stake would be marketed at a minimum valuation of 8 times earnings before interest, taxes, depreciation and amortization (EBITDA).

To get started, Bessemer advised the company on hiring accountants and a law firm with the requisite expertise for a major transaction. Bessemer then helped develop the business description and financial information for the Confidential Information Memorandum. Finally, Bessemer screened hundreds of potential strategic partners and private equity firms to identify a short list of the best potential investors while maintaining confidentiality.

The extensive preparations paid off, as three firms with strong interest competed for the minority investment. Key issues were negotiated in a highly structured transaction. The valuation benchmark for the minority stake was achieved, and the liquidity event provided the funds for the brother to pursue his interest in venture investments. Importantly, the CEO also benefited from a new equity partner with industry knowledge to help enhance operations and generate increased revenues.



valuation, which might be available through an alternative transaction structure. If family business owners sell at least 30% of the equity to the ESOP, however, they can typically defer paying any federal income tax on the capital gain, provided they reinvest the proceeds in “qualified replacement securities.” This tax benefit, if available, can be a major inducement for family business owners, particularly if diversifying their wealth is one of the primary reasons for the sale of equity in the first place.

An ESOP transaction also allows the family business owner to sell the precise equity interest required to meet the family’s liquidity objectives. This would include, for example, a small minority interest for which it might be difficult to find a third-party capital partner. Longer term, if the value of the stock appreciates meaningfully, care would need to be taken to ensure sufficient capital is available for the company to repurchase the shares from the employees as they retire.

**2. Sale to a Minority Capital Partner:** For many family business owners, the preferred investor is frequently a capital partner willing to accept a minority interest. Such an investor may be another company in a similar industry seeking to broaden its product line or expand its geographic reach. Alternatively, the sale may be a pure capital-raising event with a financial sponsor that creates a preferential ownership position and establishes a valuation benchmark for the future.

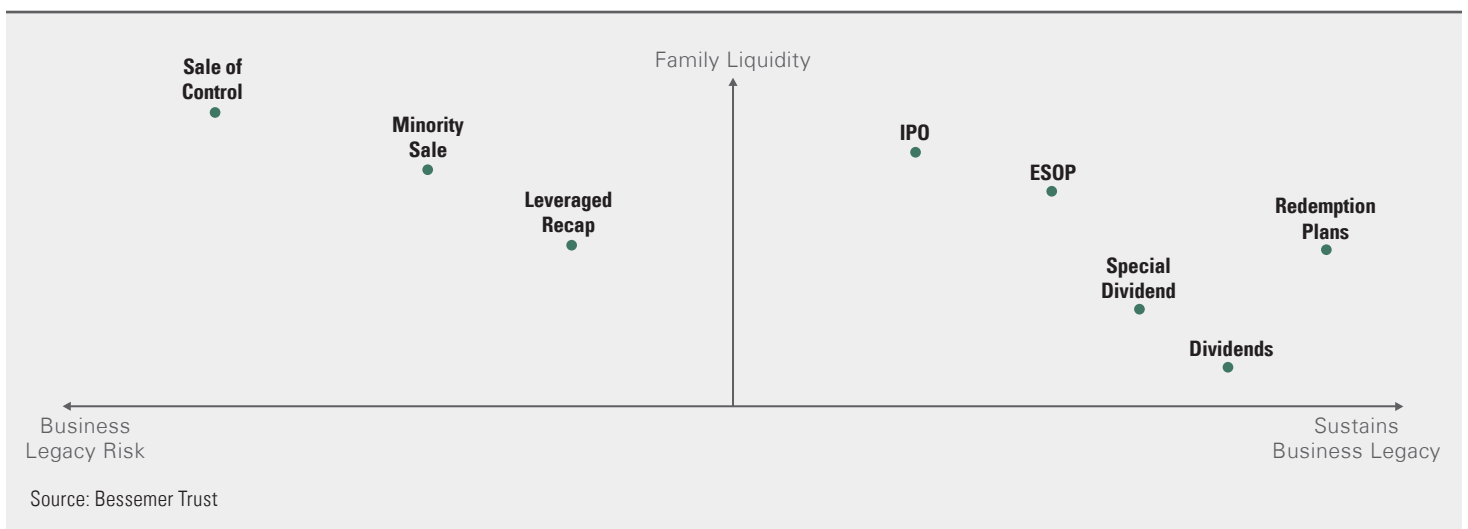
Often, such an initial minority position is followed by a second investment at a higher valuation through which a control position is acquired.

Unlike an ESOP transaction, a minority investment involves detailed negotiations with respect to the ownership interest acquired, the valuation of the shares, and the terms of a buy/sell agreement governing the future relationship. Further, minority capital partners tend to be actively engaged, requiring one or more seats on the board and a degree of negative control regarding major company decisions. (See “Minority Sale for Liquidity” Case in Point, page 4.)

**3. Initial Public Offering (IPO):** The sale of equity through a public offering of equity listed on a stock exchange has traditionally been regarded as a desirable and prestigious liquidity alternative. Most IPOs sell a minority interest in the company representing less than 30% of the equity. An IPO typically provides liquidity for the family business owner at an attractive valuation relative to private market alternatives. It also establishes access to public capital for the company to meet its future funding requirements.

Executing an IPO has always been a demanding process, but recent regulatory developments have made it even more onerous. Severe market corrections accompanied by financial scandals have led to comprehensive legislation, including the Sarbanes-Oxley Act of 2002 and the Dodd-Frank

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Act of 2010. Burdensome requirements regarding the independence, transparency, and accountability of board members and executives have tempered enthusiasm for the IPO process.

Nevertheless, the IPO market remains an attractive source of liquidity to satisfy both the personal needs of family business owners and the corporate finance requirements of companies.

- 4. Sale of Control:** A family business owner may decide it is time to sell a controlling stake in the business or exit it entirely. Reasons include industry pressures facing the company or family issues, such as the lack of an heir apparent to manage the business. Further, the passing of a founding family member with inadequate estate planning can result in a large estate tax bill and a forced sale of the company.

Although the sale of control may be an unwelcome step for some family business owners, several aspects of the transaction may mitigate their concerns.

One of the most attractive features is the premium valuation generally received for the sale of a controlling interest in a company. On average, acquirers will pay a premium of 20% to 30% more than the fair market value of a company for control over all operating policies and decisions, the right to select management and appoint the board of directors, and the determination and distribution of dividends to shareholders.

In some transactions, the acquirer may agree or even require that the family retain a minority equity interest and/or have selected family executives continue on as members of management or in consulting roles. A degree of family continuity can be reassuring for employees and customers of the company. It can also provide family members with additional compensation and perhaps, in the case of a partial sale, another liquidity opportunity from the eventual sale of their remaining equity interest.

### How We Can Help: The Family Company Advisory Group

Bessemer's Family Company Advisory Group serves as a trusted advisor to private business owners — and often works with their attorneys, accountants, and other advisors — regarding liquidity alternatives, valuation analyses, strategic initiatives, restructuring and recapitalizations, as well as governance and succession planning. This experienced team has worked with a broad array of family businesses operating in most major industry groups and ranging in value from \$50 million to more than \$10 billion.

### Providing Liquidity for the Business and for the Family

Many liquidity alternatives are available for family businesses, but determining the optimal strategy for a particular business requires balancing the personal interests of the family shareholders, including their unique tax considerations, with the corporate finance requirements of the business.

While family business owners often strive to avoid leveraging the company's balance sheet or selling equity to fund growth or distributions, excessive discipline in this regard may jeopardize the family business legacy and inhibit the lifestyle of the family.

In addition, the formal structure provided by holding the family business in a trust with the independent and objective guidance of a corporate fiduciary can help family business owners to maintain a long-term perspective and prioritize goals — for their company and their family.

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