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Pivotal moments for family enterprises
Assessing capital needs

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EDITOR'S NOTE

Like a great work of art, family enterprises are unique, crafted over time, and highly valued. While no two family enterprises are the same, they are united by a series of pivotal moments—opportunities to grow, evolve, or transform—and preparation is essential for fully seizing those opportunities. This is the second article in a series exploring the eight foundational elements that can help family enterprises maximize the opportunities that arise. Because, with the right canvas, family enterprises can craft a business that supports its evolving vision, interests, needs, and values for generations to come.

New capital options can create **new opportunities** for family enterprises

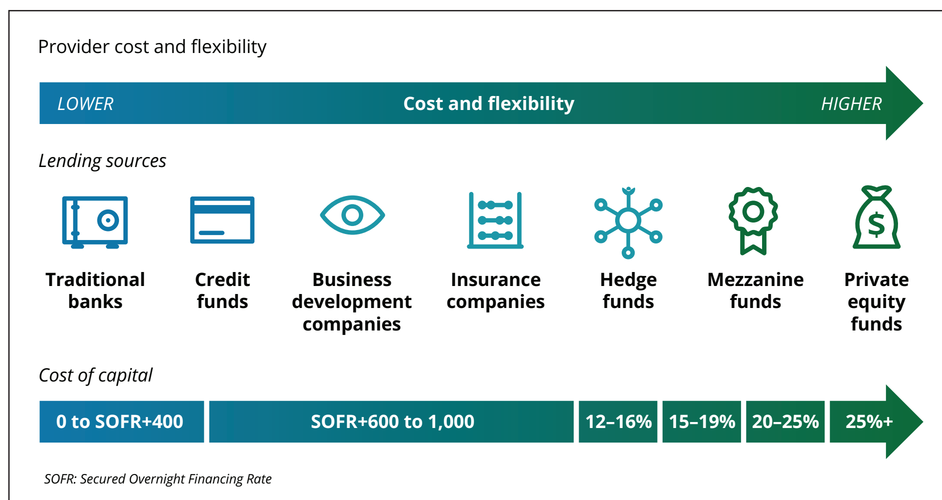
For the forward-looking family enterprise, opportunities abound. Whether diversifying into new industries, expanding existing lines of business, or adopting the latest technology, growth opportunities will likely present themselves. And, if they do, additional capital might be needed.

While seizing these opportunities can be exciting, it may introduce some unique complexities for the family enterprise. Family dynamics can have a big influence on what requires additional capital, when it's needed, and how it's accessed and deployed. As we discussed in the kickoff to this series, establishing a formalized governance structure prompts the business to align on the "what," "when," and "how" in advance. Not only can this prepare the business to seize new opportunities with confidence and agility, but it helps ensure the needs of the business are balanced with those of family members.

"Being prepared for the capital needs of your business almost always leads to increased strategic flexibility," says John Deering, Leader, Deloitte Capital Advisory. "It's a good way to know an optimal solution can be available when you need it."

Traditional and nontraditional lenders are expanding the spectrum of funding choices

In the past, family enterprises had few options for accessing capital. As a result, they largely relied on traditional commercial banks. Unfortunately, commercial banks often took a conservative stance and restricted how funds could be used, thereby limiting what a family enterprise could achieve. While the debt markets have since evolved to include new, nontraditional lenders, many family enterprises are not aware of these options.



"The private debt markets have rapidly evolved, and today there are a lot of versatile, creative, non-bank alternatives to fund a family enterprise's capital needs," Deering says. "They can also provide more flexibility, including the ability to add on to credit facilities or refinance as conditions change. A common theme when evaluating debt alternatives is finding the optimal balance on cost versus flexibility."

The commercial lending landscape has seen business development companies (BDCs), hedge funds, insurance companies, and mezzanine funds play a more significant role in capitalizing private companies in recent years, accounting for a majority of all private leveraged finance transactions (S&P Capital IQ). These emerging players are providing creative capital structures to pursue acquisitions and other growth initiatives, accelerate capital expenditures to fuel organic growth, fund special dividends, buy out minority shareholders, or restructure debt to eliminate existing, potentially restrictive financial covenants.

BDCs are noteworthy non-bank lenders as they have emerged as a compelling vehicle for accredited and institutional investors looking for an alternative to public equity and debt markets. With record amounts of investible funds, or "dry powder" being raised, BDCs have become a popular choice among middle-market companies seeking first-lien term loans, unitranche financings, subordinated debt, structured equity, and equity co-investments.

Private equity funds have also emerged as an important alternative when evaluating long-term capital needs and shareholder liquidity goals. Like BDCs, private equity funds also have large amounts of dry powder. There was roughly $1.3 trillion in uninvested private equity capital as of September 2021, and fund managers are under increasing pressure to deploy it in fresh opportunities.[1] However, rising deal values by private equity is a key theme in looking back at 2021.

"The big story will be when private equity took over as the driving force for M&A," says Phil Colaco, CEO, Deloitte Corporate Finance LLC. "In 2021, private equity funds were paying higher multiples than strategics, which I've never seen in my career. The rise in the past year of private equity-backed deals has been astronomical."

The chart above demonstrates the various types of financing sources driving competition and flexibility across the private debt markets, as well as how this competition yields a range of structural creativity and pricing dynamics.

The importance of a capital needs assessment

The proliferation of capital solutions is certainly good news for family enterprises, as it affords them greater creative license; however, proper timing is an important consideration to take full advantage of these options, as both internal and external factors play a role.

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[1] https://www.preqin.com/insights/global-reports/2022-preqin-global-private-equity-report

Within the business, leadership transitions, pending distribution requirements, and major initiatives may help determine the optimal time to execute a capital acquisition. Likewise, environmental factors such as economic trends, the political landscape, and workforce issues are also key considerations that can elevate one solution over another at a moment in time. Also, companies should factor in the time it takes to build key relationships with funders. Just as an owner spent time building a relationship of trust with their original lender, it's important to build relationships to gain access to the non-bank capital providers.

This is where a capital needs assessment can help. It helps business and family leaders determine their capital-raising goals and priorities, assess optimal timing, and explore funding options—all in preparation for accessing future capital. With family enterprises, capital needs assessments encourage family members to talk about the needs of first-, second-, and even third-generation family members to help ensure quick, well-informed decisions can be made when needed.

"The capital needs assessment can be the trigger that gets family members to better understand, from a strategic perspective, what the potential needs of the family and the business are," says Max Hughes, a senior vice president at Deloitte Corporate Finance LLC.

Capital needs assessments can also reveal possibilities family businesses may have previously ruled out due to assumptions of ineligibility. "We've seen many situations in which companies get excited when they learn they can finance an acquisition that's larger than they would have thought while simultaneously taking chips off the table," Deering says.

As the interests and priorities of family members evolve, a capital needs assessment may also help alleviate building pressures, such as when a family member who may have substantial equity in the business wants to move on. It might also pinpoint an overlooked issue needing to be rectified, as in the case of a family enterprise that needs a new debt structure to transfer it from one generation to the next or to redeem a shareholder who passed away.

"Sometimes the point of the assessment is to get ahead of issues before they snowball into bigger ones," Hughes says. "In other cases, assessments help ensure that businesses aren't needlessly limiting their options due to a lack of awareness of what's possible."

When a capital needs assessment identifies a near-term need, the family enterprise should explore the pros and cons of each capital alternative, including the cost of capital versus its flexibility. They should also understand real-time pricing from a wide variety of sources and have relationships to connect with lenders to execute the transaction.

Ultimately, if it's the family's desire to remain a family enterprise, understanding and evaluating its liquidity options allows the family to remain in control of the trajectory of the business and meet the needs of current and future generations.

Where to start

Every capital needs assessment begins with a list of questions. "Proper due diligence goes a long way in setting the family enterprise up for success in this process," Hughes says. To that end, the business should consider thinking through several questions during its normal governance deliberations, including:

- What are our long-term goals for the business, and are they aligned with the goals of our family?
- Is everyone in the family on board with that vision?
- Do we need outside capital to achieve these goals?
- How long do we plan on keeping the business in the family?
- Do we fully understand the range of alternatives when thinking about the capital structure of the enterprise? Are we more sensitive to cost of capital or flexibility?
- What is our appetite for additional leverage? Do we have confidence in our projections on generating ample cash flow to service incremental leverage?
- Is there incremental future value to the family and the business to give up some equity in the enterprise?
- Does a potential partner need to add strategic value?
- Have we ruled out potentially transformative transactions in the past because we were worried about being financially constrained by them?
- Is our capital structure built to last for the next few years? How about the next 10–20 years?

NEXT UP IN OUR SERIES

Incentive planning
Explore the different options and unique considerations for family enterprises.

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