Family Business

Lesson 14

Financing growth and exit strategy

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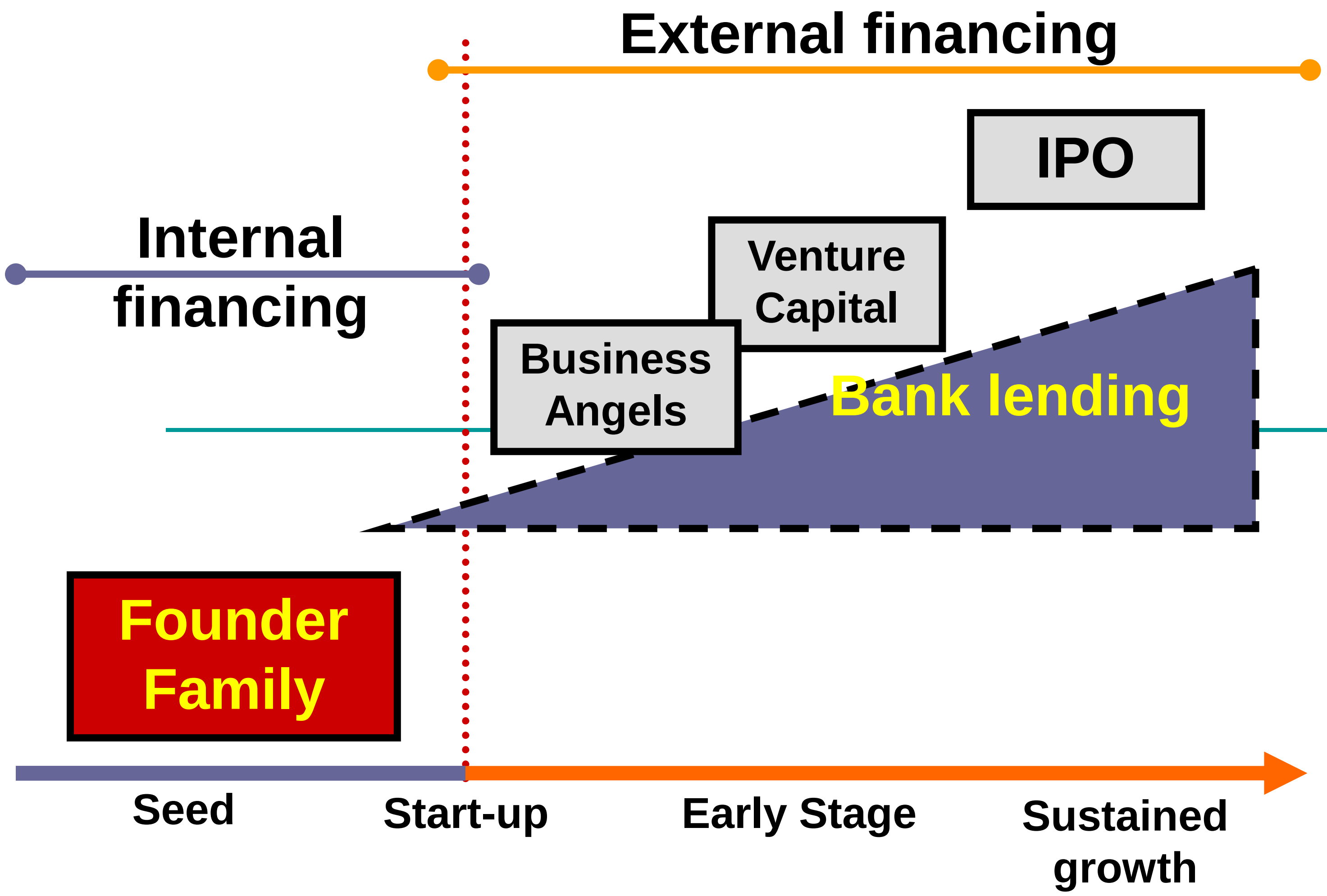
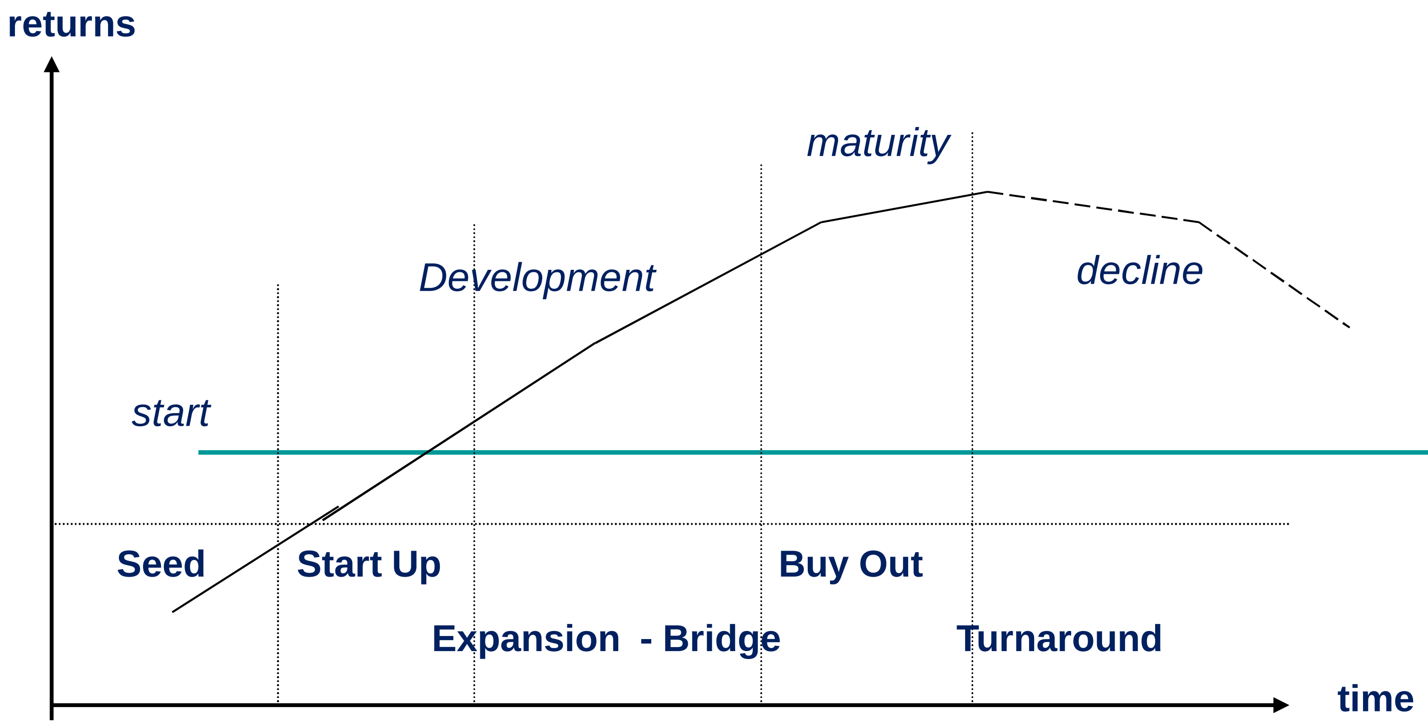
Capital is added in stages in the differents phases of the firms' creation

3F theoretically should exit ...

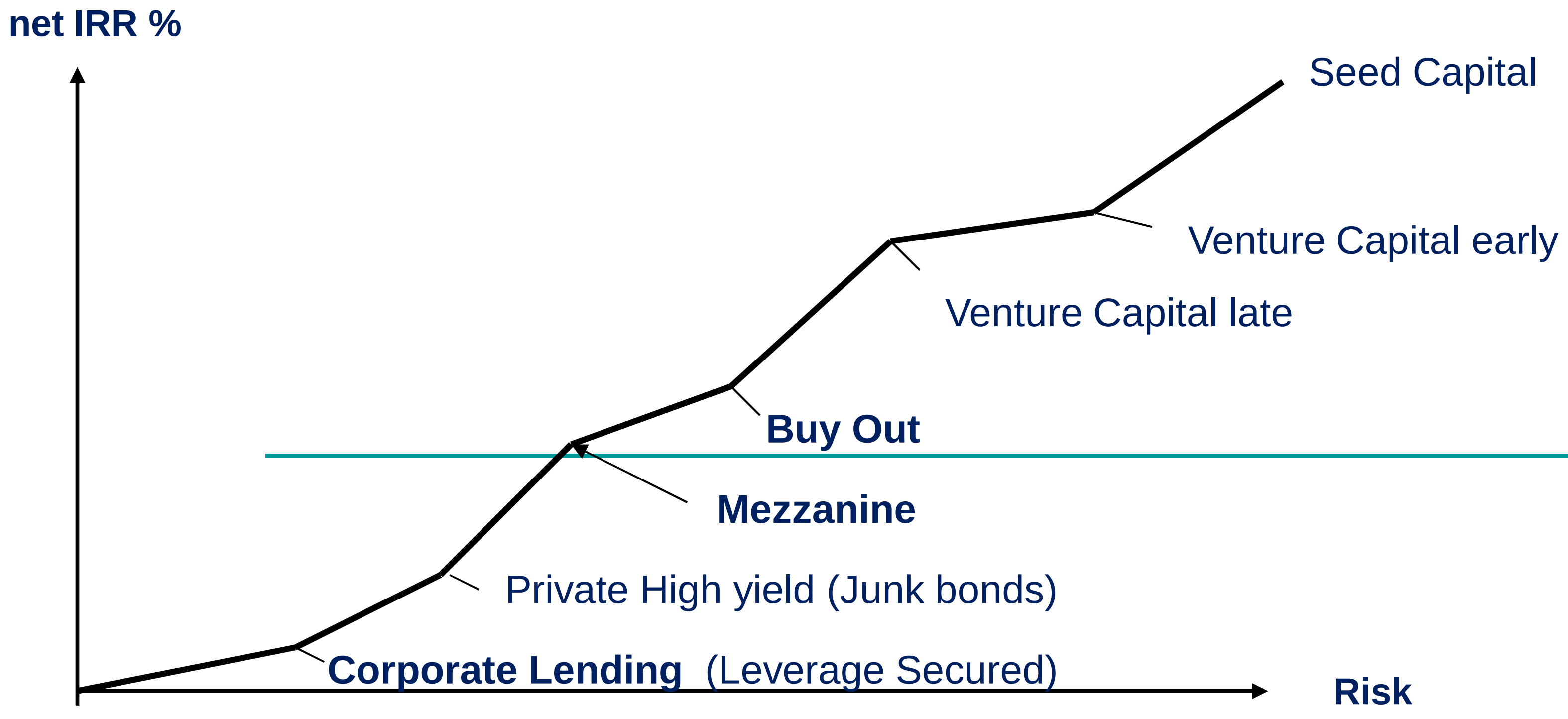


Financial life cycle



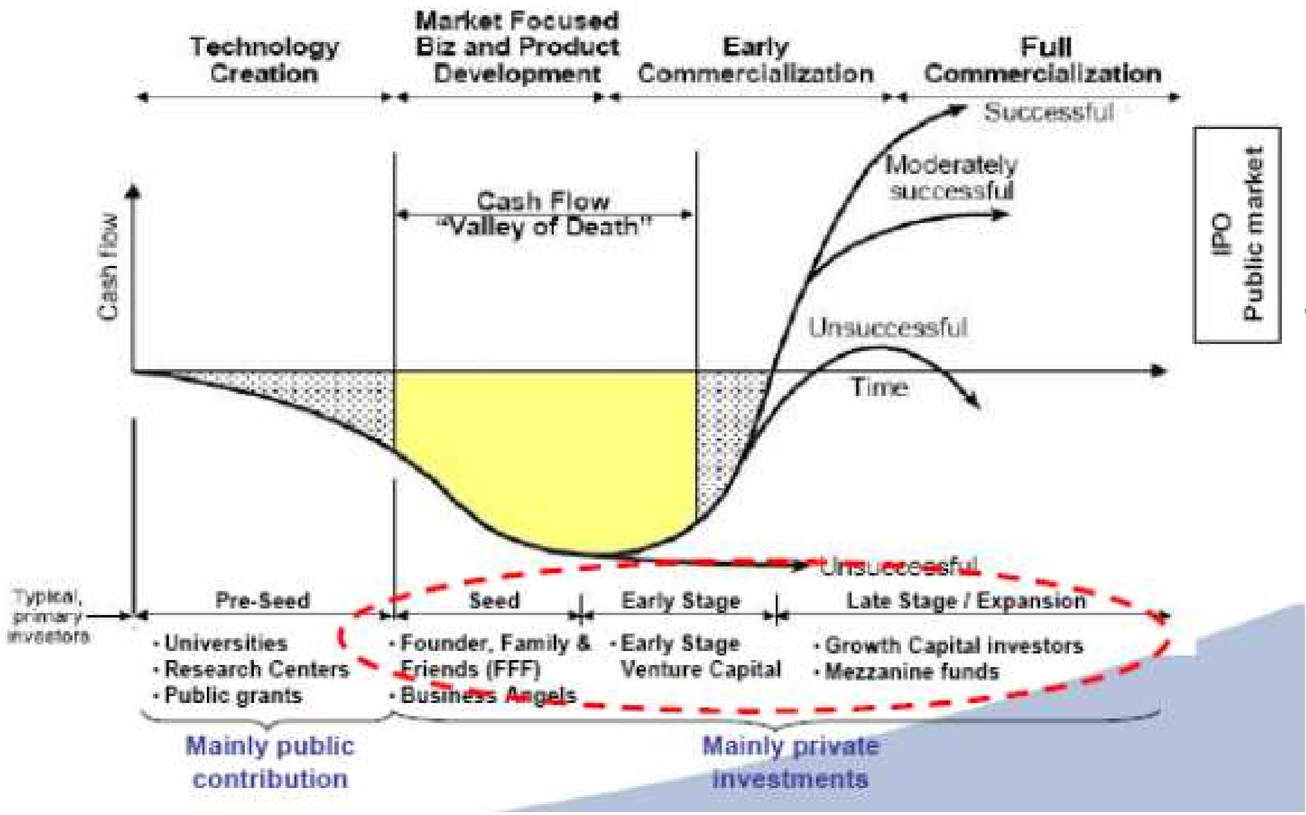
(Fonte Kunkel & Mukherjee

Type of deals for risk/return



Role of venture capital investors on firm development: evolution of cash flows

Seed and Early Stage Venture Capital investors have a primary role on supporting new company during their first years



EQUITY CAPITAL

START

- SEED FINANCING
- START UP FINANCING
- FIRST STAGE FINANCING

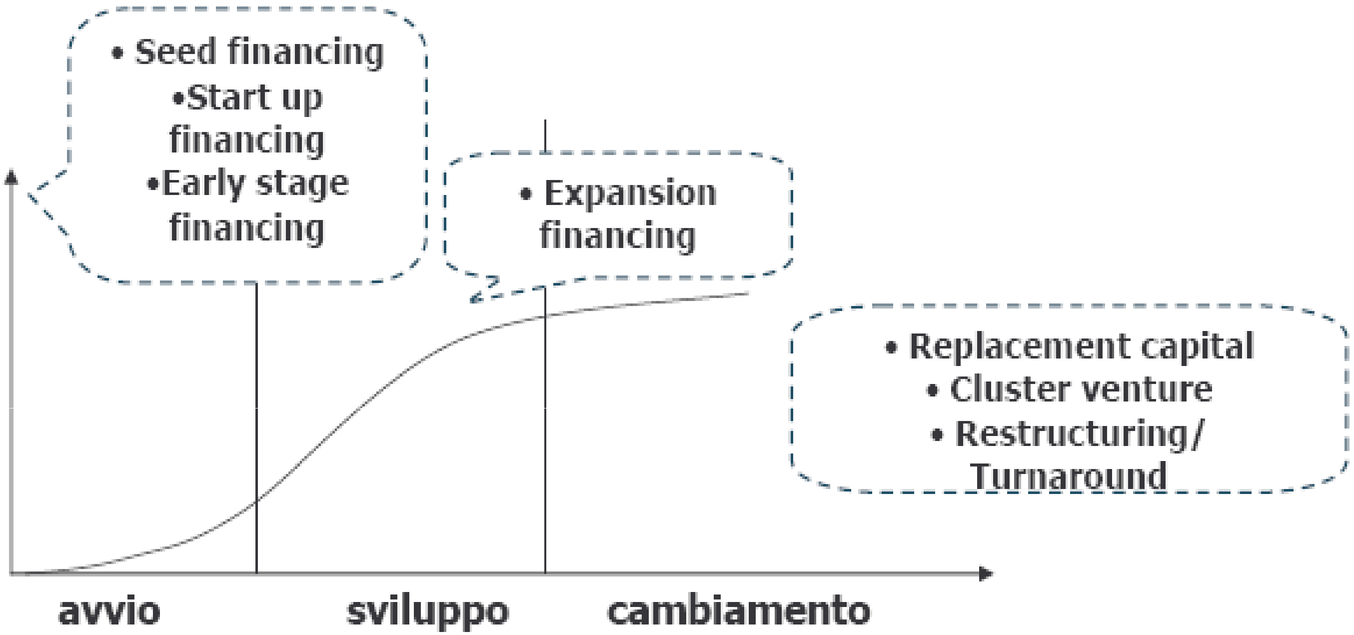
DEVELOPMENT

- BRIDGE FINANCING
- CLUSTER VENTURE

MATURITY

- REPLACEMENT CAPITAL (MBO/MBI)
- PUBLIC TO PRIVATE
- TURNAROUND FINANCING

EQUITY – THE WHOLE CYCLE



MBO – Management buy-out

MBI – Management buy-in

EBO – Employees buy-out

BIMBO – Management buy-in/buy-out

LBO – leveraged buy-out

MLBO

MLBI

ELBO

Why sell the firm

- No next generation
- Divest non-core business
- Turnaround of difficult situation
- Concentration
- Necessity of large investments

Why buy a firm

- Target firm not well run
- Underestimate by stock market
- Increase dimension
- Seeking synergy
- Eliminate competitor
- “Ego” of buyers’ management
- Strategic fit

Who buys

- Industrial strategic
- Competitors, suppliers, clients (horizontal, vertical)
- Investors (banks, hedge funds, private equity funds)
- managers

Type of Buyer

Financial

1. Less familiar with industry
2. Usually due diligence takes longer
3. Management is needed
4. Temporary investor (usually 5 – 7 years)

Type of Buyer

Strategic

1. Familiar with industry
2. Can often move faster than a Financial buyer
3. Does not necessarily require management to stay
4. May pay for synergies

Way out

- Ipo
- Trade sale
- Secondary buyout
- Re-leverage
- Write-off

Type of Sale Process

Auction (Shotgun Approach)

1. Timeframe (9 – 12 months)
2. Memorandums distributed to 100+ potential buyers
3. Management meetings/facility tours x 6 – 10 potential buyers
4. Secure the highest price
5. Less control over the ultimate partner

Type of Sale Process

Limited Process (Rifle Approach)

1. Timeframe (6 – 9 months)
2. Maintain confidentiality
3. Minimize disruption
4. Receive a fair price, not necessarily the highest price
5. Greater control over partner

Current Market Conditions

- Unprecedented Financial Upheaval
- Seizure of Credit Markets
- Uncertainty of Equity Investors – both Private and Public
- Declining Profitability
- Buying Opportunities

Evidence of capital markets overperformance: Credit Suisse Index

In our studies, we short-listed companies with a market capitalization above EUR 500 m for liquidity reasons. On average, we found that the SSFI outperformed its respective sectors by 190 bp on a quarterly basis in Europe. A similar outperformance has been observed in the US. These results are supported by academic research and media reports.

According to our analysis, this outperformance is due to three key reasons, i.e. a longer-term management focus, better alignment between management and shareholder interests and greater concentration on core business.

Credit suisse family index company list

Table 1: Current list of Credit Suisse Family Index components

Sedol	Name
2162845	CAMPBELL SOUP CO
2407911	HANSEN NATURAL CORP
7759435	ILIAD SA
2043694	APOLLO GROUP INC -CL A
2210614	MARRIOTT INTL INC
2640147	NIKE INC
2702092	PHILADELPHIA CONS HLDG CORP
2705024	PROGRESSIVE CORP-OHIO
2250870	DANAHER CORP
2576327	MENS WEARHOUSE INC
2246288	FEDERATED INVESTORS INC
5295254	ARCELOR MITTAL
5782206	BUZZI UNICEM SPA
7110753	HOLCIM LIMITED
5636927	THYSSEN KRUPP AG
2661568	ORACLE CORP
2674458	PAYCHEX INC
7151116	RICHEMONT (COMPAGNIE FINANCI
7062713	SODEXHO ALLIANCE S.A.
7184725	SWATCH GROUP OF SWITZERLAND
7156036	PHONAK HOLDING AG
7110388	ROCHE HOLDING AG
7156832	STRAUMANN HOLDING AG
5679579	INVESTOR AB
5535198	MEDIOLANUM S.P.A
4354134	UNITED INTERNET AG
2853688	STRYKER CORP
7332687	ALFA LAVAL AB
B08HBT8	ATLAS COPCO AB
5748521	FIAT SPA
7101069	PORSCHE AG
7390113	WENDEL INVESTISSEMENT
5687431	H & M HENNES & MAURITZ AB
4755317	INBEV SA
7111314	INDITEX
4057808	L'OREAL
4682329	PERNOD RICARD
5273131	ALTANA AG
4002121	BOUYGUES SA

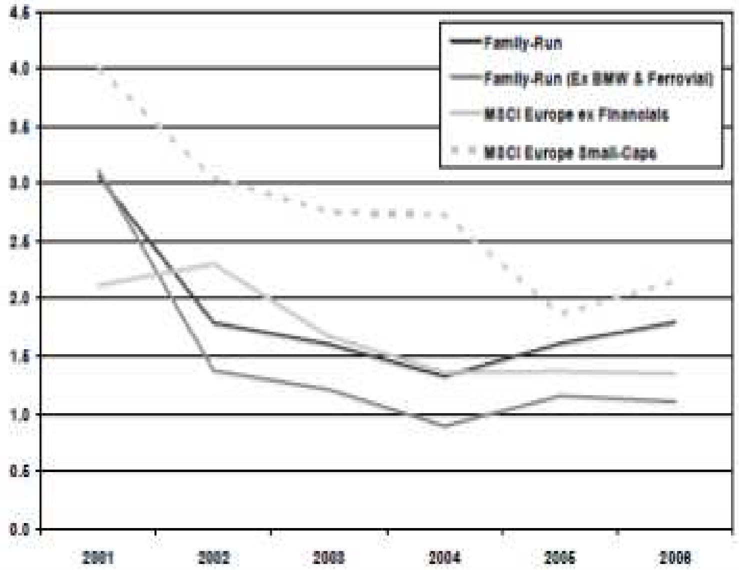
Evidence from capital markets: a basket by Morgan Stanley

Family-run companies as an attractive asset class. This group of companies has many attractive features, such as longer-term management focus and a stronger focus on core businesses. The combination of superior sales growth, below-average operating gearing and resilient margins are also key to their outperformance. In

Strong and resilient profitability. A combination of high sales growth and low operating gearing means that when growth is buoyant, profitability of this group of companies will be roughly in line with the market, but when growth slows, margins will be more resilient. Exhibit 4 shows this

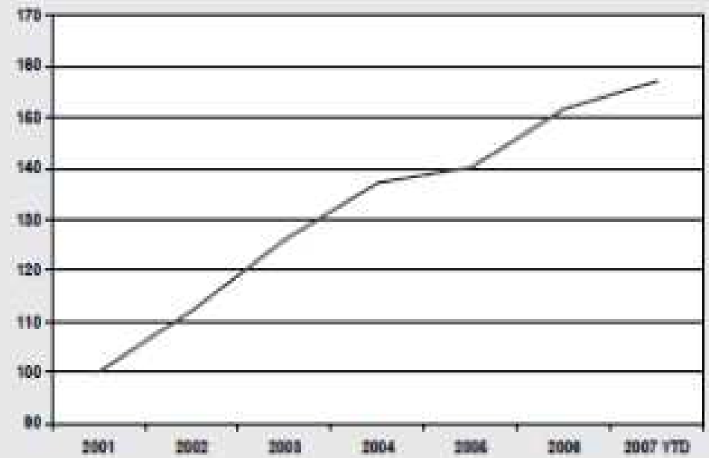
Morgan Stanley basket of family firms: data

Moderate leverage – net debt to EBITDA



Note: Chart shows net debt to EBITDA of the basket of family-run companies and MSCI Europe ex financials. Source: Lionshare, MSCI, Worldscope, Morgan Stanley Research

Strategy Beats the Market by 869bps Per Annum



Note: Chart shows cumulative relative total return of family-run companies; Total return measured from 31 Dec 01 to now, based on equal-weighted basket of family controlled companies (rebalanced annually); exclude transaction costs. Source: Lionshare, MSCI, Morgan Stanley Research

Performance of family business PLCs versus Footsie companies

The graph shows that family-controlled and patrimonial companies perform quite well in terms of shareholder returns during the last six years period, with an increase of around 30 base points for the FB30 Index and around 45 points for the FB All-Share Index. Finally, the graph reveals that FB All-Share Index and FB30 Index out-perform the FTSE All-Share Index by 40% and 25% respectively.

Finance theories and family firms

According to the pecking-order hypothesis (Myers, 1984) companies finance their capital needs in a hierarchical fashion. Firstly, by using internally available funds, followed by debt and then, finally, external equity. Arguably, the pecking order hypothesis is particularly relevant to closely held family firms, characterised by an aversion to outside capital infusions (Gallo and Vilaseca, 1996; Romano et al, 1997; Poutziouris et al, 1997; Poutziouris et al, 1998; Poutziouris, 2001a). This is because they experience relatively more restrictive transactional and behavioural costs in raising external equity (Pettit and Singer, 1985). In the case of the growing family firms, heavy investments in organic and/or acquisitive expansion and innovation enabling technologies and global marketing [niche] strategies, could result in the exhaustion of debt facilities, and therefore compel the owner family to seek external (private and public) equity.

10 golden rules on how not to loose the firm…..

1. Believe that your son is able to manage the firm
2. Mix the role of shareholder with that of manager
3. Insist to maintain control of the firm
4. Delay opening up the firm's capital to outside capital
5. Incapable of choosing good managers

….or how to learn from others'mistakes

1. Unable to create an environment between owners and managers oriented towards value creation
2. Unable to recognize that past success factors have inexhorably changed
3. Increase debt leverage beyond safety limits
4. Diversification: danger or opportunity?
5. Believe to be smarter that the others