

# Creating a plan for realizing 'trapped' wealth

BY GEORGE ISAAC

There are many reasons why a family company ceases operations, but one routinely missed by family business boards, CEOs and advisers is the failure to view the family business as an “investment asset” rather than an “operating entity.” This often results in disruptive family dynamics over time, since individual shareholders have differing investment objectives and needs. It also exposes families to inappropriate investment concentration and unrecognized “tail” risks, and causes them to incur lower family shareholder realized return with less liquidity. The inevitable consequence is the silent and unseen evaporation of family wealth—often over a single generation.

Of course, family businesses have multiple reasons for existing, but ignoring sound investment management principles for your family company carries a huge hidden cost. For example, when I was the CEO of my family's businesses, we focused on the company's return on equity (ROE). Under that metric, we were very successful in posting great returns for several consecutive years. However, we failed to recognize the significant difference between “realized” and “unrealized” ROE—and, unfortunately, so do most family business owners. Simply stated, 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.

Too few families understand these risks and the corresponding diminished shareholder ROE. They fail to recognize the importance



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of developing and implementing strategies to partially realize trapped family business wealth as it is being created. While many professional advisers focus on creating and preserving family wealth, few concentrate on realizing family business wealth prior to a liquidity event.

## Realizing family business wealth

To address this issue, families should evaluate how to partially realize “trapped” family business wealth—prior to the sale of the business, or sometimes as an alternative to the sale of the family business. By realizing trapped family business wealth, the families can:

- Improve overall family wealth management investment performance by increasing realized internal rates of return, liquidity and diversification and reducing portfolio volatility and exposure to tail risks.
- Provide family liquidity to meet both family and individual shareholder needs and objectives.
- Provide retirement funding for succession planning without selling the business.
- Facilitate advanced asset protection and wealth transfer strategies to support estate planning.
- Improve family dynamics by providing multiple special-purpose entities for family member engagement as investors and directors.
- Introduce better financial management disciplines into managing the family business.

## Implementing a wealth realization strategy

The first step is to evaluate the family business's cash flow generation capability, sustainability and volatility along with its capital needs. A combination of in-depth company and industry knowledge with an honest and objective operational and financial review of the business is essential to define parameters on how much wealth realization is feasible without negatively affecting the golden goose—your family business.

The next step addresses the “softer” issues associated with family business dynamics, the often-overlooked issues that undermine multigenerational business longevity. Thoughtful and objective individual confidential conversations with key active and passive stakeholders are critical to developing a conceptual framework that meets both business and family needs. Long-term success requires understanding and addressing the technical/financial structural issues, individual family members' needs, and family dynamics and culture.

Once these foundational steps are completed, the next step is to evaluate alternative business capital structures and shareholder distribution strategies against both the liquidity and diversification objectives of the family while

meeting the current and future capital requirements of the business. A variety of options should be evaluated: recapitalizing the business through additional debt or sale-leaseback transactions; spinning off non-core assets (such as real estate) into separate companies or preparing them for sale; improving working capital management; and instituting ongoing annual distribution strategies. As part of this phase, investment models of the family's overall wealth portfolio, including the family business, are evaluated. We recommend constructing multiple investment portfolios based on differing investment asset class allocations. Each portfolio should be evaluated using a range of inputs to understand the potential investment results. The final portfolio design should best meet the family's investment management objectives and goals for shareholder liquidity, risk and returns.

In the final step, one or more special-purpose entities with specific investment strategies and customized shareholder agreements are created to house cash or other assets distributed from the operating enterprise. With properly designed special-purpose entities, one can mitigate any revised business capital structure risks while meeting both family and family business wealth management objectives. As part of this phase, estate planning and tax-efficient wealth transfer often occur with input from the company's estate counsel.

### Common objections

Some family business CEOs state, "I would rather stay invested in my business, where I understand the risks, than diversify into other investment asset classes." On a superficial level, that response appears to have merit, but an analysis with real company data often proves the opposite. In fact, lack of diversification creates both a high risk and an underperforming family wealth portfolio.

Family business CEOs typically fail to account for a number of uncontrollable and unpredictable tail risks, such as:

- Loss of a major customer, critical supplier or key employee.
- Obsolescence of a product or a service.
- Governmental regulatory or product liability problems.
- Family feuds/litigation.
- Business interruptions due to uncontrollable events.
- Declining future business performance.
- Market changes in interest rates, equity multiples or tax rates that have a negative impact on business valuations.

Also, if cash is not distributed to shareholders, then their internal rate of return is zero, even if the business returns look great on paper. Unrealized cash returns create a significant hidden cost. As an example, by initiating an annual cash distribution strategy to begin partially realizing trapped family business wealth, one business improved its shareholder return on equity from 13% to 19%.

Another common reaction is, "Our family doesn't like debt," or "Our business has very little debt so we can maintain a lower risk business for future generations." In the short term, companies with lower debt have lower financial risks. However, over the longer term, families must consider the significant risks and costs associated with that strategy, such as reduced shareholder returns. This can prevent accumulation of the growth capital necessary to protect and grow the family business for future generations.

We often explain to families that no debt means the family is using its precious equity capital to finance accounts receivable and inventories. In today's marketplace, working capital lines from a bank are charging around 3%. As a result of self-funding, the family is making an unconscious decision to invest family equity capital into a 3% returning asset, a good example of wealth evaporation over time.

Every business owner should consider this fundamental question: How many years do you wait to begin partially realizing some of your trapped family business wealth through transfers into a well-managed family wealth investment preservation program?

### Improved family dynamics

As an additional benefit, partially realizing family business wealth by creating additional investment entities will increase the opportunities for family member participation. For example, active business stakeholders could serve on the family business board while passive stakeholders could serve on one or more family investment companies. Other family members could serve on the family foundation, and others could run a family enterprise bank (for lending to other family members). In addition to financial benefits, implementing these strategies can improve family connectedness, engagement, communication and compensation. All these benefits together will support long-term positive family dynamics and enterprise longevity. Developing a family business wealth realization strategy can meet family as well as family business objectives. 