THE FAMILY PRIVATE EQUITY MODEL: WHEN THE EPIPHANY OCCURS

When your client's family business is their best investment

The idea of business succession planning for family-owned businesses has changed in recent years. In the past, it was assumed a child would one day take over the business from his or her parent. Now, however, that assumption has changed for a number of families. It is rare to see a business run by a second- or third-generation family owner.

We started seeing a cultural shift in the mid-2000's, when business owners who were ready to retire began coming to us and asking us to help them sell their business because they did not have a family member in place to take it over. In previous generations, an often unspoken powerful message was delivered by parents to their children: the "family business" means the family must run the company, irrespective of desire or competency. Such heavy-handed succession of family businesses resulted in a predictable failure of many of the family businesses. Far too often, children of family business owners lack the desire and/or the skills to be as successful as their parents or grandparents. Without such desire and skills, the transition of the family business to the next generation often times turns out to be the worst thing that ever happened to the younger generation taking over the business, the family business employees, and the senior generation. We often describe the fall-off of business and related problems as the "succession planning dip." The "dip" would be a dip in the business revenue, profit, and most importantly, family relations.

As education of family business owners evolved, owners getting ready to retire in the early and mid-2000's decided to take a different approach. Long before business succession was even considered, the business owners would recommend their children should "follow their dreams" and find a job they "love." Such advice often led to children not being involved in the family business, and thus, owners with no family to take over their business.

Nevertheless, these business owners, like previous generations, were reluctant to sell. Like their parents and grandparents, not only were these business owners struggling with whether they were ready to part with the business they had spent decades building, they also felt responsible for their employees and to the community. Their fear was, as they had seen too often before, an outside buyer would make promises to keep the business in the region and take care of the employees and the community. Rarely are such promises fulfilled, and not long after the sale, the buyer's strategy or management changes and the business is sold to another buyer, who does not know or care about such promises. The new owner either shutters or moves the business, resulting in valued employees losing their jobs and the community they cared about suffering from the loss.

The business owners have another desire: TIME. They don't want to work 60 hours a week anymore. They would rather travel, spend time with family and friends, enjoy hobbies, and more. Additionally, they understand the value of their company in comparison to stock market investments. Successful company returns are often three or four times what can be earned on the open market. Why else would private equity firms be interested in buying family-owned companies? Given all of this (lacking a clear successor, wanting more time, and understanding their business is their best investment), what is a business owner to do?

The Solution: Family Private Equity Model

The solution, it turned out, was relatively simple and has worked for dozens of business owners in northwestern Pennsylvania in the last decade. We call it the "Family Private Equity Model."

The Family Private Equity Model allows families to **retain ownership** of the business while hiring a Chief Executive Officer (CEO) and professional management to take over day-to-day operations. Often, the senior generation business owner continues to stay involved as chairperson of the Board of Directors. In many cases, we see the business owner staying on not just as the chairperson of the Board, but also as an employee, often taking on a specific role they truly love and which meets their skill set. Such a role might be in product development or client development, allowing the owner to step away from the big, time-consuming day-to-day decisions while maintaining an active role in a position she or he enjoys. Often, they concentrate on the role they really wanted when they created the family business but found themselves burdened by the other mundane functions they had to undertake to have a successful business (for example, meeting with attorneys, CPAs, bankers, government officials, etc.).

The concept is similar to a private equity firm buying the family business. But in this scenario, the family retains the business—perhaps the best investment the family may ever have. As many owners have said to us, "There is no place I could put my money that would give the yields that my own company generates and none that I could trust like I trust my own company."

This is the Family Private Equity Model Epiphany: the business owner treats his or her company as *financial vehicle*, which has many alternatives, rather than merely an operating company that spins off cash.

The Benefits

The Family Private Equity Model has many benefits. Here are four (4):

1. **No seller's remorse.** The owner continues to benefit from his or her business. When you sell a business, it is one-and-done. But by maintaining ownership, the owner and the family can continue to benefit from profits in the years to come.
2. **Owner Can Take a Step Back.** The owner can step back, but continue to be involved. For many owners, the idea of selling a company can be extremely difficult because they do not know what they will do without the business they have spent decades working to build. But by hiring a CEO and maintaining Board control, the owner can take a step back from the day-to-day operations while still holding a company role.
3. **Commitment to Employees and Community.** Most business owners, rather than being the crass capitalists we see on TV, care very much about their community and employees. Time and again we have heard from business owners who tell us they would take less money in the sale if we can find a buyer who will keep a business local. By maintaining ownership, the owner can guarantee the location of the business and the breadth of its community involvement.
4. **New Energy.** A new CEO can bring new energy. If an owner is thinking of selling, it is likely that enthusiasm and energy have been flagging for a while. Bringing in a new CEO, one with different skills and experiences, can mean a shot in the arm to a business and result

in unexpected growth, opportunity, and success. For the new CEO, having the owner just a phone call away can also be a boost, as he or she will have the benefit of having trusted expertise and institutional knowledge close at hand.

Measure and Manage. Don't Meddle.

While the Family Private Equity Model is a relatively simple concept, it is not necessarily the easiest succession plan to put in place. What is the number one reason it can be difficult? The owner.

Most owners do not know how to let go. After decades in the role themselves, they do not know how to manage—and when not to manage—an incoming company CEO. The instinct is to interfere and micromanage. We find that the greatest challenge is not whether the new CEO can do the job, but whether the owner allows the new CEO to do that job. We get it: the owner has spent decades building the company and making it successful. It is hard to let go, but for this model to work, the owner has to take a step (or three) back from the business. Because letting go can be so difficult for owners, we require clients who want to move forward with the Family Private Equity Model to complete a training program on how to transition from company CEO to company Board chairperson. We have found a successful transfer of business responsibilities requires a structured process that encourages an owner to incrementally step back and transfer real authority to a successor. By establishing clear goals and expectations, the new CEO and the owner can be fair to each other in judging whether the new arrangement is a success.

Part of the process is profiling the current owner/president's attributes, skills, experience and behavior profile. The next step is defining the potential outcomes at the entity level (with the business as a financial vehicle), including the following:

(1) Build & sell
(2) President buyout
(3) Management buyout
(4) Merger of unequal
(5) Family succession
(6) Private equity platform

A strategic assessment of the company is also necessary, including a definition of critical structural deficiencies and an establishment of key outcomes. What would be different in 5, 7 and 10 years, post transition?

Keep in mind as well – filling the new president position requires a thoughtful and professionally performed executive search. It is critical to find an executive who is a good fit with the owner *as well as* the business. Often, we also want them to have the potential to become a future buyer of the business.

We also require the establishment of a Board of Directors—a group whose responsibilities include helping the owner learn to govern without managing. The Board of Directors, typically made up of five (5) to seven (7) people, includes the owner, the CEO, and outside Board members. If stock in the company has been gifted or shared with family members or key employees, some Boards also include top employees or next generation family members.

A good Board of Directors will act as advisors who can help the owner determine when to give the new CEO room and when to hold them back. The Family Private Equity Model is simple on paper, but it is a creative solution that takes a lot of work, thought and cooperation. We have seen that work pay off dozens of times when the model achieves the owner's goals of being a good family investment as well as an important part of the community the owner cares about.

What Happens Post-Owner?

Obviously, the owner's time comes to an end at some point. The early stages of the Family Private Equity Model provide a great opportunity to bring in the family members that "follow their dreams" and allow them to learn about the company. Family members who have not been actively involved in the company need to be engaged with the company on a gradual basis. The family members and the Board need to consider a process that involves working with the owner and their descendants to identify which descendants will be considered "Board eligible."

"Board eligible" includes those descendants who choose to work through the process of engaging with the current Board of Directors, key management employees, and key business advisors for the company to form the family governance team for the Family Private Equity Model.

The Bottom Line

The Family Private Equity Model is a compelling option for many family-owned businesses to consider. In order to be successful; however, it requires a process tailored to address all the transition issues specific to each company, guided by an experienced professional (or team of professionals). The process includes strategic assessment, leadership assessment, establishment of goals, executive search, executive coaching and onboarding, board of directors management, and governance. Threading through these key issues are legal and financial considerations, which are accomplished through sound professional advice and guidance.

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