Lesson 13

Financial evaluation of a Family business

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Figure 2 Financial flows in the family firm

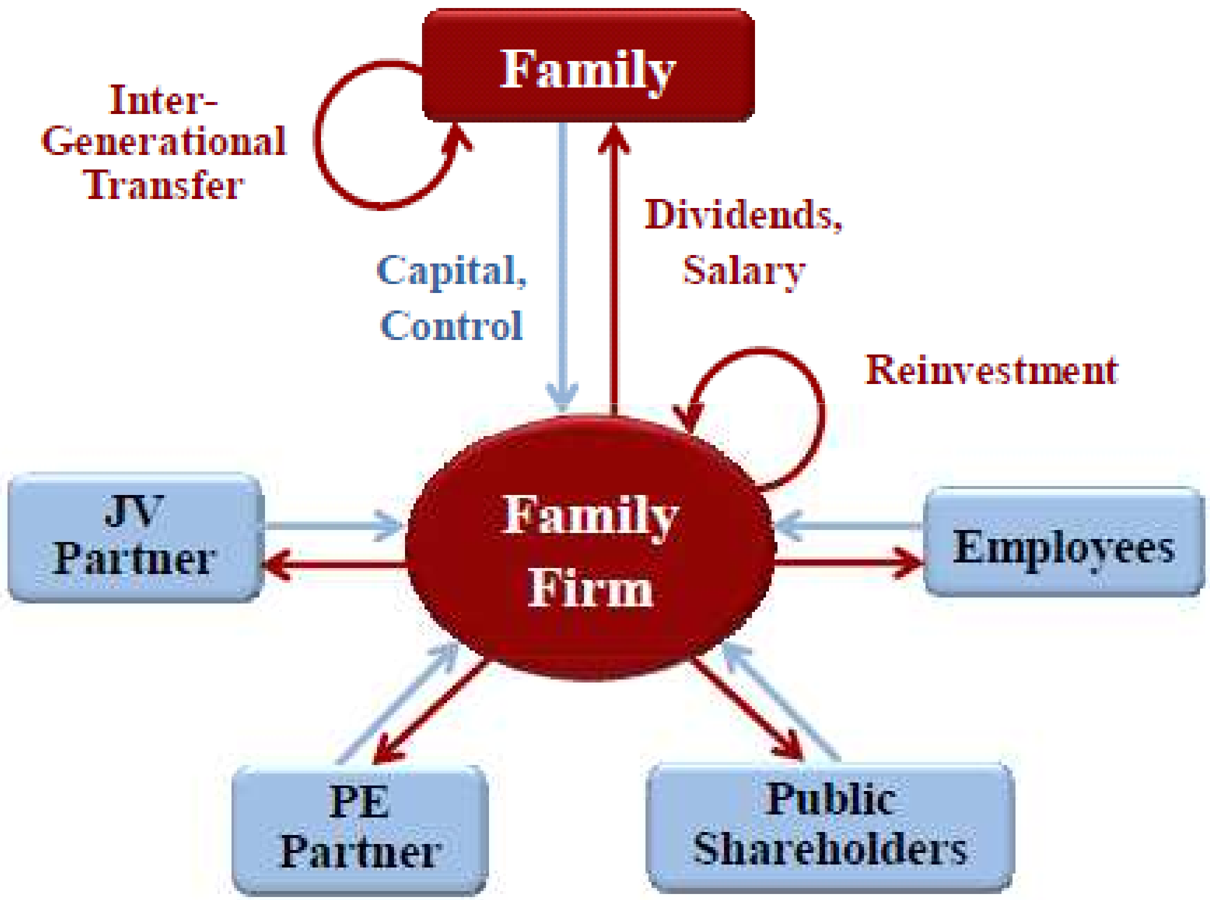


Figure 3 Financial flows in the family firm system

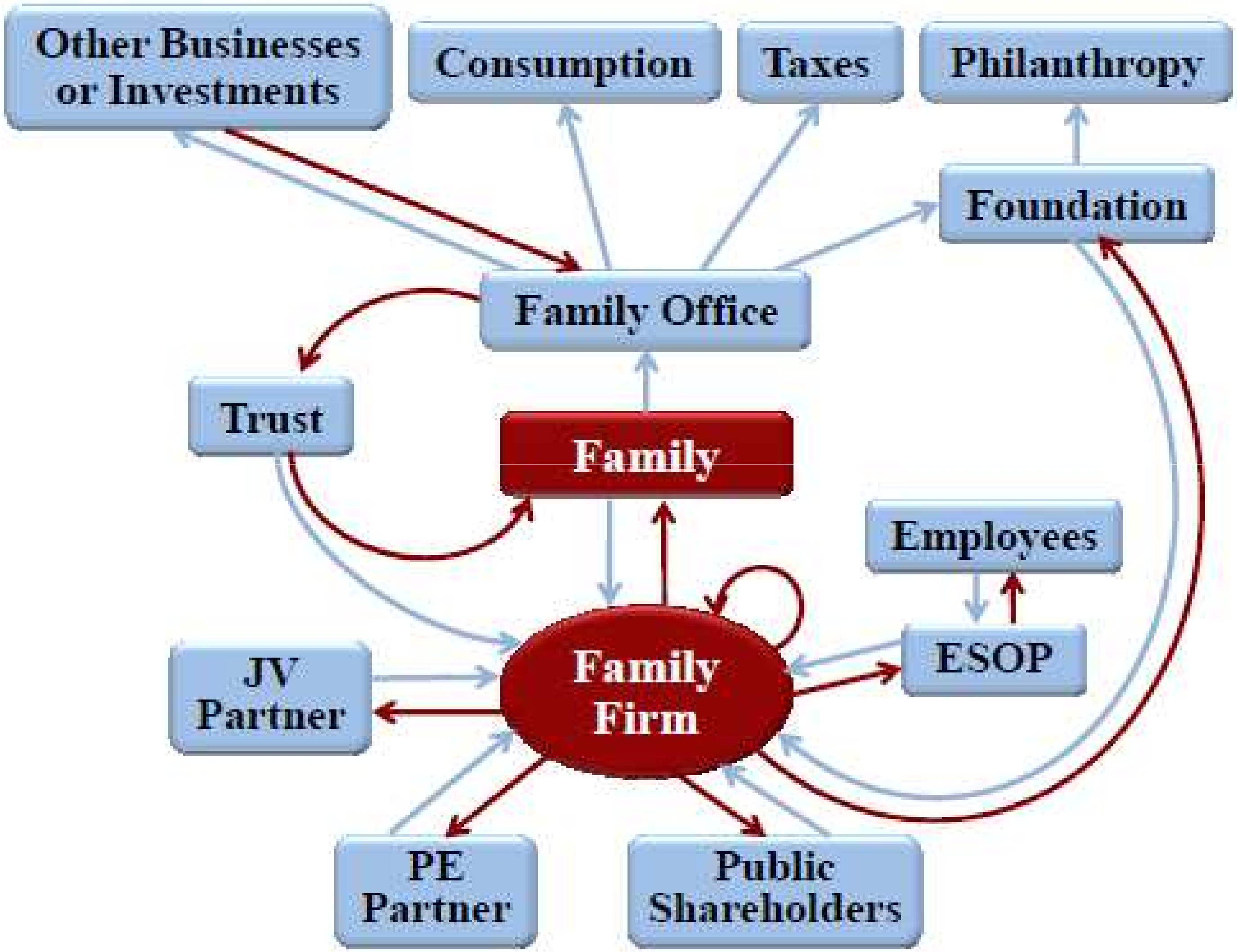
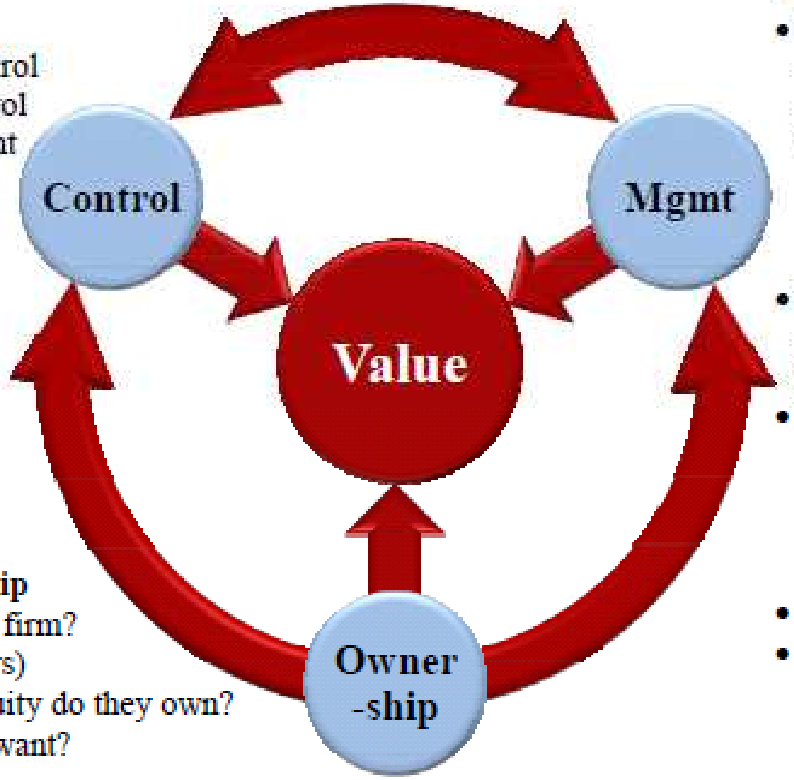


Figure 4 Framework for decision-making in family firms



2. Control
- Who controls the firm?
- How?
  a) Ownership
  b) Voting control
  c) Board control
  d) Management

3. Management
- Who manages the firm?
- Who controls whom? (Owners vs. managers)
- Which management aspects or decisions are affected by family control?
  a) Functional
  b) Strategic

4. Value
- How much is the company worth? To whom?
  a) The family
  b) Other shareholders
- Is the family creating value? For whom?
  a) The family only
  b) All shareholders (including non-family)
  c) Other stakeholders (employees, customers)
  d) Society at large
- How? (through which O-C-M combination)?
- Can more value be created through a different set of O-C-M choices? E.g.
  a) (Different source of) outside capital
  b) Keeping control but not management

1. Ownership
- Who owns the firm? (family & others)
- How much equity do they own?
- What do they want?

5. Intergenerational transfers
- Does the family want to transfer to future generations ownership, control, management, and/or value (wealth)? To whom?
- Which succession and/or estate plan can best facilitate the desired transfer?
- How are other stakeholders affected by the plan?

Determinants of Value

- Management team
- Growth rate
- Margins (Gross and EBITDA)
- Industry (cyclical & seasonality)
- Customer concentration

CAPITAL BUDGETING IS THE PROCESS OF PLANNING FOR PURCHASES OF LONG-TERM ASSETS

Main objective of investment analysis is the selection of those projects which will maximise the wealth of the owners (or shareholders) of the enterprise

It involves a consideration of future events, not past performance

The Ideal Evaluation Method should:

1. include **all cash flows** that occur during the life of the project,
2. consider the **time value of money**,
3. incorporate the **required rate of return** on the project.

Investment evaluation in 3 basic steps

1) Forecast all relevant after-tax expected cash flows generated by the project

2) Estimate the opportunity cost of capital--*r* (reflects the time value of money and the risk) as seen

3) Evaluation methods

- DCF (discounted cash flows)
  - NPV (net present value)
    Accept project if NPV is positive
    Reject project if NPV is negative
  - IRR (internal rate of return)
    Accept project if IRR > r
- Payback
- EVA

Forecasting cash flows

<u>Cash Flows from Operations</u>

	Revenue
-	Cost of Goods Sold
-	Depreciation
-	Selling, General & Admin.
=	Operating Profit
-	Cash Taxes on Operating Profit
=	Net Operating Profit After Tax (NOPAT)
+	Depreciation
-	Capital Expenditures
-	Increase in Working Capital
=	Cash Flow from Operations

FACTORS OF FOUR DIFFERENT METHODS TO PERFORM THE EVALUATION OF GOING CONCERNS

	Description	Driver
Payback Period	Payback Period = number of years to recover initial costs. How long does it take the project to “pay back” its initial investment?	Time
NPV	Net Present Value (NPV) = Total PV of future CF’s - Initial Investment	Cash
IRR	IRR: the discount that sets NPV to zero	Capital remuneration
EVA	(ROI-WACC) * IC	Economic value added

Ideal target company

- Low leverage
- Strong cash generation , both for current business and for additional debt burden service
- Stable growth
- Good quality assets (can act as guarantee)
- Consolidated market share
- Small capex need
- Good management
- Non-core, divestable assets

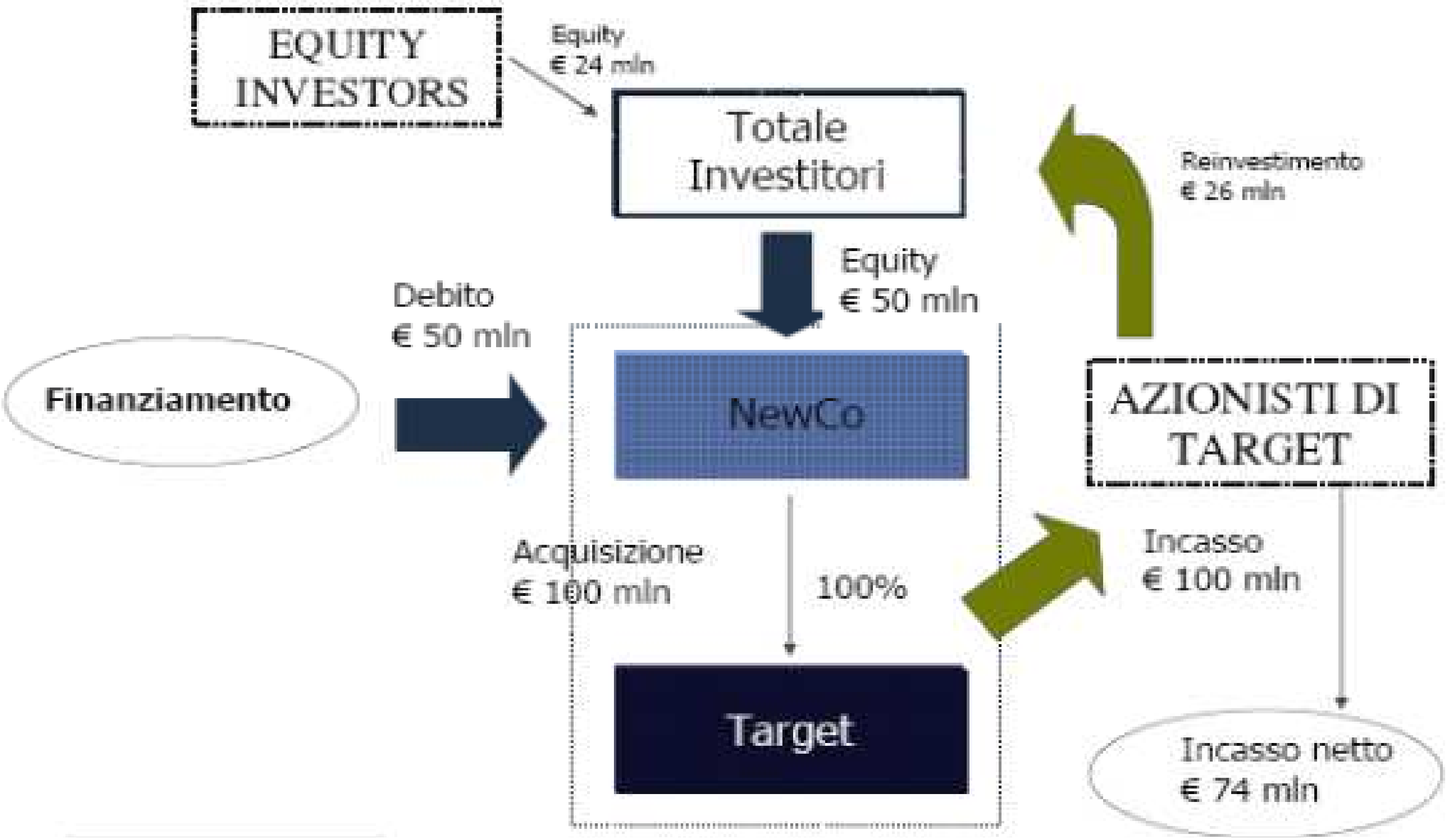
Risks

- Excessive leverage
- Unfavourable Market
- Price too high
- Difficult integration
- Overconfidence in realizing synergies

Important issues

- Most acquisition do not create as much value as expected
- Buyers' stock price suffers
- Price is seldom as important as integration issues

Typical structure



Levers to create value

Three primary levers are used by private equity managers to generate returns:

1. Leverage

2. Operating Improvements

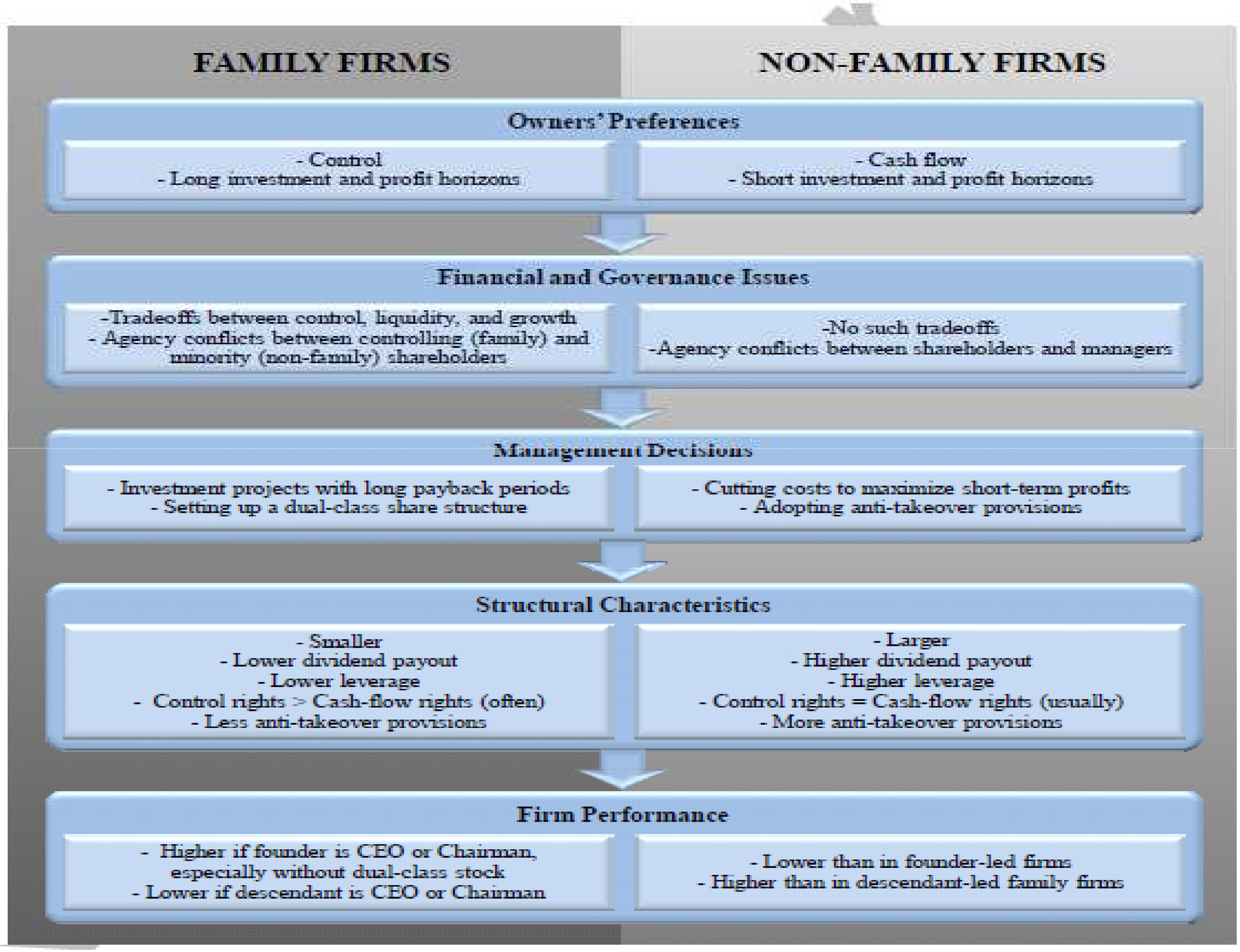
3. Multiple Expansion

How to create Equity Value – Example

	Leverage				EBITDA Expansion				Multiple Expansion			
	t 0	*t 1*	*t 2*	*t 3*	*t 0*	*t 1*	*t 2*	*t 3*	*t 0*	*t 1*	*t 2*	*t 3*
EBITDA	10	10	10	10	**10**	**11**	**12**	**13**	10	11	12	13
Multipl	8x	8x	8x	8x	8x	8x	8x	8x	**8x**	**8.3x**	**8.6x**	**9x**
Enterprise Value	80	80	80	80	80	88	96	104	80	91	103	117
net Debt	**45**	**40**	**35**	**30**	45	39	32	24	45	39	32	24
Equity Value	**35**	**40**	**45**	**50**	**35**	**49**	**64**	**80**	**35**	**52**	**71**	**93**
Buyers yield	**MoM[1] 1.4x IRR[2] 12.6%**				**MoM[1] 2.3x IRR[2] 31.7%**				**MoM[1] 2.7x IRR[2] 38.5%**			

[1] **M**ultiple **o**f **M**oney: rapporto tra Equity Value all'uscita dall'investimento e Equity Value pagato inizialmente
[2] **I**nternal **R**ate of **R**eturn

Figure 1 Differences Between Family and Non-Family Firms



Positive attributes of family-controlled PLCs

- Devotion and commitment instilled from generation to generation since family wealth and heritage is linked to the family business.
- Long-term strategic horizon – they are not in the business of adventurous growth to impress opportunistic investors with short-term returns.
- Financial prudence is symptomatic of the drive to sustain financial health and autonomy; this is to insulate the family wealth creation from outside interferences.
- Strategic focus in the core business – the respondents had developed special capabilities to exploit (without excessive risk exposure) opportunities in their sectors.
- Stability and stewardship drawn from the dominant owning family.
- Harmonious relations with loyal investors who respect and understand the family way of governing growth and development.
- Culture of trans-generational sustainable development as they are driven by duty of responsible ownership to steer their companies across business cycles.
- Defensive ownership – they are administering control schemes, e.g. trusts that will block hostile takeovers.
- Vision to keep the family at the helm of the business, as they are custodians of their heritage and guardians of their destiny.

Problems posed by family ownership

- Family domination coupled with absence of governance scheme to regulate the role of family members could lead to damaging conflict.
- The chasm between family values versus business practices that professional non-family managers promote could erode goal alignment of stakeholders.
- Nepotism that could not only jeopardise the business performance but also strain relations with outside investors.
- The failure of family to evolve, adopt open thinking, and be ready for change in areas such as corporate governance, financial strategies etc.
- The expropriation of special benefits for the family at the cost of other shareholders.
- Management of 'sacred cows' – the failure of family owner-directors to decide whether to divest, or dispose of, assets which has sentimental value to the family.

Evaluating family firms: peculiarities

- Family firms are normally private, stock is unaivalable and its value must be estimated
- Traditional methods like multiples and DCF must be adjusted to account for illiquidity
- Control has value, called % premium
- Controlling shareholders have more exit options : ipo, m&a, leverage, etc.
- Family shareholders are less diversified and hence more risky (higher beta and wacc)
- Value of a share= cashflow rights (economic) + control rights (voting)

Major differences in financial statements for family firms

- Careful on formal meaning of debt/equity ratio: in f.f. leverage is dictated by owners'willingness to guarantee more personal risk
- ROA and ROE mean less if the personal and corporate assets are mixed in the balance sheet
- In f.f. profitability does not necessarily drive decisions, life-style is important
- Cashflow methods may not apply when investments are made at low irr for different reasons, like moving wealth out of the firm
- In fast growing f.f., short term funds are frequently used to finance fixed assets
- Banks are poor financial counsellors to f.f.

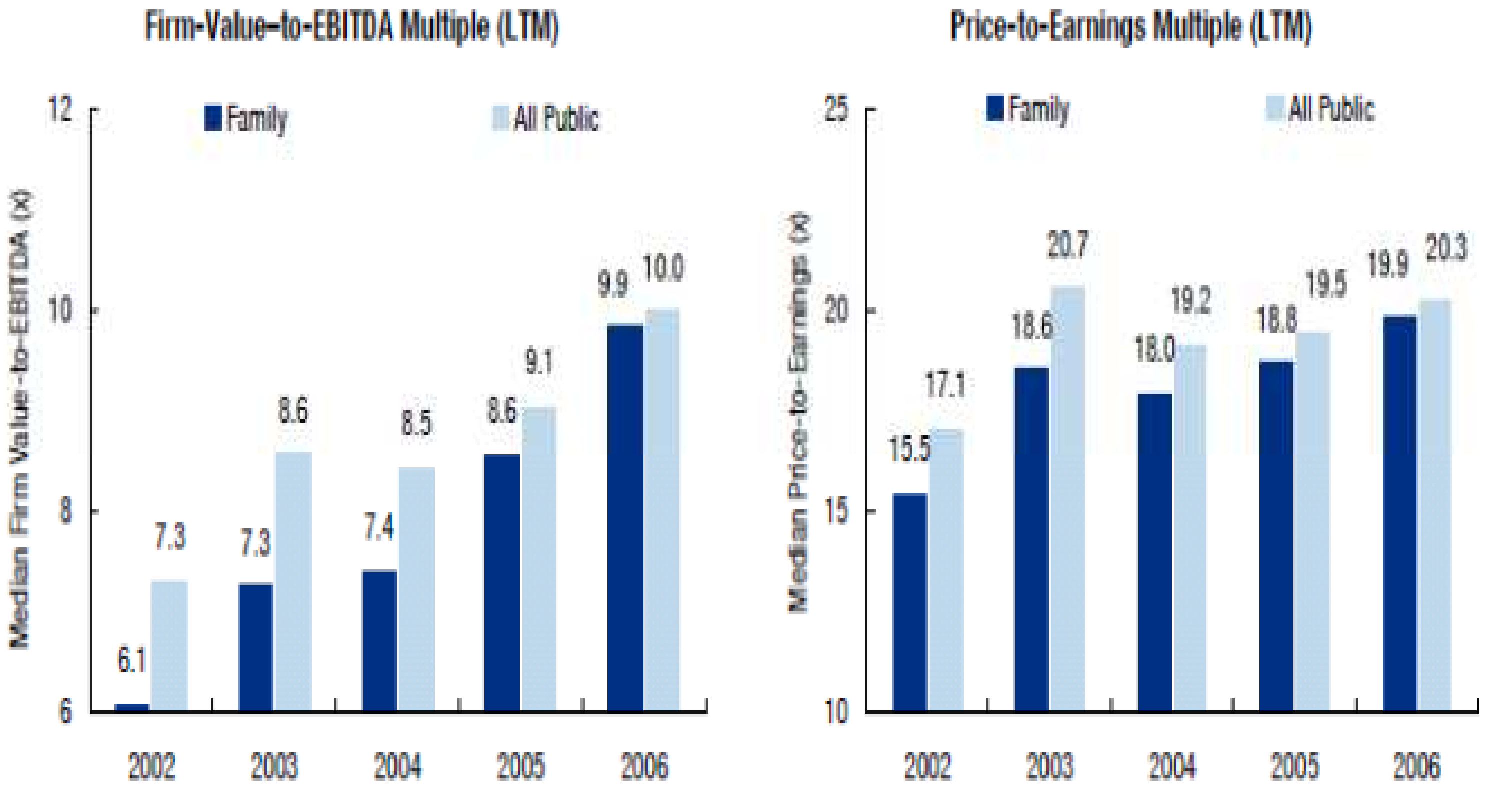
Investors’ and analysts’ view

In the past, minority investors have often been wary of the control and influence of the founding family and concerned about the possibility that the family’s interest may supersede theirs in crucial financial and strategic decisions. In some emerging markets, these concerns are amplified by perceptions of low financial transparency.
As a result of these challenges, the conventional view has been that family businesses trade at a substantial discount compared to other public companies.

The inherent conservatism towards debt and the potential dilutive effects of equity sometimes make family companies reluctant to seek large amounts of capital. Instead, family companies often display a preference for growing to the degree permitted by internal cash flow generation

Conventional investors' worry about lower valuation for family firms has somewhat disappeared…

Figure 5. A Disappearing Valuation Discount for Family Companies



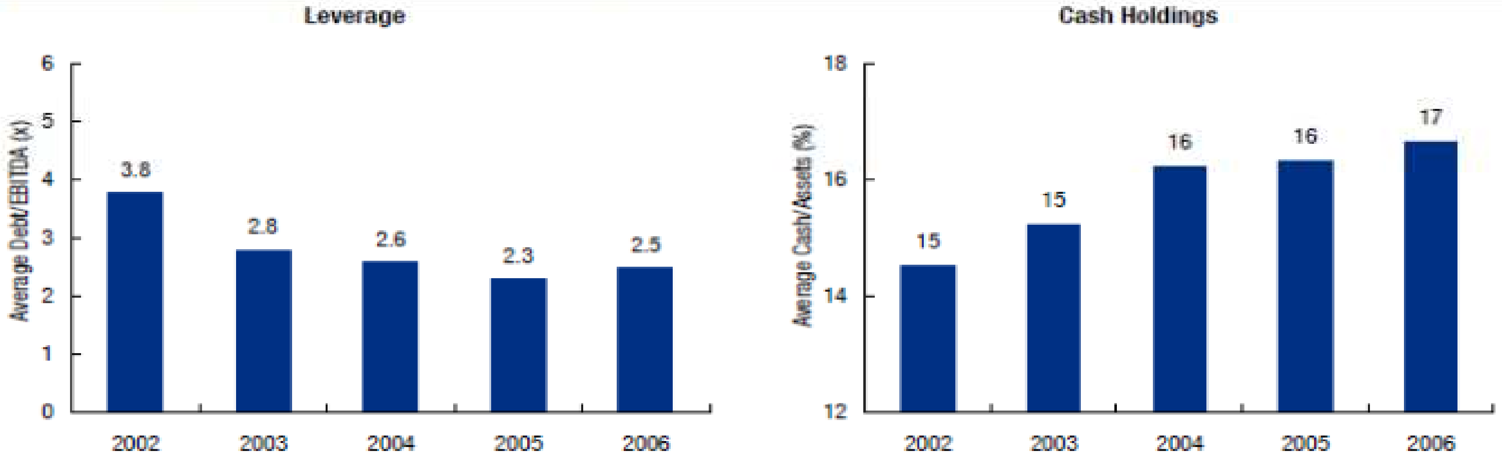
Sources: FactSet and Citi.

Family companies have strengthened their balance sheet

Family companies have historically preferred more conservative balance sheets than public companies. Their leverage ratios have dropped even further over the past five years. Starting from an average debt-to-EBITDA ratio of 3.8x in 2002, leverage has dropped by about a third to 2.5x by year-end 2006.

More revealing are the quickly rising cash holdings of family companies.

Figure 9. Declining Leverage Ratios and Rising Cash Holdings for Family Companies, 2002–2006



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