7 capital planning questions for family businesses

In a tough capital-raising environment, family enterprises are revising their approach to budgeting, forecasting and financial decisions

EY

Building a better working world

At a glance

- Company capitalization decisions have become more complex in the face of macroeconomic, lending and operational challenges.
- Family businesses should assess capital and funding needs against external data, credit market changes, adjusting valuations, and financial or tax incentives.
- Maintaining long-term family control can benefit from understanding how capital markets fields of play align with business and shareholder needs.

Growing family companies need to be adequately capitalized to fund their current operating needs, future growth and development, and the periodic liquidity requirements of their shareholders. But after nearly two decades of historically low cost of capital and abundant capital market liquidity, family-owned businesses are finding that company capitalization decisions have become more complex in 2024.

There are many challenges. Amid the broader landscape, rate tightening by the Fed has increased the cost of borrowing in the range of 300 to more than 500 basis points for most businesses,[1] the M2 money supply has contracted in a similar manner to what occurred during the Great Depression in the 1930s,[2] and the biggest bond market rout in almost 250 years has occurred.[3]

On the lending side, balance sheet asset risk exposure, stemming from commercial real estate loan write-downs and deposit withdrawals, has impacted bank liquidity, tightened credit acceptance and curtailed lending activities. In turn, many alternative lenders face challenges with existing portfolio companies.

Businesses are facing internal capital challenges as well. Inflation and other supply chain factors have impacted gross margins and operating income, capital budgets have been slashed in the B2B market, and cap rates for real estate valuations have deteriorated. The fear of recession has also limited capital market access for many businesses.

It's clear that the rules of the game have shifted in today's capital markets, so many family businesses are looking at how to re-evaluate their company capitalization plans. As part of that process, they need to better understand how the capital markets have changed, as well as how their business would be assessed by participants in the capital markets. In this way, they can better quantify their capital availability and more accurately calculate the cost of capital.

[1] Haskins, Justin, "New data reveals a crash not seen since Great Depression could hit in 2024," FOXBusiness, 5 October 2023, ©2023 FOX News Network, LLC.

[2] McGeever, Jamie, "US money supply falling at fastest rate since 1930s," Reuters, 30 March 2023, ©2023 Reuters.

[3] Glover, George, "The rout in US Treasurys is now the worst bond bear market of all time," Business Insider, 9 October 2023, ©2023 Insider Inc. and finanzen.net GmbH (Imprint).

Capitalization planning tools

Here are some tools to consider before developing your capitalization plan:

- Business Value Range Analysis (VRA) calculation tools
- Credit Quality & Capacity Assessment data and analysis
- Capital Market/Credit Placement Assessment research
- Capital Market Qualification (CMQ) Scoring data and tools
- Capital Markets Trends (CMT) Assessment data
- Weighted Average Cost of Capital (WACC) Recalculation data
- Upgraded Financial Planning & Analysis (FP&A) Modeling tools
- Business Reinvestment & Capex ROIC Analysis Prioritization tools and processes
- Liquidity Profile & Enterprise Risk Forecasting data and tools

Key questions leadership should be asking

The capital strategy of business-owning families and their companies has always been a critical component of the long-term growth trajectory of successful family enterprises. Given today's economic environment of higher interest rates and greater cost of capital, even the most efficient capital plans should be reexamined and assessed. Today's economy requires effective capital planning to be informed, resilient and efficient while mitigating risk to effectively develop capital alternatives to fund business growth and shareholder liquidity needs with a focus on continued family control of the enterprise.

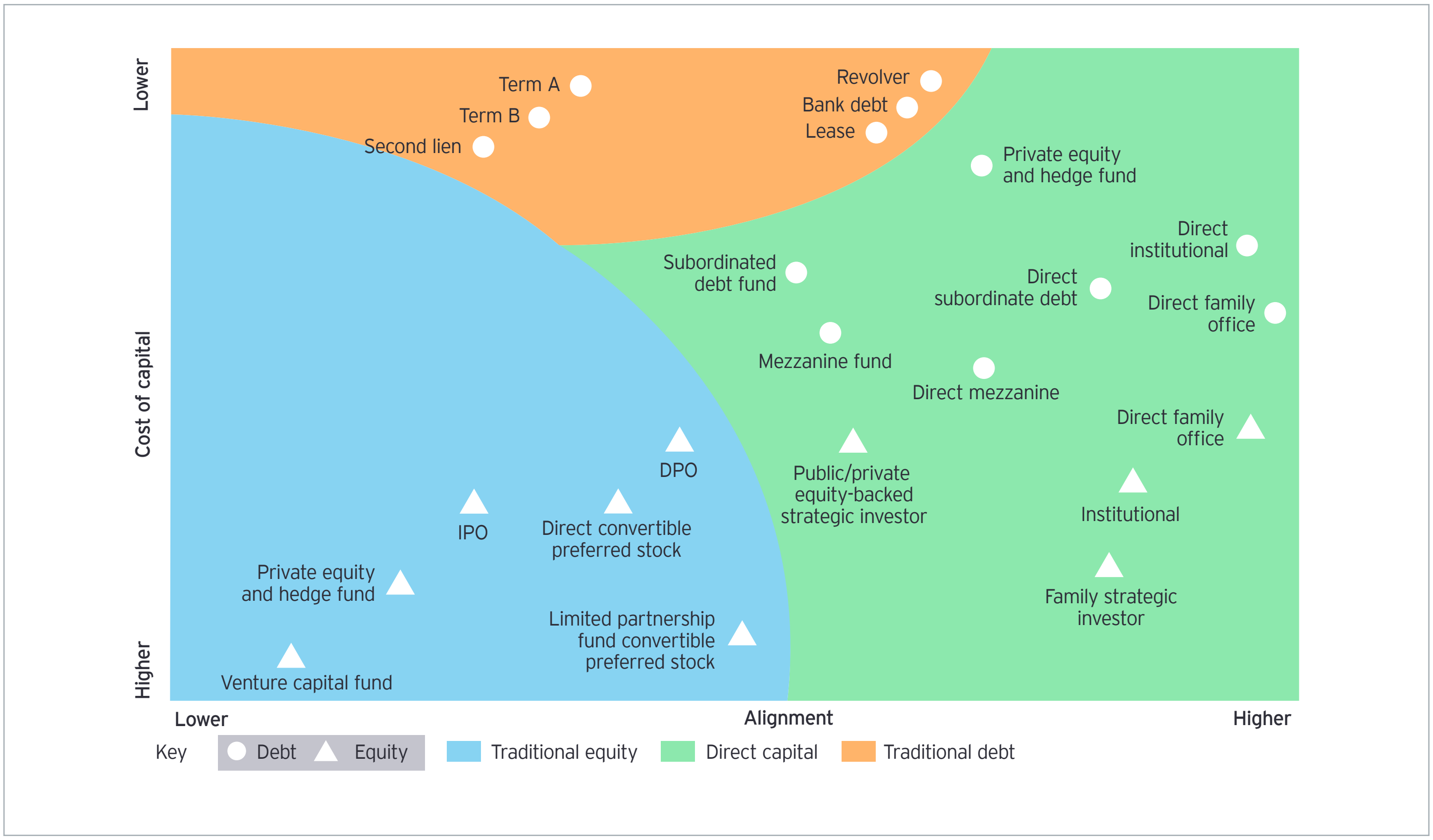
As you move through your annual budget or strategic planning process, consider these key questions when you assess the capital needs and funding requirements of your business:

1. What external capital market data is obtained by our financial management team to assess our company capitalization alternatives? Are the data sources adequate? Should they be supplemented?
2. If our credit facility will be renewing within the next 18 months, are we certain that our bank(s) will renew the facility, will changes in covenants will be required, and what changes in pricing should we expect?
3. Does our team truly understand the changes occurring in the credit markets, including the expansion of non-bank, private capital lenders? If so, what information or process has been used to identify non-traditional sources of capital?
4. Given that valuations have started to decline for many private businesses, would now be a good time to consider acquisitions? If so, what funding options, aside from debt capital, might be available?
5. Do we truly understand the capital markets fields of play, how our business would be valued or credit scored, and what segments and which participants might be productive capital partners for us in the future?
6. Do we understand the range of federal, state and local financial or tax incentives to encourage ongoing business investment and expansion?
7. Do our board, executive team and primary shareholders understand the shifts that have occurred in the capital markets and the valuation of private companies? Do we need to revisit the shareholders agreement or dividend or liquidity policies for owners?

Understanding the capital markets fields of play

When considering access to the broader capital markets, understanding the capital markets fields of play and how they might align with the long-term capital needs of a business and its shareholders is important. This is especially true if maintaining long-term family control is a key consideration.

Capital markets fields of play



Sourcing and managing capital that aligns with the family enterprise's long-term capital agenda can be challenging, particularly if you want to keep family ownership control and create more value for future generations. Many times, nontraditional capital sources, including the direct capital markets (e.g., insurance companies, pension funds and family offices), have better capital alignment with the long-term outlook of family businesses, such as flexible terms and extended commitment periods.

By thoroughly evaluating each option by considering the associated costs, risks and benefits, business-owning families can make a well-informed decision about the most suitable funding source for their capital needs.

In brief

Business-owning families can better position themselves for success when developing updated views of company capitalization alternatives by performing a thorough evaluation of financial readiness and establishing clear and balanced financial objectives. They also should make certain that their boards and financial management team members have access to relevant capital market data and contacts. And if access to the capital markets is needed, families need to understand the available funding options that will best align with the long-term capitalization needs of the family enterprise.

EY | Building a better working world

EY exists to build a better working world, helping to create long-term value for clients, people and society and build trust in the capital markets.

Enabled by data and technology, diverse EY teams in over 150 countries provide trust through assurance and help clients grow, transform and operate.

Working across assurance, consulting, law, strategy, tax and transactions, EY teams ask better questions to find new answers for the complex issues facing our world today.

US SCORE no. 22232-241US
CSG no. 2307-4277610
ED None

ey.com

Authors

James Bly
EY Private Family Enterprise
Business Services Managing Director
Ernst & Young LLP

Gene Peck
EY Private Family Enterprise
Business Services Managing Director
Ernst & Young LLP

Contributing author

Bobby Stover
EY Americas Family Enterprise
and Family Office Leader