1 + 1 = 3

Maximizing value within a family business

As leadership within family businesses transitions to the next generation, there is a renewed focus on maximizing and enhancing the family’s wealth.
Our research has shown that one of the most significant challenges now facing family businesses is how to maintain the balance between business goals (such as growth) and family goals (such as maintaining family values and protecting the family wealth.) The challenge is magnified with the development and globalization of financial markets, which has increased the accessibility, and in turn, the opportunity as well as the risk.

A key factor that drives value within family businesses is the ongoing effective allocation of capital across asset types and sectors as markets transition over time. This is a common oversight in many family businesses across the region. In order to maximize value, it is essential to assess where the capital of the group is allocated, and following that, manage and monitor that capital over time. Where is the family business exposed? Where is it over exposed? Is the business positioned to capture the next cyclical trends?

But how do you assess where capital within the family business is allocated?

A common perception among family businesses is that capital—or value—can be adequately measured by reference to accounting measures such as shareholder equity (book value) or total funds invested. In simple terms, book value equals the total reported assets of the group less its total liabilities. This measure therefore provides a historical perspective and more likely reflects what shareholders would receive if the group were to be liquidated in an orderly manner, rather than the value attributed to its future earning power as a going concern. Future earnings (and therefore value) will be influenced by its brand, contracts in hand, relationships with its customers, competitive positioning, and goodwill, among other factors—all of which may not be captured in a book value measure. As such, in most instances book value materially underestimates the value of the family business and any capital allocation decision based on this measure is likely to be misleading.

Family businesses are typically characterized by one (or several) core operating businesses, together with other investments that have been added over time as the group’s wealth has accumulated. When assessing the real value within a family business, a “sum of parts” approach is typically applied whereby each business and investment is valued separately with the objective to reflect what a third party would trade each single asset at having regard to its risk and growth characteristics. The individual parts are assessed using common valuation methodologies (such as discounted cash flows, market multiples, etc.) with the results aggregated to the total value of the group (adjusted for any centralized costs or non-operating items.)

Given their inherent nature, assessing the value of a diverse and complex conglomerate does pose many additional challenges as compared to a standard valuation that needs to be considered, including, but not limited to:

1. Assessing a target/optimal capital structure for each business and group given the willingness of family businesses to take on debt historically;
2. The relationship between the businesses within the group (e.g. related party trading), as well as intercompany funding. How should these be treated if one were to assess value from a third party perspective?
3. Whether the consolidated value of the ‘parts’ reflects what may be achieved in a sale to a third party of the group on a stand-alone basis. Should an additional premium or discount be applied to the consolidated value in recognition of the business structure, track record, or other factor?

Measuring value within a family business has taken on a renewed level of importance as leadership transitions to the next generation. Excess returns are largely driven by the effective allocation and management of capital over time, particularly amid market and financial developments.

Accurately measuring value (real worth) and where it is allocated across various categories allows shareholders to better analyze their portfolio against the overall strategy and other benchmarks. It is the regular management and monitoring of that capital that is paramount to ensure the capital is efficiently utilized and returns are maximized. While there is an abundance of metrics and factors that may be monitored over time, it is important that these be tailored to the group based on its specific strategy, operations and characteristics. From a financial perspective, attributes that are assessed and monitored to ensure value is maximized within a family business may include:

- **Return attributes**: The measure of return over time and how that compares to appropriately suited benchmarks. The drivers of return are also monitored by reference to the particular investments, industry and how these may be dissected between capital growth vs. income (i.e. dividend.)
- **Risk attributes**: Monitoring and managing risk within the portfolio and/or certain investments with reference to factors such as budgeting accuracy, level of financial leverage, ability to fund commitments and the relative risk between business segments (i.e. degree of diversification.)
- **Performance attribution**: Measuring actual and relative performance of the portfolio and investments (or groups) using financial metrics such as returns on equity and invested capital. Assessing the return on capital relative to the cost of the capital deployed is an important test on whether value is being created.
- **Liquidity and cash management**: Consideration of the group’s liquidity position is also important to assess the ability of the group to fund growth opportunities, pay dividends and manage exit strategies.

Given the typical structure of a family business, each of the above can be analyzed at a portfolio level, and/or by various sub-segments such as core versus non-core, by asset class, industry, geography or maturity.

An effective method of presenting such attributes to senior stakeholders is via “scorecards” or “dashboards,” whereby these factors are measured and then regularly tracked against historical performance, suitable market benchmarks, and internal targets. These dashboards would then allow decision-makers to promptly identify any deviations over time and then take the necessary action, be it a focused effort on the improvement on existing assets, rebalancing the portfolio (through acquisitions and divestures) or simply adapting the overall strategy.

Measuring value within a family business has taken on a renewed level of importance as leadership transitions to the next generation. Excess returns are largely driven by the effective allocation and management of capital over time, particularly amid market and financial developments. The family business’ capital (real wealth) should be appropriately measured using standard valuation methodologies typically based on a sum of the parts approach, and then analyzed against the existing strategy. Regularly monitoring the allocation of value and tailored key performance metrics over time provides shareholders an active way to adapt to market trends and drive the overall value of the group and wealth of the family.

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