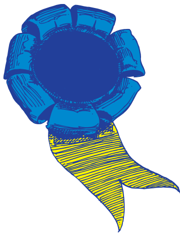
Financial Advisory
Investment Banking
Private Equity

Winter 2003

de Visscher & Co.

EXTRA! EXTRA!



In December 2002, de Visscher & Co. was recognized as one of the top middle market M&A Firms of the year by the Mergers & Acquisitions Advisor, a professional organization for the investment banking industry. de Visscher & Co. received special recognition for the Nash-elmo transaction highlighted in our last newsletter.

Putting Family Business Valuation in Context

By James A. Murphy and Christopher L. Craley of de Visscher & Co.
Adapted from Goodkind Labaton Rudoff & Sucharow Lawnews

Introduction

As advisors and shareholders to family-owned businesses, valuation is an important element of many of our firm's engagements. More often than not, our work is complicated by previous or internal valuations, which applied the standard techniques without considering the purpose of the valuation, family dynamics and the impact of the process itself. Tragically, such valuations can lead to strategic mistakes for the business with concomitant adverse impacts on shareholder value creation and liquidity. Applied properly and placed within the right context, a valuation can be utilized to motivate action, evaluate strategic alternatives for the business and analyze mechanisms for shareholder liquidity.

Valuation Pitfalls

While many valuation techniques are not mathematically complex, the scope for abuse of valuation techniques is broad. Values based upon ungrounded forecasts, inappropriate market comparables and misjudgment of management quickly become gospel within a business. Taken out of the appropriate context, valuation techniques lead to inaccurate values and more importantly, lead to misguided strategic decisions, particularly in the evaluation of accessing growth capital or family shareholder liquidity needs.

One of the most common valuation pitfalls is the hockey stick nature of many discounted cash flow forecasts. While the forecast or discounted cash flow valuation methodology is arguably the most theoretically correct, it requires the acceptance of many assumptions and is the most susceptible to the "garbage in, garbage out" problem. One of the more pervasive pitfalls is a forecast not grounded in the fundamentals of the industry and the competitive position of the company. A forecast must reflect industry dynamics such as the level of direct and indirect competition, barriers to entry, customer pressures, supplier pressure and the regulatory environment. In industries characterized by little product differentiation and slow growth, shareholders must carefully analyze forecasts, which show growth faster than the industry rate, because the cost of gaining market share will often be margin erosion. From a more quantitative standpoint, many forecasts that show large sales increases fail to account for the capital expenditure required for increased capacity and the working capital required for higher sales. Based upon a management forecast, one family business decided to pursue a stand-alone strategy rather than accept an attractive offer from a strategic partner. Despite a large increase in sales half way through the forecast period, the company faced a liquidity crisis, and the family was forced to sell at a substantial discount to the prior offer in order to salvage some portion of the family's net worth, which had been concentrated in the family business.

Inappropriate use of comparables analysis is a second common valuation pitfall that drives false conceptions of value. Similar SIC codes or even product lines do not necessarily mean that the valuation ratios exhibited by publicly traded companies, such as market value to net income, are directly transferable. For example, if the differences in the growth rates, margins and size of the comparable companies are not taken into account, the valuation may either be too high or too low. On the other hand, most publicly traded share prices reflect a minority ownership stake that does not have control. If one is valuing a controlling ownership stake in a private company using comparable multiples from public companies, a

(Continued on page 2)

(Continued from page 1)

control premium must be added to the equity value of the private company.

In addition to avoiding valuation pitfalls, one must insure that the valuation reflects its ultimate purpose. For instance, a valuation to be used for estate planning and gifting would reflect a full discount for minority interest and lack of marketability, while a buy-out of minority shareholders in a private company would normally include discounts to account for its minority (i.e., non-control) position and its lack of marketability arrived at on a negotiated basis. A valuation used to measure overall shareholder value creation and the success of a business strategy beyond single year performance measures will likely rest on forecasted assumptions specific to the company on a stand-alone basis. On the other hand, a valuation conducted in order to establish a purchase price for the sale of the business to a strategic buyer will be the highest possible value, including the value of any synergies that might result from the combination of the two businesses.

Special Concerns of Family Businesses

For family business owners, it is particularly important to properly sequence the establishment of values under these different scenarios. If estate planning transactions are not conducted prior to a sale, investment, or financing transaction, the likely higher value placed on the business will peg the value for subsequent estate planning transactions.

In the case of family businesses, valuations that remove the business from the context of family dynamics have ignored a crucial factor in shareholder value creation and destruction. Understanding family dynamics in a family business valuation is an important part of establishing the context of the valuation, as family ownership and/or participation in the management of a business can have either a positive or negative impact on the business. This Family Effect, which one can define as "the level of satisfaction, confidence, dedication and commitment to the business" that the family shareholders demonstrate, manifests itself, among other ways, in the business's cost of capital, and in this way, impacts how one values a business, especially under the discounted cash flow method.[1]

In successful family businesses, the Family Effect produces "patient" capital whereby family owners are willing to trade current returns for long-term shareholder value creation. Again, the context is important in applying this valuation concept. This patient cost of capital will not necessarily be what a strategic buyer uses to discount the company's forecast in evaluating a potential acquisition, but from the family's viewpoint, the cost of patient capital may radically change the evaluation of the offered purchased price versus the perceived value of continued ownership under the forecasted assumptions. On the other hand, conflict or discord in the board room can often paralyze strategic decision making, causing perfectly grounded forecasts to be unattainable, and therefore, unrealistic. In another example, a control-oriented family business patriarch who had failed to plan for succession and institutionalize his knowledge, jeopardized the value of his business upon a sale when potential buyers realized that top-quality next generation family management had not been groomed for succession and that most customer relationships and product knowledge would walk out of the door when the patriarch left or died. No matter what financial analysis of comparables indicated, in this case the business was not worth comparable industry valuation multiples.

Putting Valuation to Use

Finally, before embarking on a valuation engagement it is important to evaluate the impact of the valuation exercise itself. "What is my business worth" is often the tip of an iceberg comprised of questions such as "How can I transition the business from the senior generation to the junior generation without losing control?" or "How can I buy out my sister?" Because shareholders often request valuations amid confusion, dissatisfaction or even open conflict, valuations often have repercussions beyond the purpose for which they were originally intended. While a valuation can be useful in resolving shareholder conflict, certain shareholders might seize upon a high valuation as justification to pursue a sale of the company. For the management team or group of shareholders who requested the valuation in order to raise capital to pursue a growth opportunity, the sudden movement to sell the company can be demoralizing and lead to paralysis. A valuation also sets expectations, sometimes ones that cannot be met. For instance, the state of the financing markets, the outlook for the stock market and the overall economy often influence the value that can actually be realized by shareholders. The current difficulty in the senior debt lending environment has meant that valuations, which discounted cash flow and comparable analysis might reasonably support, are simply not attainable in certain types of transactions, such as a leveraged recapitalization.

On the positive side, a valuation exercise can be a motivating force and useful decision-making tool, particularly in the context of evaluating the shareholder value creation potential of alternative strategies. For one 4th generation family-owned company, the exercise of projecting the valuation of the company on a go-it-alone basis (that is, maintaining 100% ownership without an acquisition) as opposed to accepting some ownership dilution by raising capital and taking on an equity partner to pursue the acquisition provided useful input in determining a course of action.

In family businesses, a valuation fits within a complex web of other systems – family dynamics, estate and succession planning, the control needs of the majority, the business strategy and the interests of employees – and the overlap of these systems cannot be ignored. By itself, a valuation of a closely-held business interest is a useful data point. Put in context, a valuation is a useful tool to assist family business shareholders in addressing important issues such as structuring an estate plan, developing a strategic plan and planning for partial or full shareholder liquidity.

---

[1] Financing Transitions: Managing Capital and Liquidity in the Family Business, de Visscher, François M., Aronoff, Dr. Craig E., Ward, Dr. John L. pg. 20. Business Ownership Resources, 1995.

■

The Perils of Not Diversifying

By François de Visscher

"Fortunes are made through concentration and are kept through diversification," goes an old family business adage. The Rockefellers made their fortune in Standard Oil and kept it in ventures like Chase Manhattan Bank, Eastern Airlines and McDonnell Douglas. The Pitcairns went from Pittsburgh Plate Glass to real estate, airlines and their family-run Pitcairn Trust Company. The Phippses of U.S. Steel transformed their family office into a financial advisory business.

But how many family companies are actually following that sage advice? From the Fords to Bill Gates, a brilliant idea has often spawned a vast family empire. As the business passes on from the founder to the sibling generation and then to a cousins' coalition, most families have continued to concentrate their wealth much in the original family business.

Why is "diversification" such a foreign word in many business family circles? To many families it's tantamount to rejecting the family's heritage. Diversification requires sacrificing precious cash flow from the family business to be invested in building other assets. In some cases, it may even require sacrificing a slice of ownership to outsiders in order to free up funds. Business owning families tend to want to preserve the family business at the detriment of preserving or growing the family wealth. The Family Business has been the "baby" for many generations. It required so many sacrifices, so many efforts, so many risks to finally succeed as the source of most family wealth. But the bottom line is this: Succession, liquidity needs of shareholders and wealth return expectations can often prevent the smooth passage of a single business through the generations.

So consider some compelling arguments for spreading the family wealth beyond the family business:

"Stay rich to get rich," goes another old saying. The stock market slump during the last two years has provided a rude lesson for many families with all their eggs in one basket. Even owners of private companies have seen the value of their business diminish commensurately with the decline in public-market value. Contrary to the false lessons of the high-tech '90's, building family wealth is a long-term process. It requires vision, heritage, and long-term strategic investment decisions. Any large fluctuations of value can jeopardize the long-term investment strategy, or even the very rationale for investing together as a business-owning family.

The need for steady wealth building is particularly true with multi-generation families whose risk tolerance is relatively limited. Shareholders depend on the family wealth for income and for asset growth. A large decline in the value of family wealth, in or outside the business, can negatively impact inactive shareholders' patient capital, resulting in defections and sometimes, in the worst circumstances, sale of the entire business. Proper diversification and allocation of family assets helps the family build wealth and ultimately control the timing and the price of future value realization.

But where and how should you diversify your assets? Obviously, proper diversification requires judicious investment allocation. Typically, a family would place its "diversification assets" in classes of assets whose value doesn't fluctuate with the value of the business: real estate, say, or private equity, and in some cases public stocks.

If financial considerations were the only reason to diversify, that should be sufficient motivation to run out and do so. But there's another important advantage: Diversification can also help the succession of wealth from one generation to another.

One of the greatest impediments to orderly succession is to reconcile goals of active and inactive shareholders. Active shareholders typically feel entitled to market-based salaries and benefits and want to reinvest much of the company's cash flow to expand the business. Inactive shareholders often prefer that the company provide them with liquidity in the form of dividends and other benefits, which limits the capital available for the company's growth.

Diversification can be a very powerful tool to avoid such conflicts and allowing the family business to stay in the family's hands. By passing on shares of the business to active shareholders and non-business assets of equivalent value to inactive shareholders, you avoid this common collision of goals.

Consider a Swedish family business that had diversified and built up considerable wealth outside the business over the years. By the time the third generation came along, only one family member remained in the business. He inherited 100% ownership, while his siblings and cousins inherited real estate and financial assets of equal value.

One of the critical hurdles of diversifying family wealth is for family members to see the need to pass on a business family heritage, not just a family business. A business family heritage goes beyond the bricks and mortar of the family business. It is the heritage of the wealth built over generations. Even at the founder generation, some visionary patriarchs understood this well and focused on

(Continued on page 4)

(Continued from page 3)

"total family wealth." In his own lifetime Matthew G. Norton, a founder of Weyerhauser Corp., diversified into construction materials, real estate and financial management through his Laird Norton Trust Company.

Another hurdle is persuading business owners that not all siblings or family members need to inherit the same assets. The emotional obstacle here is often based on the strong attachment family members may feel to the business. If they no longer own shares of the company, how can they remain connected and identified with that important aspect of the family legacy and identity?

Just how much should family businesses diversify? That depends on the number of generations and inactive shareholders.

There are no exact ideal numbers, but in general a new business usually requires all available capital, just to stay afloat. By the second generation, when one or more siblings may have inherited shares, the family should consider diversifying as much as 30% of the company's value into other assets, which could include real estate, other business ventures, or a family foundation. By generation three, when multiple cousins may have inherited shares, the family might diversify another 10 to 25% of the company's value into outside assets.

As a business passes from the founder to the next generation, the owners' first responsibility is not necessarily to save and build the family business, but to save and build the wealth—by diversifying—so that it can perpetuate throughout future generations. In the process, he could be saving the family business as well.

■

Save the Date...

We will be speaking or participating at the following conferences:

Family's in Business Conference
April 3 and 4, 2003 - *Amsterdam*

IMA Conference
June 21-25, 2003 - *Nashville*

LOEDSTAR
June 17-19, 2003 - *London*

Family Firm Institute Conference
October 1-4, 2003 - *Toronto*

President Bush Proposal Could Be A Real Bonanza For U.S. Family Companies

François de Visscher and Christopher Craley

As of today the public debate and commentary on President Bush's proposal to eliminate or substantially reduce taxes on dividends have focused primarily on the impact on public companies. But what about the opportunities for family companies? Most of us do not expect the proposal to survive in its existing form, but a reduction of the taxes on dividends to at least capital gain rates and even the reduction of double taxation of dividends would significantly impact the way family companies resolve the ever present conflict between the liquidity needs of shareholders and the growth capital needs of the business.

Just think of the following aspects:

- The payment of dividends economically, could reduce the urge to sell stock to gain liquidity;
- It could make periodic redemption plans more attractive by eliminating the "dividend tax" on stock sold in a redemption plan and even eliminate the imputed "stock dividend" tax to the non-selling shareholders;
- It could make the use of the Sub-S, and all of their restrictions, obsolete as no double taxes would be imputed on dividends;
- It could promote the use of holding company structures to design "control" and capital programs as the issue of double taxation of funds among affiliates would be eliminated;
- It could reinstate the popularity of designing long term dividends policies including extraordinary dividends on certain events such as sale of assets;
- It could make preferred stock recaps more attractive as a succession vehicle since dividends on preferred stocks would no longer carry a large penalty;
- It could allow a larger amount of capital to remain in the Company for re-investment;
- The opportunity for more value creation or value destruction will exist as less money is "leaving the system" to go to the government. Shareholder's should carefully analyze the best use of the additional available funds – whether to take out of the Company and reinvest elsewhere or leave in the Company.

■

de Visscher & Co.

is an independent financial advisor to business owning families and closely held businesses worldwide. Through a unique combination of financial advisory, capital raising and investment banking services the team at de Visscher & Co. creates high value-added solutions to the liquidity needs of shareholders and the capital needs of their businesses. Family Capital Growth Partners, a private equity fund affiliated with de Visscher & Co. also provides equity and subordinated capital to growth-oriented closely held and family-owned businesses.

104 Field Point Road
Greenwich, CT 06830
Tel: 203-629-6500 Fax: 203-629-6547
Website: www.devisscher.com e-mail: worldhq@devisscher.com