Is your board *really* looking after shareholders' interests?

The common error is confusing business wealth creation with shareholder wealth 'realization.' They are not the same; at times, not even close.

By George Isaac

Surprisingly, many private company boards pay little attention to perhaps their most important function, maximizing realized shareholder value. Despite their legal and fiduciary responsibility to exercise this function, boards often fail to give it much attention. My experience from serving on 14 different boards is that this issue is seldom even on the agenda!

Private company boards typically review business and financial plans and budgets, challenge business strategies, discuss organizational issues, and approve major transactions such as loans, acquisitions, or the sale of the business. They rarely challenge management to look at shareholders' equity as an *investment*, much as a wealth manager might do.

Too often, the board looks at the business solely as the "operating entity" versus the shareholders' "investment." As a result, boards do not apply traditional investment management principles in their oversight role and miss the important board responsibility of protecting the interests of the shareholders. The common error is confusing business wealth creation with shareholder wealth "realization." They are not the same; at times, not even close.

We have witnessed too many businesses lose a lifetime of wealth creation, often due to no fault of their own. The Great Recession of 2008 is one recent example. Many businesses and, correspondingly, shareholders, will never get their values back to pre-2008 levels. Even if they do, when considering the time value of money, these shareholders have lost considerable wealth.

Inevitable consequence

When I was the CEO of my family's businesses, we focused on the "company" return on equity (ROE). Under that metric, we were very suc-

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cessful, posting double-digit returns for several consecutive years, much to the satisfaction of our board and shareholders. However, we failed to recognize the significance between "realized" and "unrealized" shareholder ROE. So do most business boards. Shareholder ROE is not realized until cash is in the shareholders' pocket. Prior to that, it is an "unrealized stock gain" with all of the associated risks.

Many boards, by "failing to act" (another prime board responsibility), have their shareholders exposed to unrecognized "tail" risks, lower ROEs, and less liquidity than alternatives discussed below. The inevitable consequence is the silent and unseen evaporation of shareholder wealth, often over a single generation.

To address this issue, boards need to evaluate how to realize business wealth — prior to the sale of the business or other future liquidity event. When they do, they will serve their shareholders by:

• Improving overall shareholder investment performance by increasing realized internal rates of return and decreasing exposures to tail risks.

• Providing liquidity to the shareholders; even to the extent of providing an alternative to needing to sell a business for liquidity needs.

• Introducing better financial management disciplines into managing the business, similar to private equity investment firms.

Implementing a strategy for wealth realization

The first step is to evaluate the business's future cash flow generation capability, sustainability and volatility along with its capital needs. In-depth company and industry knowledge supported with a professional and objective operational and financial review of the business is essential. The goal is to determine the amount of free cash flow that can be expected over the next three to five years.

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The next step is to evaluate alternative business capital structures and shareholder distribution strategies. The goal is to meet the current and future capital requirements of the business while *protecting and 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 generate increased cash flow.

In the final step, alternative business scenarios, financial management practices, capital structures, and shareholder distribution strategies need to be developed. Next, financial models need to be created to evaluate 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 entity with the same ownership group. This provides a separate standby LLC to support the main operating business in case funds are needed, loans need to be guaranteed, or asset protection strategies separate from the operating business are important.

Common objections

Some business CEOs state, "I am comfortable being invested in my business, where I understand the risks. I also do not like to incur debt for the company." Many boards do not challenge CEOs on these preferences since they appear to be a lower-risk approach to managing the business. On a superficial level, that response appears to have merit, but an analysis with real company data often proves the opposite.

Boards and CEOs often fail to account for uncontrollable and unpredictable tail risks that might occur, such as:

• Major customer, supplier or key employee loss.

• Product or service obsolescence.

• Governmental regulatory or product liability problems.

• Shareholder feuds/litigation.

• Business interruptions due to uncontrollable events.

• Declining future business performance.

• Market changes in interest rates, equity multiples or tax rates that negatively impact shareholder value.

Remember, if cash is not distributed to shareholders, then their internal rate of return is zero, even if the business returns look great on paper.

While we do not recommend highly leveraged companies, many businesses similar to my family business had no debt in its capital structure. Of course, in the short term, companies with lower

debt have lower financial risks. Over the longer term, boards must consider the significant risks and costs associated with that strategy. One simple example of the cost of a no debt strategy is with working capital management. With no debt, the board is using shareholders' equity capital to finance accounts receivable and inventories. In today's marketplace, working capital lines from a bank are costing around 3%. As a result of self-funding, the board is making an unconscious decision to invest shareholder equity capital into a 3% returning asset, a good example of wealth evaporation over time.

Client case study

In a recent client case, we projected two different scenarios for a growing manufacturing company. In the first scenario, the company used annual operating cash flow to provide capital for growth prior to borrowing additional funds; shareholder distributions were made beginning in year 5 after all debt was paid off. In the second scenario, operating cash flows were distributed annually beginning in the first year to the shareholders; capital for growth was provided through additional bank debt. Both businesses were projected to be sold for the same enterprise value in year 10. The results between the first and second scenarios were significant: Scenario II was far superior to Scenario I on all metrics, including:

- Shareholder-realized ROEs increased from 13.3% to 19.1% due to the timing of cash distribution.
- Shareholder liquidity and realization of their equity values through cash distributions increased from $22 million to $83 million during the nine years prior to the sale.
- Cumulative shareholder wealth "realized" through year 9 increased from 14% to 52% of total shareholder proceeds received over the 10 years; half of the value of the company was received by the shareholder group without selling the company!
- Maximum debt to EBITDA ratio was well controlled in both scenarios, increasing from 0 to 2.5 times.

REMEMBER, IF CASH IS NOT DISTRIBUTED TO SHAREHOLDERS, THEN THEIR INTERNAL RATE OF RETURN IS ZERO, EVEN IF THE BUSINESS RETURNS LOOK GREAT ON PAPER.

By focusing on shareholder value realization strategies, your board can develop alternative strategies that will significantly increase the value shareholders receive from their investment, even without improving operating results.

The fundamental question

Every business board needs to consider this fundamental question: How many years do you wait to begin partially realizing shareholder wealth? Some should immediately begin realizing the wealth and others such as high-growth companies need to retain their capital for a period prior to harvesting some of the created wealth. It is a question too many private company boards are not asking, resulting in too many shareholder groups not being well served. ■

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