Family Firms and Private Equity Companies

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– European Experiences

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Private Equity: An Important Player in Family Succession

- Private equity funds **stand for 25% of the global M&A activity**.

- **39% of European buyouts** in 2007 were targeting **family** firms.

But there are just 3 published academic papers on private equity investments in family firms

Sources: Jensen, 2007; CMBOR, 2007

For Whom is This Presentation?

- **Family firms looking to sell**

  Understand acquirers' perception and potentially get higher valuation

- **Private equity funds and other acquirers of family firms**

  Benchmark attitude towards family firms and be better prepared to handle family firm investments

- **Academia**

  Get exposed to a research topic that is still "in its infancy" (Achleitner et al., 2008)

- **Regulators**

  European Commission report stated that buy-out financing have a potential to "… make an important contribution to facilitating generational change in family owned businesses"

Research Outline

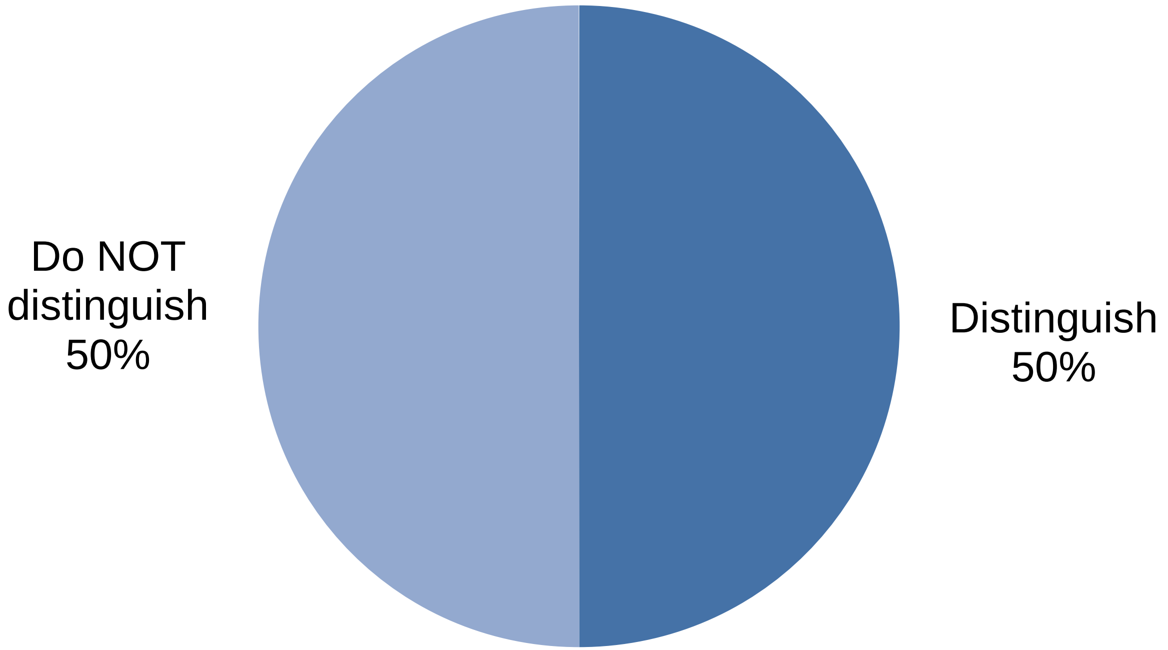
- Family business academia and family firms themselves recognize their distinctiveness.

- We have tried to understand if third parties, in particular investors, perceive family firms as a separate class of companies and what characteristics they attribute to family firms.

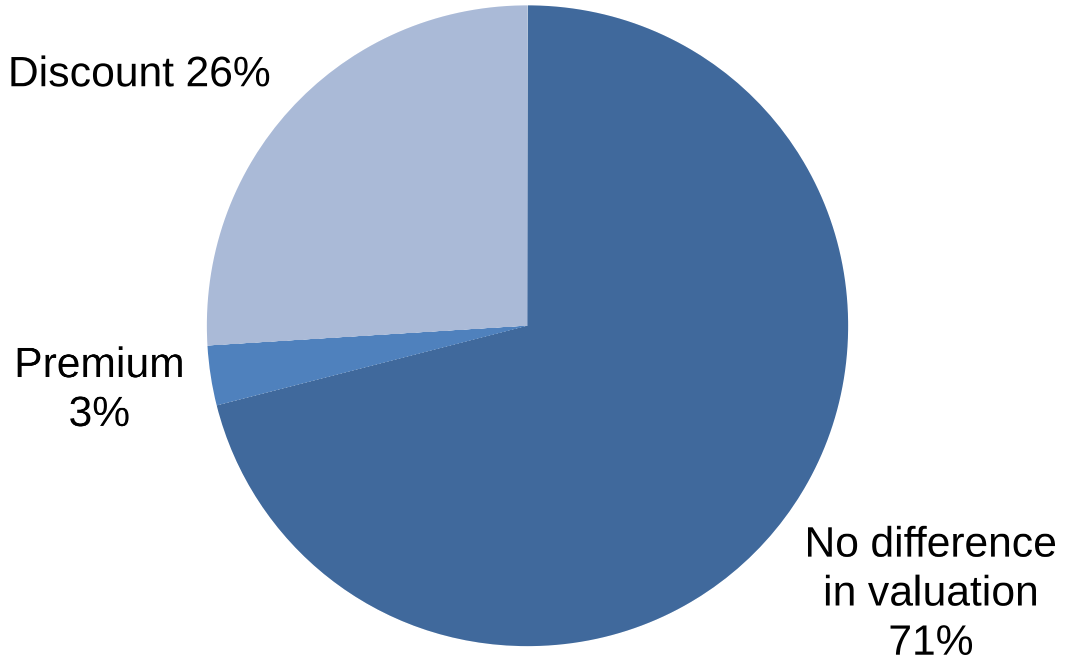
Lack of previous research on the topic → An exploratory study

154 responses from PE in Western Europe
plus 6 expert interviews.

Distinguish Between Family- and Non-family Firms?



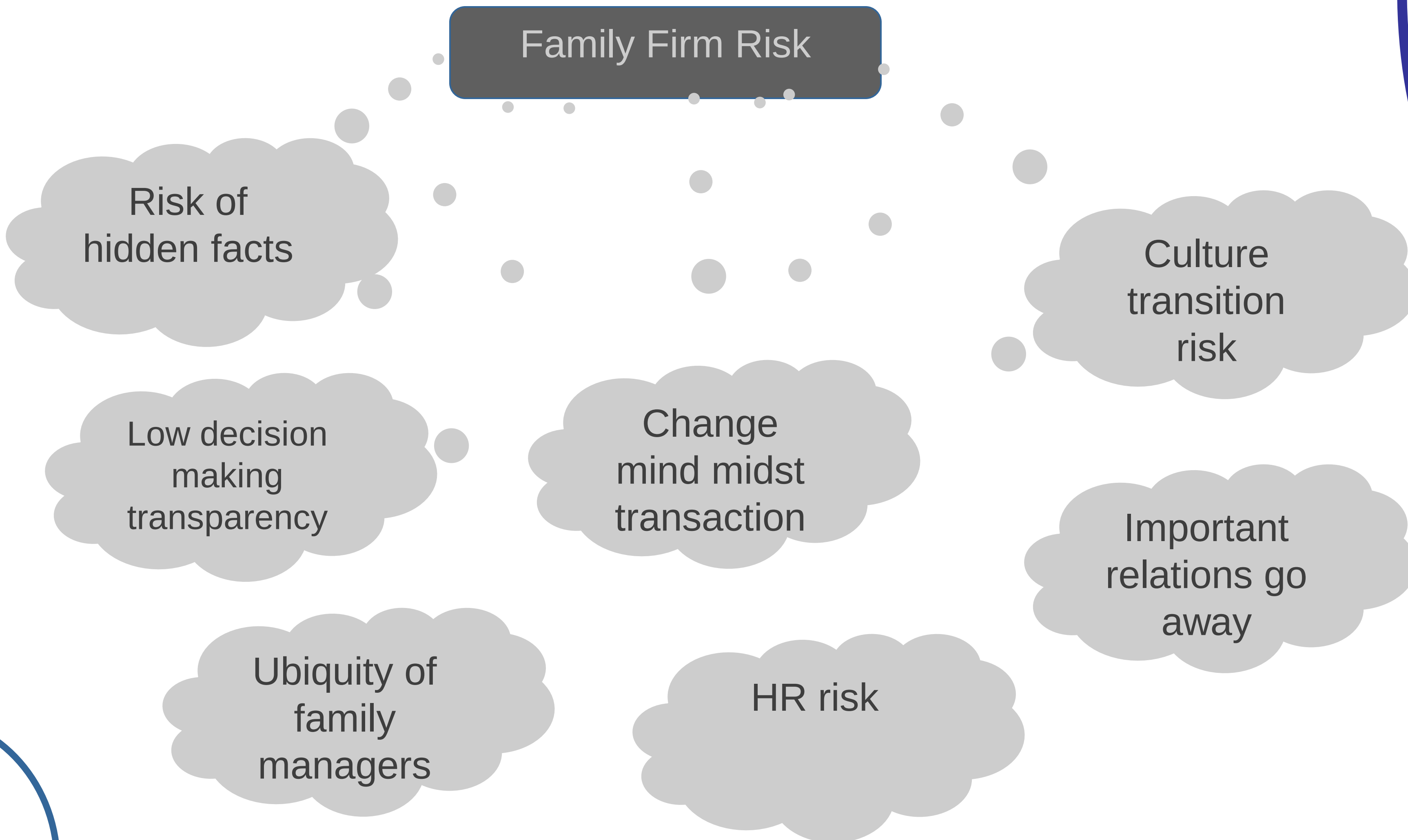
Difference in Valuation?



Family Firms’ Characteristics

Family Firm Target Characteristic	Frequency	% of total	% of those who see diff.
Higher risk investment	51	33.1%	66.2%
Acquisition process & deal structure differ	42	27.3%	54.5%
Emotions & intuition	35	22.7%	45.5%
Family before business interests	31	20.1%	40.3%
Poor management & lower quality managers	29	18.8%	37.7%
Poor transparency & need more due-diligence	27	17.5%	35.1%
Less MIS and formal structures	24	15.6%	31.2%
Complex shareholder structure & conflicts inside family	17	11.0%	22.1%
Dominance of single individuals / very small groups	16	10.4%	20.8%
Financially inefficient & lower levels of growth	15	9.7%	19.5%
Long-term orientation	12	7.8%	15.6%

Characteristic #1: Higher Risk Investment



How do PE Firms Adjust for Higher Risk?

Return from riskier investments is less certain and uncertainty is what the markets (and investors) dislike. Our research found two ways in which PE firms adjust for the higher risk.

Price

Deal Structure

Price

The correlation coefficient between the characteristic “Higher risk investment” and the question regarding difference in price is negative and significant (-0.461). This means that those who perceive family firms as riskier investments are also those who pay less.

This however does not imply that

Family Firm = Discount

automatically.

“…family businesses often trade at a significant discount, but this is not because they are family businesses…it is because family businesses often adopt business and management practices which can only work in a family environment.”

Deal Structure

Counterparty risk can be mitigated by a **proper deal structure**.
The following tools can be implemented:

Motivate collaboration

Ownership
keeping a minority ownership with the family during the period of investment

Earn out provision
established to be assured that the firm will achieve financial goals as promised by the seller

Avoid unpleasant surprises

Escrow account
established to mitigate the risk of untrue representations made by the seller

"Broken deal" clause

Deal Structure (cont.)

Family Firm Risk

Risk of hidden facts

Low decision making transparency

Ubiquity of family managers

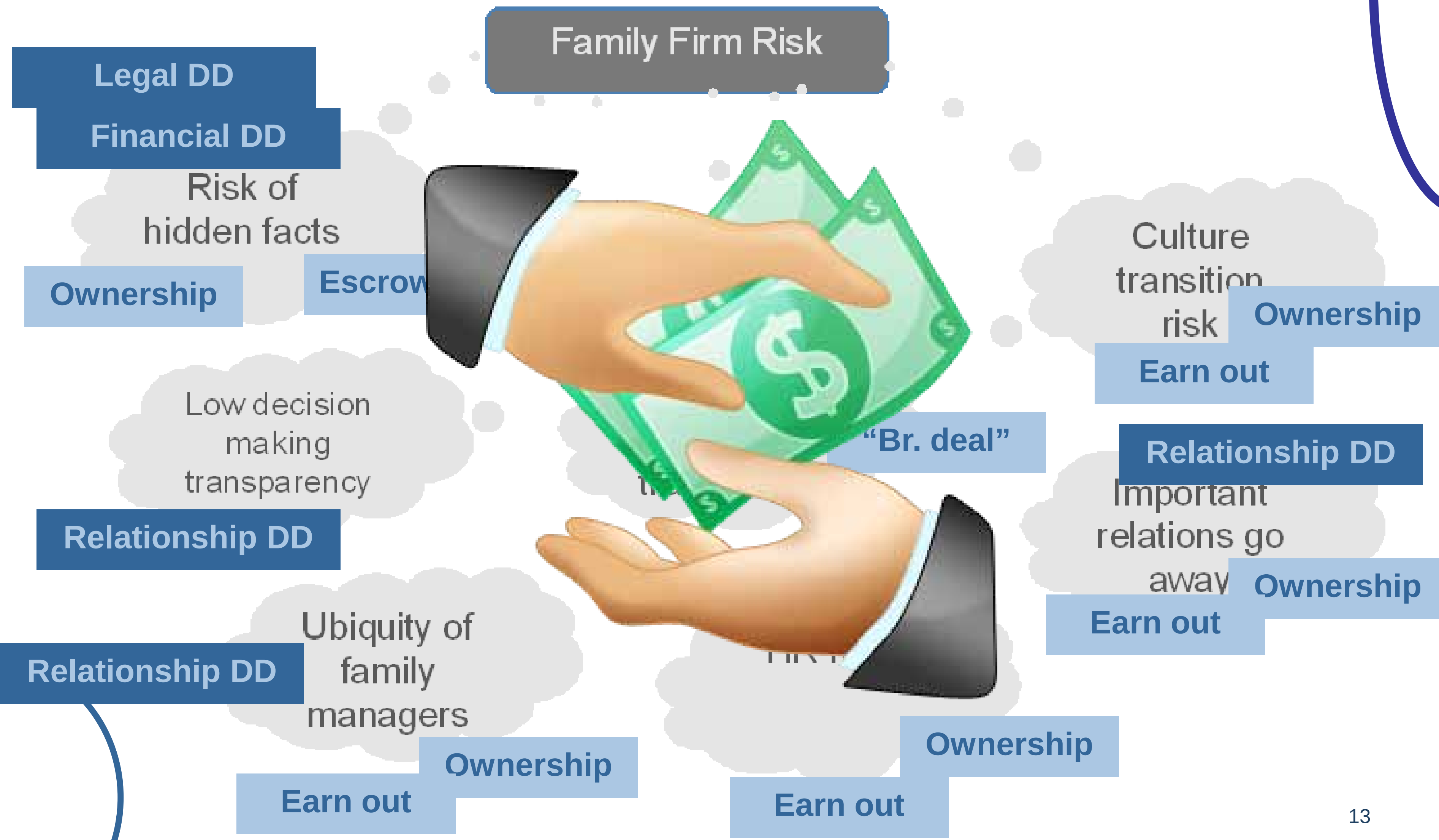
Change mind midst transaction

HR risk

Culture transition risk

Important relations go away

Deal Structure (cont.)



Deal Structure (cont.)

Family Firm Risk

Go / No Go

Risk of hidden facts

Culture transition risk

Low decision making transparency

Change mind midst transaction

Important relations go away

Ubiquity of family managers

HR risk

Other Characteristics

- Several experts noted that some of characteristics were not really family business related, but were rather associated with small businesses.

  “That is more the question of scale”

- Academic literature often finds small businesses to demonstrate the same characteristics that private equity professionals used to describe family firms:
  - Poor managerial competence (Jennings and Beaver,1997)
  - Even the most basic management practices not implemented (Watkins, 1983)
  - Less need for MIS: the owner-manager often is not convinced of necessity for procedures to monitor performance (Fuller-Love, 2006)
  - Dominance of single individuals (Fuller-Love, 2006)
  - Higher degree of integration of personal and business affairs (Ang, 1991)

Family Firms Characteristics and Private Equity Skills

Family firm characteristic	Private equity action	Evidence
Lack of MIS	Introduce MIS	The level of professionalization in a family firm increases following a buyout (CMBOR, 2007)
Financial inefficiency	Streamline operations	Majority of studies on the economic effects of buyouts document a positive impact on operating profitability and productivity within the buyout firm (Vinten, 2007)
Lower levels of growth	Take on debt & grow	Family firms have lower levels of debt (Gallo & Villaseca, 1996) & buyout is financed with 60 to 90% of debt (Kaplan & Stroemberg, 2009), hence there is more space for implementing the leverage
Poor management	*Partially resolved*	Enhance management team with more competent members & specifying contractual restrictions on the behavior of managers (Wood & Wright, 2009)

Perception of Family Firms by Private Equity Firms

Family Firms = Risky & Poorly-Run?

Good Upside Potential?

Implications for Practitioners: Acquirers

- Family firms form a particular class of acquisition targets and hence deserve a special approach.
- Further research will benefit family firm acquirers who will be able to:
  - get a grasp on family firm specific risks
  - better handle investment process in family firms
  - understand if they should value family firms differently

Implications for Practitioners: Family Firms

- Family firms can get an idea of how they are seen by potential acquirers and improve their preparation for the sale process.

- To reach higher valuation of their business, we suggest that family firms should:

  - increase transparency by introducing MIS and outlining responsibilities

  - hire an external manager

  - hire a good advisor assessing costs that offset, at least to some extent, the benefit of reduced underpricing

THANK YOU!

BACKUP SLIDES

RESEARCH TOPIC

Family Firm Succession … Outside the Family

Succession was and remains an important topic in the family business academia

1988 → 2003

The pioneers of the family business research understood that a key issue challenging the majority of family firms was succession and dedicated their articles to this topic (Handler, 1989; Wortman, 1994).

Dyer and Sanchez (1998) reviewed 186 articles published in Family Business Review between 1988 and 1997 and noted that succession was still a dominant theme.

Chrisman et al. (2003) analyzed 190 articles published in 1996 throughout 2003 and came to the same conclusion: succession was the main topic in 22% of all the articles analyzed.

+

From a practical side, succession is gaining even more importance in the current demographic situation when the baby-boomers, many of whom are family business founders, are starting to approach "retirement age and having to confront succession and change of ownership issues" (Hickey, 2005).

Family Firm Succession...Outside the Family

Not all the family businesses are able and willing to stay in the family hands.

Not always are they successful in transferring their businesses to the next generation (Lansberg, 1999).

Family firm exit can open up the way (and free up some capital) to pursue new business opportunities.

Logics

+

Family firms are perceived to be *"…a very hot market in terms of the number of deals"* (Reinebach, 2007).

The majority of family businesses sooner or later will change hands and this fact is rather universal and independent of cultural context or economic environment (Lee et al., 2003).

Evidence

=

The topic of the family business sale is important.

Yet, as to Howorth et al. (2004), *"family firms succession research focuses almost exclusively on internal succession"*.

METHODOLOGY

Questionnaire

Definition: Family firm is a company in which multiple members of the same family are involved as major owners or top managers, either contemporaneously or over time.

1. Do you distinguish between family- and non-family firms when analyzing your targets?

2. Imagine you have two privately-held companies equal in every respect with the only difference that the one is a family firm and the other not: do you have a reason to pay more (positive difference, premium) or less (negative, discount) for a family firm target?

3. What is this difference due to? What particular traits does a family firm have that translate in a premium or discount?

Methodology

- The **coding procedure** was performed by **both co-authors.**

- We registered frequencies for the first and second questions and employed **content analysis** for the third question.

Emergent Coding Steps

The steps to follow were outlined in Haney et al. (1998) and Stemler (2001).

1)Two people **independently review** the material and come up with a **set of features that form a checklist**.

2)Researchers **compare notes** and **reconcile any differences** that show up on their initial checklists.

3)Researchers **use a consolidated checklist to independently apply coding.**

4)Researchers **check the reliability** of the coding. If the level of reliability is not acceptable, then the researchers repeat the previous steps. Once the reliability has been established, the coding is applied on a large-scale basis.

SAMPLE

Respondents

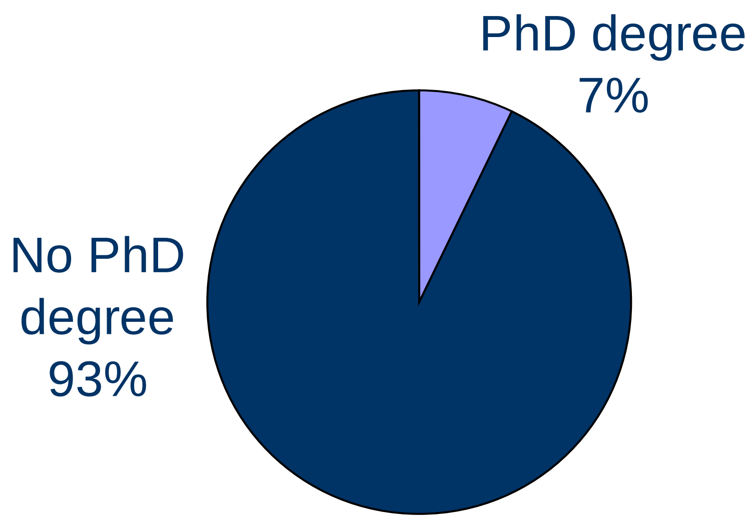
- 14 Phone + 140 E-mail + 13 N/A = **154** used in analysis
  + follow-up with 5 face-to-face and 1 phone expert interviews

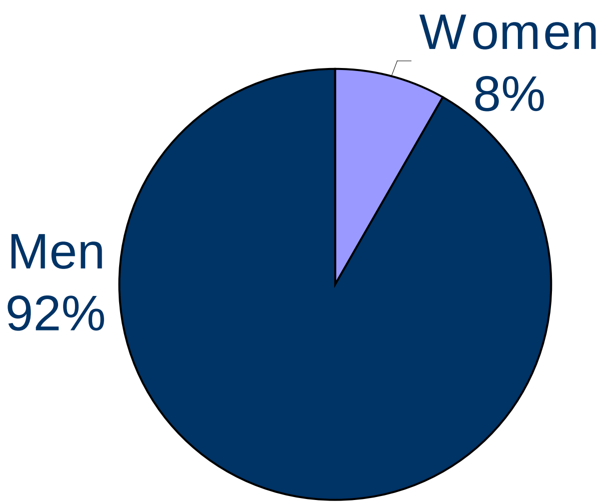
- **October to December 2008** (main part); January 2010 (experts)

- The **whole population of private equity companies that have acquired Western-European targets in the last eight years** and were covered by the Mergermarket database.
  - 984 (database) → 751 (contacted)
  - E-mails sent to one or two professionals at every location of a private equity firm.

Respondents (cont.)

- Most of the respondents are investment managers / directors, some of them however are partners, managing directors and CEOs.





- Phone interviews were mostly conducted in English. Language partition of written responses is the following: Italian (2.9%), French (12.1%), German (22.1%), English (62.9%).