CFH
Investment Banking

Family Business

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Opening Statement

- “ The vast majority of businesses world-wide are started, funded, and owned by families, and these firms create most of the employment in the global economy.” *Stanford University, GSBGEN 334.*

- It is not about the type of business ownership, it is all about the way the business is being run. Ample examples of extremely well managed family businesses can be found. Conversely, many listed and closed shareholding companies have had their share of disastrous performance.

- This presentation addresses the main challenges family businesses face, namely improving efficiency, succession planning and family feud, growth limitations and financial constraints, and lack of proper corporate governance. Often are the cases where there is a dire need for family businesses to instill self discipline.

Source: Stanford University, GSBGEN 334.

Introduction to Family Business

Global & Local Perspective

- Family business is the oldest and most common model of economic organization. Family businesses play an important role in job creation and economic development, contributing a minimum of 70% to the global GDP.

- The majority of companies throughout the world, from corner shops to multinational publicly listed organizations are considered family businesses.

- In Lebanon, family businesses are considered the base of the economy constituting around 90% of the private sector.

Source: Project (MBA) Suliman S. Olayan School of Business.

Introduction to Family Business

Global & Local Perspective (Cont'd)

- Family businesses face several challenges such as succession planning and family feud, growth limitations and financial constraints, and lack of proper corporate governance.

- Some family businesses opt to mitigate these challenges by opening up capital or partnering with financial or strategic investors. Each type of investors have their advantages and disadvantages.

Challenges Facing Family Business

Family Businesses Top 3 Challenges

- Family businesses face several challenges among which are the following:

1. **Succession Plan and Family Feud:** Globally, 30% of family businesses last into a second generation, 12% into a third generation, and 3% into a fourth generation or beyond. In Lebanon, only 10% transfer to the third generation. This is due to poor succession planning by acting family members.

Source: Harvard Business Review & American University of Beirut, Suliman S. Olayan School of Business

Challenges Facing Family Business

Family Businesses Top 3 Challenges (cont'd)

2. **Growth Limitation and Financial Constraints:** Family businesses prefer not to raise capital from third parties, thus being constrained to raising cash by leveraging the business. Excess use of leverage increases fixed costs, constrains cash flows, and limits the business's ability to take risk and implement new growth initiatives.

3. **Lack of Proper Corporate Governance:** Governance issues such as internal hierarchies, the element of accountability, lack of oversight, and regulations tend to be taken less seriously at family businesses.

Source: Harvard Business Review & American University of Beirut, Suliman S. Olayan School of Business

Challenges Facing Family Business

Succession Plan and Family Feud

- Many family businesses struggle to formulate a succession plan.

- **Nepotism and absence of Meritocracy:** In many family-owned businesses nepotism is viewed as a source of labor and a route to succession. However, competence and delivery must be the main criteria for employment and promotion. To avoid the prevailing phenomena of - الطفل المعجزة - the “whiz-kid” syndrome. The element of meritocracy is often absent.

- **Key Man Risk:** The reputation of the business and the revenues are usually associated with the managing family member (mixing between the brand and the effective owner).

Challenges Facing Family Business

Succession Plan and Family Feud (Cont'd)

- **Lack of Succession Plan:** Many family firms lack clear succession plans. As an observation, the member of the family who is running the business does not usually have a clear succession plan and appears to be staying forever and behaves accordingly.

- It is of utmost importance to have a solid succession plan early on and in place to avoid the issue of lack of continuity, family feud, etc.

Challenges Facing Family Business

Growth Limitation and Financial Constraints

- Although leveraging the business can increase financial returns without ceding a stake of the business, it also presents the following challenges:

- **Constrained Cash Flow:** Debt repayments are a fixed obligation regardless of profits and cash flow status. This raises the risk of insolvency for the business during cyclical financial periods.

- **Less Room to Maneuver:** Overuse of debt can severely limit future cash flow and stifle growth. This limits the business's ability to take risk and implement new growth initiatives. Moreover, banks usually require securities against the loan granted, such securities freeze the family members' personal assets.

Challenges Facing Family Business

Lack of Proper Corporate Governance

♦ Family businesses face the following issues related to corporate governance:

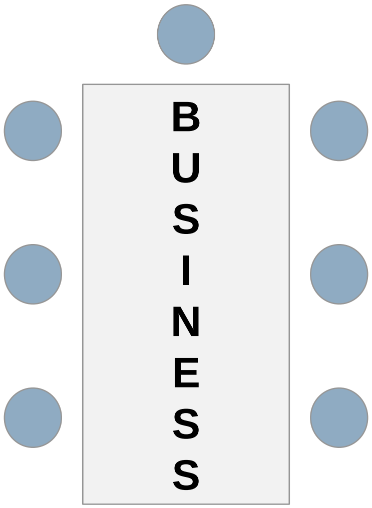
- **Conflict of Interest and Dividend Policy:** The interests of a family member or the entire family may not be aligned with the interest of the business. A common example is prioritizing dividend distributions over retaining earnings, which could limit the business's growth potential.

- **Business Intransparency:** Family businesses, usually, lack proper advisory or supervisory boards, which increases the legal and operational risk.

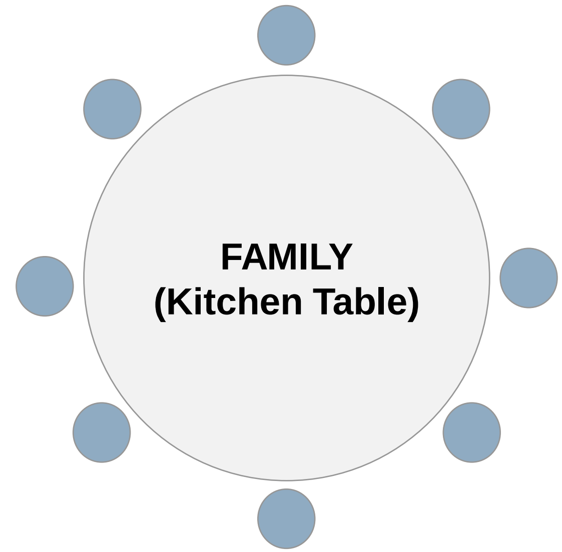
- **Talent - Management:** Family businesses tend to hire family members in key management positions with low regards to their skills and abilities. This demotivates other members of the management team giving rise to possible resignations and loss of talent.

Family Business Structures for Proper Governance

Separating the Family from the Business



- Direct family members are granted seats in a family council that signs a family charter regulating the family and its relationship with the business.
- All members of the family council shall be considered equal as if sitting at the family kitchen table.
- The council shall act as an advisor to the board of directors who is responsible of taking business decisions and sets the business strategies.
- The board shall include both family and non-family members, however shall be chaired by a family descendant and act distinctly from the council.
- The board shall be regulated by the company bylaws and government regulations.
- Coordination between the chair of the board and the head of the council is required.



BOD Dual Mandate → **Advisory**

BOD Dual Mandate → **Oversight**

Council → **Blood Line**

Council → **In-laws**

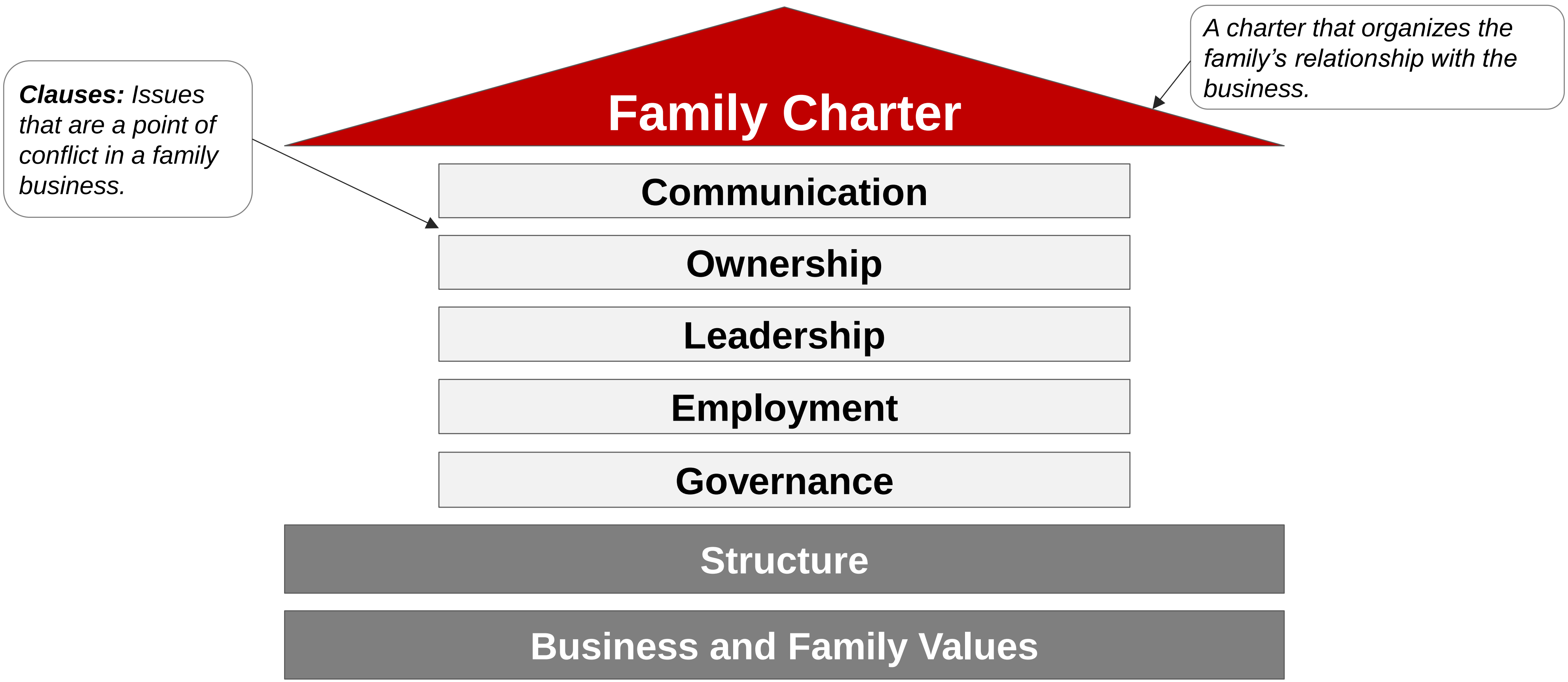
Governance → **Family Charter**

A legally binding document

 Source: Family Business Resource Centre

Family Business Structures for Proper Governance

Family Charter



 Source: Family Business Resource Centre

Opening Up Capital – Financial Investor

Benefits of Capital Increase

- Opening up capital to outside investors could lead to the following benefits for family businesses:

- **Flexibility & Efficiency:** The business has no obligation to distribute dividends or repay investors' initial investment. The capital increase will reduce the pressure on the cash flow and aids growth initiatives.

- **Optimal Capital Structure:** The business will optimize its capital structure by opening up its equity to third parties. The capital increase will assist the business in not exceeding the optimal debt to equity ratio.

- **Better Corporate Governance & Succession Plan:** The investor/partner will help institutionalize the company and put proper corporate governance practices into place. The investor will also help formulate a succession plan or a potential exit.

Opening Up Capital – Strategic Investor

Benefits of a Strategic Investor

- Investment Banks usually advise sourcing external funding from a strategic investor. The advantages of inviting strategic investors are highlighted below:

- **Growth Potential:** Strategic investors help with product development, sales, creating joint ventures, building connections, and introducing the business to new markets.

- **Better Corporate Governance & Succession Plan:** The strategic investor helps institutionalize the company, put proper corporate governance practices into place, and formulate a potential succession or exit plan.

Important Note:
It is worth noting that there is no free lunch. In both cases, when opening up the capital to either financial or strategic investors the management is now accountable for its actions and needs to periodically report the company's performance to the investors. Moreover, the new investors will require certain minority rights terms such as: change of control terms, drag along, put option, affirmative voting on certain subjects, BOD seat, etc.

Role of Investment Banks

- The key role of an investment bank is to provide the appropriate advise to family businesses (hopefully) and other business types in this regard. The advise may relate to opening up the capital, identifying strategic partners and/or financial investors, provide advise on possible mergers or acquisitions (M/A) and joint ventures (JV), or even to provide advise on a possible exit strategy.

Closing Statement

- Behavioral economist Richard Thaler was awarded the Nobel Prize for Economics in October 2017. Mr. Thaler's research suggests that people tend to be irrational, involve emotions in decision making, and ascribe more value to things merely because they own them (Endowment Effect).

- This applies to family businesses, especially in our region, where owners tend to be emotionally attached to their businesses refusing to open up the capital or exit the business, when due.

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