

Avoiding the ‘wealth evaporation trap’

On day two of the summit, **George Isaac** will share a case study of how a wealthy family can fall prey to the ‘wealth evaporation trap’. He explains the meaning of this term and the need for family offices to create a roadmap to success

More than 50% of family offices own an associated family business, while others have significant investments in private equity transactions. It is not difficult to see that a disproportionate part of a family’s wealth can quickly be consumed into an illiquid single asset class investment. In such situations, it is common to see more than 50% of a family’s wealth concentrated in family enterprises. From a wealth portfolio management perspective, this is an undesirable situation.

Under these circumstances, families are unknowingly taking on unrecognised risks, causing lower returns on investment for family shareholders and less liquidity. The core problem here is the misalignment of the family business assets with the overall family investment portfolio.

In this scenario, families see the business solely as an ‘operating entity’ and their other assets as ‘investments’. As a result, different investment paradigms and objectives are utilised and the family enterprise asset class is managed separately from the family’s wealth portfolio, resulting in underperformance. It also exposes the family to various ‘tail risks’, which are often unforeseen and unpredictable.

The inevitable consequence is the silent and unseen evaporation of family wealth – often over a single generation.

The first step to solving this problem is recognising that the value of a family business is best described as ‘unrealised stock gains’. That is, the value is not realised until the cash ends up in the owner’s pocket. My firm has created the Family Wealth Roadmap™, which introduces strategies and a process to address these problems by ‘realising’ part of the family business’ wealth as it is being created.

The Roadmap starts by evaluating the family business’ cash-flow generation capability, sustainability and volatility, along with its capital needs. Typically completed by a joint client-consultant project team, this approach provides in-



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depth company and industry knowledge, supported by a consultant’s independent and objective operational and financial review of the business.

While understanding the needs of the operating business is the starting point, the next step is addressing the ‘softer’ issues associated with family enterprise dynamics, the often overlooked issues that undermine multi-generational enterprise longevity. Thoughtful, reflective and objective individual conversations with key active and passive stakeholders are critical to developing a conceptual framework for redesigning the family wealth management

structure. Long-term success requires understanding and addressing both the technical/financial structural issues along with the family's unique dynamic and culture. Contrary to common belief, most family enterprises fail from one generation to the next because family members inadequately address the softer succession planning and behavioural issues – not the business issues.

Once these foundational steps are completed, we begin evaluating alternative business capital structures and shareholder distribution strategies against both the liquidity and diversification objectives of the family and the capital requirements for the business. As part of this phase, we reallocate investments into alternate asset classes to test results against investment management objectives.

The final step is the 'art' of the Roadmap, where we create one or more special purpose entities (SPEs) with specific financial strategies and customised shareholder agreements to house capital distributed from the operating enterprise. With properly designed SPEs, it is possible to mitigate any potential capital structure associated risks and meet both family and family business wealth management and asset protection objectives. As part of this phase, estate planning and tax-efficient wealth transfer often occur with input from the project team's estate counsel.

The benefits of implementing the Roadmap include:

- available capital to support the family enterprise's current and future needs;
- improved risk management, particularly unforeseen tail risks;
- improved family liquidity;
- tailored investments to meet individual family members' needs and objectives;
- improved risk-adjusted portfolio internal rates of return for the entire family wealth portfolio;
- customised and tax-efficient transfer of family wealth while maintaining family business control positions;
- increased family wealth asset protection; and
- improved family stakeholder satisfaction.

A multifaceted project team is recommended to implement the Roadmap. This would be composed of legal resources (corporate and estate), investment advisers, an insurance adviser and a family office/business consultant. It should be overseen by a family steering committee, typically composed of the family office senior executives, other key non-executive family members and the family business chief executive officer and chief financial officer. Representatives from multiple generations are involved at times, including

Family Wealth Roadmap™ Process



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future family member stakeholders.

In addition, a project of this nature facilitates opportunities for more family member participation. Active stakeholders could serve primarily on the family business board, for example, while passive stakeholders could serve primarily on the family's investment company SPE. Family members could serve on the family foundation SPE while others on a family enterprise bank SPE – for lending to other family members. The point is that, in addition to financial benefits, many other benefits such as improved family member connectivity, engagement, communication and compensation result from implementing the Roadmap. All of these benefits combined will support long-term positive family dynamics and enterprise longevity. ●

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