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Family-owned Businesses Get A Second Look

Tom Stein, Buyouts Newsletter
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Private equity firms have never been big fans of family-owned businesses. After all, who needs the drama of a founder that can't bear to let go of his "baby", or squabbling siblings whose bickering can quickly poison a deal? Life is much simpler when business is just business, and not an extended session of family counseling.

But lately, private equity firms are taking a new look at family-owned businesses. A number of factors are suddenly making these deals more attractive. Firstly, baby boomers with a large investment in the family business are approaching retirement and are eager to resolve succession issues while creating more liquidity for their golden years. This has led to a glut of interesting new opportunities entering the market. An improved economy, higher multiples, and more attractive capital gains rates are also enticing more sellers into the market.

"This is the most robust market for quality, family-owned businesses that we have seen in a number of years," says David Gellman, a managing partner at private-equity firm FdG Associates in New York.

Tiff Armstrong, a managing partner at middle market investment banking firm Harris Williams & Co. in Richmond, Va., confirms the boost in selling activity. "We are definitely seeing a bigger percentage of family-owned business selling out to strategic buyers," he says.

Private equity firms, for their part, have more money than ever to put to work, thanks in part to readily available debt. At the same time, there are more and more firms converging on the same deals. Staying competitive in this environment increasingly means finding new niches to explore-and family-owned businesses are looking better by the minute.

In fact, these businesses are turning out to be very solid investments. In the one of the only studies of its kind, the European Venture Capital & Private Equity Association, along with the Center for Management Buy-Out Research, recently surveyed a number of European family-owned company buyouts. The study found that these companies grew faster for the first three years post-buyout, and that the average number of employees climbed an eye-opening 67.3% after the buyout.

The survey attributed the positive results to the injection of new capital in the business, stronger financial incentives for management, and the fresh ideas, higher energy and desire for improvement that comes with a buyout. Experts note that another reason family firms perform so well post-buyout is that prior management was often resistant to change and had done little to improve the business in the years preceding the buyout.

Of course, there are still some private equity firms that refuse to invest in family businesses. Heritage Partners in Boston isn't one of those firms, but managing partner Peter Hermann can certainly sympathize. He says investing in a family business often rises to the level of Shakespearean theater.

"Ninety percent of these transactions are about psychology," says Hermann, whose firm deals almost exclusively with family-owned businesses. He's often contending with emotional, eccentric CEOs who can change their minds on a daily basis. And then there's the festering family issues like who Dad loved more, who's the favorite child and who's the screw-up. Of course, there's always the burning question of what will happen to loyal uncle Ernie, the treasurer of the company who, by the way, doesn't know how to count.

"I can certainly understand private equity firms that decide life is too short to deal with these lunatic families," jokes Hermann. "These deals can take a lot out of you."

Family businesses can also be sloppily run, especially compared to a division of a public company that is being spun out. In some cases, they have never had an outside audit, never thought about things like income recognition, and wouldn't know compliance requirements like Sarbanes Oxley from the Chicago White Sox.

"You see some funny things in a family business that you wouldn't see in a more institutionalized company," says Douglas Newhouse, a managing partner at Sterling Investment Partners in Westport, Conn. "You can come across large personal expenses for things like private pilots, so you have to figure out what is legitimate and what is not."

Another reason why some private equity firms prefer to steer clear of family businesses is that these deals can take several years from the time you first meet the family until it finally closes. By contrast, other buyout deals such as a corporate divesture can typically close in just six months. Whereas these deals are purely about business, the sale of a family business is dripping with pure emotion.

Still, the unconventional nature of family businesses is often what makes them so attractive to private equity firms. For instance, price by itself may not be the principal consideration in the sale of a family business, which means private equity firms can get in relatively cheap compared to other deals. Owners of family businesses have been known to lower the price in exchange for certain guarantees, such as keeping the company in the same town where it was founded, retaining key employees, and foregoing layoffs.

"Some of these families are like royalty in their small towns," says Hermann. "They want to be able to walk into the local grocery store and not have everyone hate them for moving the business and losing jobs. There are all these ethical, moral, and lifestyle issues that come into play."

Armstrong adds that families remain emotionally vested in their companies, even after the sale. "The good name of the business and its continued success are very important to these sellers," he says. "They don't want to sell out to someone who is just going to dismantle the business."

Many of these deals boil down to chemistry. FdG's Gellman says it's comical how many private equity guys will waltz into a meeting with a family business owner in their Gucci shoes and then proceed to take cell phone calls and play with their Blackberries under the table. "Many of these owners have come to work for 30 years in their bowling shirts," he says. "You have to be sensitive to who they are and understand the emotional connection they have to the business."

Culture also plays a huge role. Sterling is close to finalizing an investment in an 85-year-old family business that makes and distributes branded products. Because the deal is not yet complete, Newhouse declines to name the company. Though competition for the deal was stiff, he says his firm was able to gain an upper hand thanks to the comfortable working relationship it was able to form with third-generation family members that have committed to staying on with the business.

"This is a deal where we are providing liquidity for the second generation and backing the third generation," says Newhouse. "The family members remaining are not cashing out, so it's important that we all know how to work together and form a real partnership." Sterling will become a majority shareholder in the business. Newhouse says the plan is to rapidly grow the business over the next five to seven years and capture new market share before selling out at a premium.

Indeed, many family businesses now prefer to deal with private equity firms because they can retain a piece of the company and have a chance to make even more money down the road-the so-called "second bite of the apple." By contrast, when families sell out to direct competitors or large corporations there is usually no chance to have any continuing equity.

"Equity funds usually buy 80% of the business, which allows the owners to continue on with the business, watch it grow, and ultimately secure another payday," says Richard Kintz, a managing partner at the law firm of Sheppard Mullin Richter & Hampton who represents family businesses. "It's very possible that in five years' time, the families will secure a bigger payday with the remaining 20% than they did with the initial 80 percent."