Family businesses have historically viewed selling up as a failure. But, as **Marc Mullen** explains, many are now looking beyond the blood line to ensure their dynasty lives on

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bloodMoney

KPMG's recent survey of mid-size family and owner-managed businesses revealed that 52 per cent of owner-managers and 62 per cent of family owners would sell the business if the right offer came along. The survey also exploded the myth that family owners are emotionally attached to their business. Only eight per cent of ex-family businesses said they missed the business, while 14 per cent of owner-managers said they did. "What was surprising to us was the fact that so few sellers missed their business post-sale," says Adrian Dray, partner at KPMG. "Tempting offers have opened avenues up for respondents and I am delighted the vast majority feel they made the right decision to sell. Emotion is a critical element of all our lives, but these owners have successfully divorced emotion from commerciality."

The second home

There are many drivers behind this change in attitude to ownership, not least changes to the tax regime, and the introduction of capital gains tax taper relief in 1998 is a prime example. But what is without question is that family companies are presently providing regular, healthy and lucrative deal flow for corporate finance advisers.

To deal with the conflicting demands of family members, advisers are turning to banks and private equity houses for more innovative deals to make sure the family leaves the negotiating table intact. The successful transfer of the business to the next generation can be a minefield and many family firms either fail to plan for succession or wander into it without asking the difficult questions about the future owner-managers from the next generation.

A number of situations usually arise. For example, the second generation may have the entrepreneurial bent, but wish to start new ideas afresh with cash from the family business. Greek-Cypriot entrepreneur Stelios Haji-Ioannou used a loan from his father to establish the Easy empire, which has interests in a huge range of businesses, including shipping, air travel, hotels, car rental, cinemas, buses, music retail, serviced offices, personal finance and telecoms.

A more straightforward situation is where the owner does not have a next generation or has little faith in the ability of their offspring to take over the reins. A simple exit strategy, a trade sale or a management buy-out – if there is adequate second-tier management in place – may solve the problem and allow the owner to take the cash and put it into a more diversified, less risky portfolio to provide for their retirement.

"It is really about understanding where they are as a business, spotting the need to change and being able to be flexible and to adapt the investment or business strategy," says Grant Gordon, director-general of the Institute of Family Business. "The other challenge is in terms of how families are managing the business. More and more are professionally managed, which in reality means the whole process of succession is about getting the best people in as managers of the business. It is not about the family severing its links with the business, but working hand-in-hand with professional management. Those at the forefront are mixing the best of family stewardship with professional management. It might be a wrench to come to the decision to sell the business, but once the owner has got past that, action is required."

Young guns

A common, but more complex situation, is where the younger generation is deeply involved in the business and pulling it in a different, possibly riskier, direction. At the same time, the older generation may have one eye on winding down with a low-risk pension. The two goals are simply not compatible and a more innovative approach is needed.

"Funding markets have developed their sophistication to be able to deal with this difference in strategy and come to an agreement that achieves what both parties want," says Keith Pickering, partner at Catalyst Corporate Finance. "Integrated finance-style products could suit more family businesses as they keep the lion's share of the equity with the family."

David Williams, who founded Sand Aire Private Equity (which has a specialisation in family businesses) before joining Graphite Capital, says founders can often take on a valuable role as part of the new management team, without necessarily being responsible for the day-to-day running of the business. Graphite invested in the buy-out of Cinque Ports, the holiday home and caravan parks group, and the deal saw one co-founder leave the business while the other rolled a substantial amount of his proceeds into the new vehicle and became responsible for acquisitions.

PHOTOLIBRARY

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> *Adrian Dray, KPMG*

Williams is pragmatic about retaining founder management. "Often the company is being sold on with a professional management team. Some wealth is rolled over into the new vehicle and with the founder in a non-executive role, we retain some important knowledge," he explains. "Family businesses are more open to advice now and with more sophisticated innovative financial instruments, they are prepared to consider more options."

Graphite also invested in Summit Medical, which designs, manufactures and distributes medical devices and accessories. In this deal, a new chief executive was integrated into the management team when the founder sold the business. The founder rolled over a small percentage of his proceeds into the company and became a non-executive.

Some owner-managed businesses are now turning to private equity to fund growth through acquisitions. 3i's Growth Capital arm specialises in mid-market companies looking for such capital. In March 2004, 3i bought a 38 per cent stake in Williams Lea, an information management company it had been involved with since 1965. 3i's €50m investment was used to make three acquisitions and secure long-term contracts. Two years later, 3i sold its stake for €158m. "Part of our strategy is building relationship-led partnerships and that can make a difference," says 3i director Rupert Bell. "We have three or four conditions that really matter, rather than blanket provisions. We persuade the lawyers to take a more focused view."

Strong relationships are also particularly important when dealing with family businesses. "As an adviser, you take a slightly different approach," says Edward Nicholson, managing partner of the Mercator Partnership, which specialises in advising family firms on strategic issues. "With a big corporate, you are not sure if the person you deal with will be doing the job in a year. Whereas with a family business, you are looking to build a long-term relationship – to be part of the core advisory group. With big companies, you might talk about a long-term relationship, but really you are looking for the next deal."

Capital territories

Family businesses have traditionally looked to banks for debt to fund expansion or acquisitions, viewing venture capitalists with anything from outright scepticism to healthy reticence. The active ownership approach of many private equity firms, with board representation and continuous

reporting, interferes too much for many family owners, while the industry's three-to-five year investment horizon is also too short-term for entrepreneurs looking to build a legacy.

For owner-managed businesses, independent advice can be crucial to reaching agreement on any transaction. A study by the Centre for Management Buy-Out Research at Nottingham University showed that mutually agreed prices are arrived at more frequently where vendors and management seek independent advice. Where a vendor attempts to propose a price that is in their own interest, a private equity investor may be in a stronger position than management to challenge it. Management may be concerned that if they challenge a dominant owner they could risk losing the deal and possibly their jobs.

Howard Hackney, head of family business at Grant Thornton, says family ownership and professional management teams can work, but "the owner has to be very lucky to get a strong management team that does not want a piece of equity. A good team will always want an equity stake and one that does not want equity will not always be the strongest of management."

Family fortunes

Families are notorious for not wanting equity distributed outside their blood line. "Family businesses are open to getting the best talent they can, but there is the question of equity, which can be a very real problem," says Mercator's Nicholson. However, he argues that it may be possible to attract management through other means, such as shadow equity, bonuses or improved working conditions, and that money is not always the only factor behind an executive's choice about where they work.

Whether it is a trade sale, a management buy-out or a structured handover to the next generation, expectations of business valuation will not always be based on the normal criteria. For example, the valuation driver will often be a calculation of how much capital they need to provide the desired level of income in retirement.

Grant Thornton's Hackney says this often creates significant debate. "There is always a tussle over price," he says. "The exiting generation needs to have the financial security to pass on the business. The level of valuation differences varies, but I have seen business valuations range from £18m to £5m. If the £18m is not fundable, you have to give them an earn-out and a non-executive role. Usually I prefer ex-management to step out of the business completely, but it is about striking a balance that works."

Often owner-mangers will have built the business from scratch and it is not always easy to let go. Paul Lupton, corporate finance partner at Deloitte, says he has seen people hanging on too long. "They say 'It is worth X today, but it will be worth 2X in two years.' Generally I am seeing more pragmatism, but it is a gradual process – it's very rare for owners to wake up and think: 'I will sell my business.'"

Private pleasures

But not every owner-manager wants to sell the family silver. John Timpson bought back Timpsons, the shoe and shoe repair business his great grandfather started in 1865, in an MBO. The business had been sold in 1974 to retail conglomerate United Drapery Stores (UDS) due to an intransigent situation with family shareholders. He now owns 100 per cent of the business and his 35-year-old son James is the managing director. Timpson senior holds the positions of chairman and chief executive.

"It is not a family business if the family doesn't run it," he says. "To just own it does not mean it is a family business. We are fortunate that we have a family member who is managing director and is running it very well and profitably. I would keep venture capitalists well away from our business – do you want to turn it into money or a business? If the day-to-day running of our business was in the hands of so-called professional managers, I would be looking to exit. Running a family business is only partly about money. It brings a considerable amount of pride, pleasure and interest."

One advantage, provided family management is strong, is the continuity of management, which allows a long-term strategy to evolve. A recent study by Manchester Business School refuted the commonly held view that family-owned businesses do not perform as well as institutionally owned public companies. Seven per cent of the companies in the FTSE All-Share index are family controlled businesses and those businesses outperformed that index by 40 per cent between 1999 and 2005.

For some, the decision over whether to sell on can be fairly simple. Fraser Douglas is group business development vice-president at Wilo, a German family-controlled firm. Douglas bought Circulating Pumps from Baxi Group, with backing from GE Capital, and sold the company to Wilo in October. "It was good for me and good for the business," he says. "As a business we needed capital and backing for increased R&D spend. Wilo was a good third-generation family business that invests in R&D. From my point of view, paying only ten per cent tax on the gain is not only an incentive but means you have a duty to your family to sell. In terms of handing the business on you have to look over the breakfast table at your son and ask yourself: 'Would I employ him, let alone trust him with my pension?' If the answer is no, your mind is made up." ■

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➤ Succession solutions

Last September, the management team of Visage completed a successful management buy-out of the fashion house, backed by a Bank of Scotland (BoS) integrated finance package. The deal saw the first generation of the Sehgal family hand over the reins to the son and son-in-law team of Raj Sehgal and Sanjeev Mehan, who had managed the business since the late 1990s.

The Sehgal family started the business in Newcastle in the 1980s, designing takes on haute couture and sourcing the clothes from low-cost manufacturers to be sold through high-street retailers.

The brothers-in-law acquired a majority shareholding of the £100m-plus turnover business. While the business had attracted a lot of interest from both private equity firms and trade buyers over the years, Seghal and Mehan were keen to keep the business firmly in family hands and drive it forward.

"The second generation had taken the business forward hugely since they started managing it and wanted to continue to do so," explains Paul Lupton, corporate finance partner at Deloitte, who advised the brothers-in-law on the deal. "The first generation realised it was no longer vital on a day-to-day basis. The second generation was frustrated because it was driving value but not partaking in equity creation. We worked with the first and second generation to address the minor tension and came up with the optimal solution for both parties. We realised as soon as we sat round the table that the situation was not sustainable as it was and that it made sense to change. By talking frankly about what everyone wanted from the deal, we were able to approach it without resorting to an adversarial approach, which would have killed it."

There were two key drivers in selecting the ideal finance to suit the needs of both parties. Firstly, the brothers-in-law were not looking for a three-year exit plan and wanted to grow the business over the medium- to long-term. Secondly, the family wanted to retain a significant stake. The deal that was struck saw the first generation take out their 72 per cent equity stake as cash and loan notes, the second generation's stake increase from 28 to 85 per cent, and BoS take a 15 per cent stake in the business.

"This transaction is the result of many years' hard work and effort by a large number of family members," said Mehan. "The company is now in an excellent position to exploit its core strengths."