

LEADERSHIP INSIGHTS

No. 1 way to destroy your private company wealth



So your company is private? You still work for shareholders. Don't forget it.

COMMENTARY

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Many privately held businesses unwittingly destroy shareholder wealth every year because of two easily reversed flaws.

First, most boards and CEOs focus only on operating entity results. They give priority to issues such as business strategies and plans, financial budgets, organizational issues and major transactions. They often select corporate ROE (return on equity) as a major metric, which is an appropriate element to consider.

Yet surprisingly, despite their legal and fiduciary responsibilities, few private company boards pay attention to perhaps their most important function: maximizing realized shareholder ROE.

My experience as a family business consultant and as a member of 14 different boards demonstrates that this issue is seldom even on the agenda!



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Unlike public companies, private companies don't worry about daily stock prices. In public companies, shareholders can realize their value by selling their stock in the market. Private company shareholders don't have this option.

Until cash or other assets are distributed and "realized," private company shareholder returns are zero—shareholders have nothing more than an unrealized stock gain, which is exposed to all the associated business and financial risks of owning an illiquid stock. Given this difference, private companies should expand their focus from solely creating shareholder value to include strategies for realizing value for their shareholders.

The signals of shareholder wealth evaporation

This inward focus at private companies leads to what's known as "wealth evaporation." It occurs because of several factors.

1. Time value of money

The delay in distributing cash returns to shareholders has a significant impact on ROE due to the time value of money and inflation. Waiting for a future liquidity event, such as a sale of the business, can be quite costly.

2. Working capital conservatism

Many "conservatively" managed businesses shy away from corporate debt and do not aggressively manage working capital due to an abundance of retained capital. This is a misuse of equity capital. For example, a working capital line can be established today for an approximate interest cost of 3 percent. By self-funding working capital, the business is making an unconscious decision to "invest" shareholder equity capital in an investment returning a mere 3 percent. This is an example of shareholder wealth evaporation over time, and this misappropriation of equity capital can also impact funds available for business reinvestment.

3. The debt hawk

Even conservatively managed businesses have an appropriate level of debt to support the enterprise. A no-debt or low-debt policy for all but high-risk businesses results in substandard shareholder returns due to the lack of financial leverage on the balance sheet.

4. Excessive cash

If management is not disciplined on cash generation and shareholder ROE, many business decisions are made that, over time, destroy shareholder value. Examples include poor capital investments, cash consumed in excessive receivables and inventories, substandard cost controls, poor product margins and a "financially" sloppy management culture.

5. Tail-risky business

Shareholder equity retained in the business is exposed to many "tail-risks." Examples include declining future business results, new competition/products, loss of key customers, suppliers or executives, new governmental regulation, product liability claims and detrimental PR. In addition, uncontrollable economic factors, such as interest rates, valuation multiples and tax rates, can impact shareholder value. The business economic cycle is still a reality. To wit, the Great Recession of 2008 permanently destroyed shareholder ROEs for many privately-owned businesses.

"Private companies ... do not have the pressures public companies have for increasing quarterly earnings. But public companies are focused on delivering shareholder value, and that is something private companies need to do better."

Since realizing shareholder value requires cash distributions, private company CEOs and their boards need to be disciplined on implementing strategies to generate current and future cash flow. There are three primary strategies to consider:

- ➔ Recurring cash distributions from ongoing operating profits plus depreciation less required capital expenditures.
- ➔ One-time or periodic cash distributions from improvements in working capital management and restructuring of the business' capital structure.
- ➔ Cash from sale of business from increasing the company's valuation and optimizing net proceeds after taxes.

The goal is to maximize shareholder ROE while minimizing the exposure to risks or, in other words, risk-adjusted return. Our firm's consulting experience has shown that a strategy of distributing part of the business' equity appreciation to shareholders on an ongoing basis will

maximize shareholder ROE. The exception is for high-growth companies requiring equity capital to support their growth plans.

The wealth of shareholder relations

To implement a wealth realization strategy, private companies need to evaluate how to realize business wealth as it is being created. When they do so, they will serve their shareholders better by:

- Improving overall shareholder investment performance by increasing realized internal rates of return and decreasing exposures to tail risks.
- Providing liquidity to the shareholders as an alternative to selling the business to meet shareholder liquidity needs.
- Introducing better financial management disciplines into managing the business, similar to private equity investment firms.
- Improving overall shareholder relations.

The first step is to evaluate future cash-flow generation capability, sustainability, volatility and future capital needs. The goal is to determine the amount of free cash flow that can be expected to be available to shareholders over the next three to five years.

Next is to evaluate alternative business capital structures and shareholder distribution strategies. The goal here is to meet the current and future capital requirements of the business while partially realizing previously created shareholder equity through one-time or recurring shareholder distributions. A variety of options should be evaluated, such as recapitalizing the business through debt or sale-leaseback transactions; spinning off non-core assets (such as real estate) into separate companies; selling underutilized assets and outsourcing; improving working capital management and improving business operations to increase cash flow.

In the final step, alternative business scenarios, capital structures, shareholder distribution strategies and investment management policies need to be evaluated. Financial models need to be created for each scenario to determine which plan will best support the business while maximizing realized shareholder returns.

A large cushion of conservatism is always recommended. In certain instances, we have suggested transferring distributions into a special purpose LLC with the same ownership group as the business. A "standby LLC" can tax-efficiently support the main operating business if funds are needed, loans need to be guaranteed, or asset protection strategies separate from the operating business are deemed important.

Private companies have the benefit of longer time horizons for performance measurement. They do not have the pressures public companies have for increasing quarterly earnings. But public companies are focused on delivering shareholder value, and that is something private companies need to do better. Once they do, private companies will have the best of both wealth-creation worlds.

—By *George Isaac*, founder and managing principal of [George Isaac Consulting](#), which advises private company and family business clients on succession planning, governance, family dynamics, operating performance improvement and business wealth realization. Isaac is also a member of the [CNBC-YPO Chief Executive Network](#).

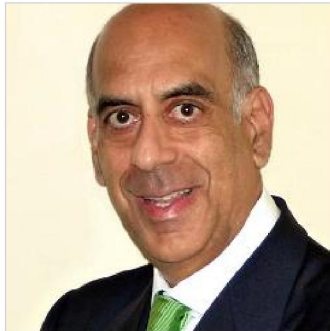
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