How do you future fit your shareholder liquidity strategy to avoid disruption?

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May 29, 2024

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Learning objectives

- Review leading practices for designing dividend and distribution policies for family operating enterprises and trusts
- Review key factors to be considered by family operating enterprises when adopting a corporate dividend policy
- Review key factors to be considered by trustee(s) when adopting a trust distribution policy

EY DNA model for family business

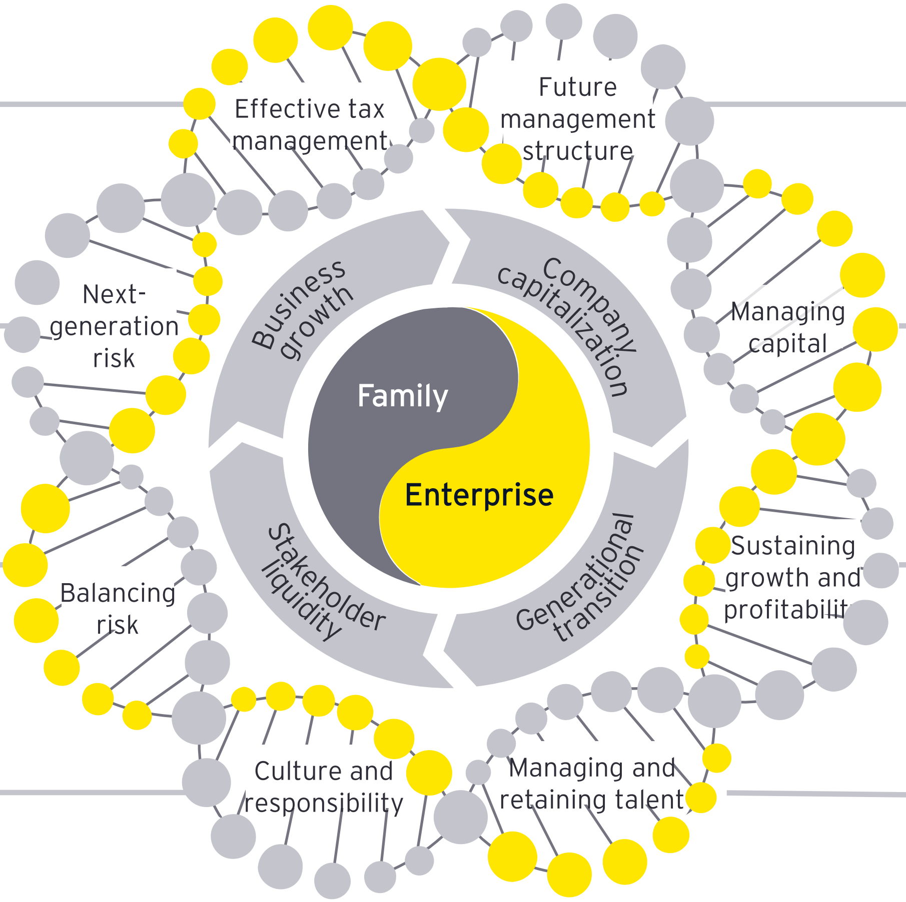
Family and business are intertwined like DNA, connecting values and assets. At the core, a family enterprise needs to focus on four strategic priorities to grow a more valuable company, avoid disruption and achieve a successful generational transition: (1) business growth, (2) company capitalization, (3) stakeholder liquidity and (4) generational transition. There are eight tactical elements embedded within the family enterprise DNA. Their performance is aligned and contributes to the success of the four strategic priorities.

- Personal income tax
- Fiduciary income tax
- Inheritance and estate tax planning
- Transaction tax
- State and local tax

- Family charter/governance
- Management of increasing number of family members
- Education/EY next-gen program
- Management of differing expectations (level of dividend payouts vs. reinvestment)

- Risk and control review
- Operational risk
- Regulatory risk
- Cyber risk
- Asset protection

- Family charter, mission statement
- Ethics, sustainable investments, social investing projects
- Philanthropy
- Art collecting and preservation



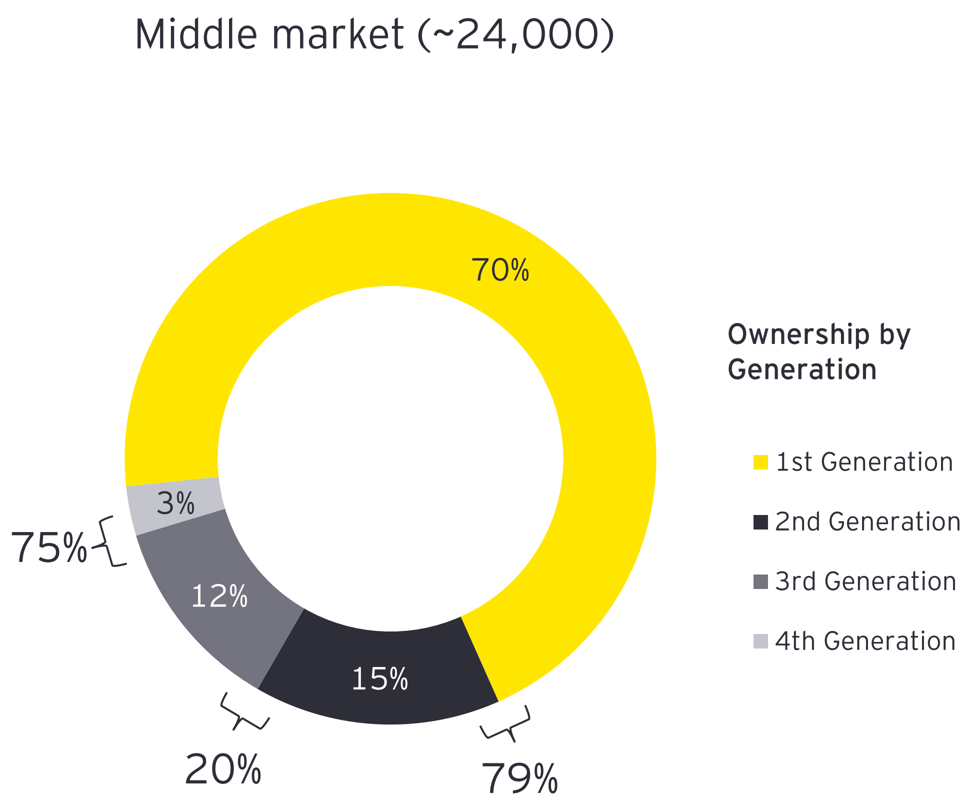
- Set up of family office and operational review
- Contingency management
- Vendor management
- Trustee succession
- Organizational design

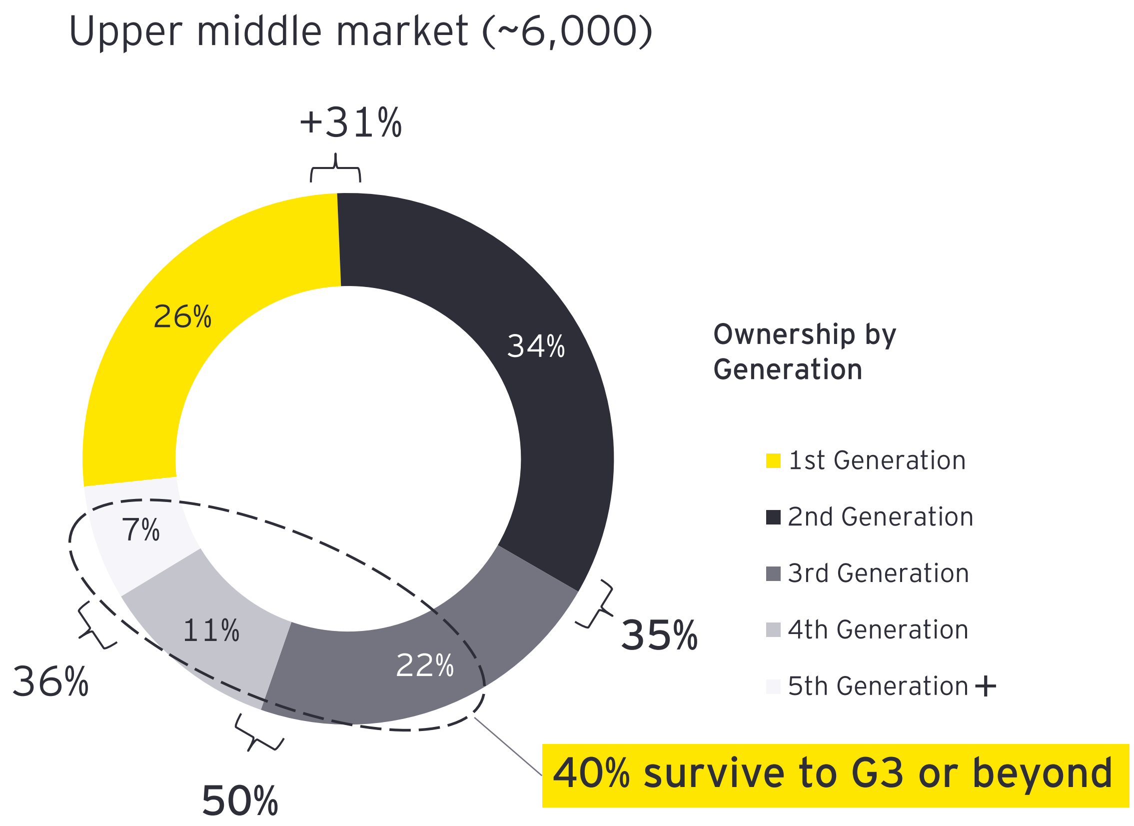
- Capital agenda/cash management
- Family bank functions
- Portfolio optimization
- Cash flow forecasting
- Acquisitions and divestitures

- Cost review and controls
- Growth to sustain family growth
- Investment vehicle design
- Review of family services and cost allocations
- Workflow, efficiencies

- HR management systems
- Recruiting non-family executives
- Principal/agent issues
- Compensation design
- Advisor transitions and management

Family business generational success – upper middle market companies





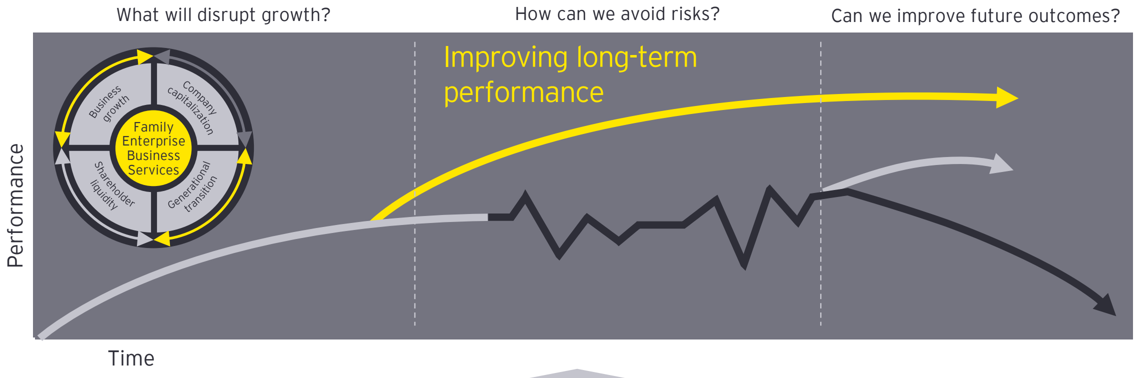
} % of businesses that do not survive past the next generation

*Source: EY Family Enterprise proprietary database.

Family enterprises require four important strategies for multigenerational success

Long-term family enterprise success requires ongoing business growth and minimized disruption

Multigenerational family enterprises are exposed to a range of possible disruptors.



Growth and competitive factors	Transition and continuity factors	Capital funding factors
‣ Changing economic environment	‣ Unclear owner strategy	‣ Fluctuating capital markets
‣ Lack of innovation	‣ Weak succession management	‣ Misaligned capital providers
‣ Industry consolidation	‣ Inadequate business governance	‣ Competing demands: capital vs. liquidity
‣ Ineffective growth strategy	‣ Conflict about risk	‣ Rapid growth lagging internal capital
‣ Aggressive competitors	‣ Unprepared heirs	‣ Burdensome cost of capital
‣ Changing customer preferences	‣ Insufficient time and effort	‣ Out-of-favor industry segment
‣ Technology and business model disruption	‣ Unexamined owner model	‣ Inadequate capital investments

Succeeding requires establishing processes to develop four core competencies

Business growth
Developing, implementing and monitoring long-term strategies and initiatives to enhance performance

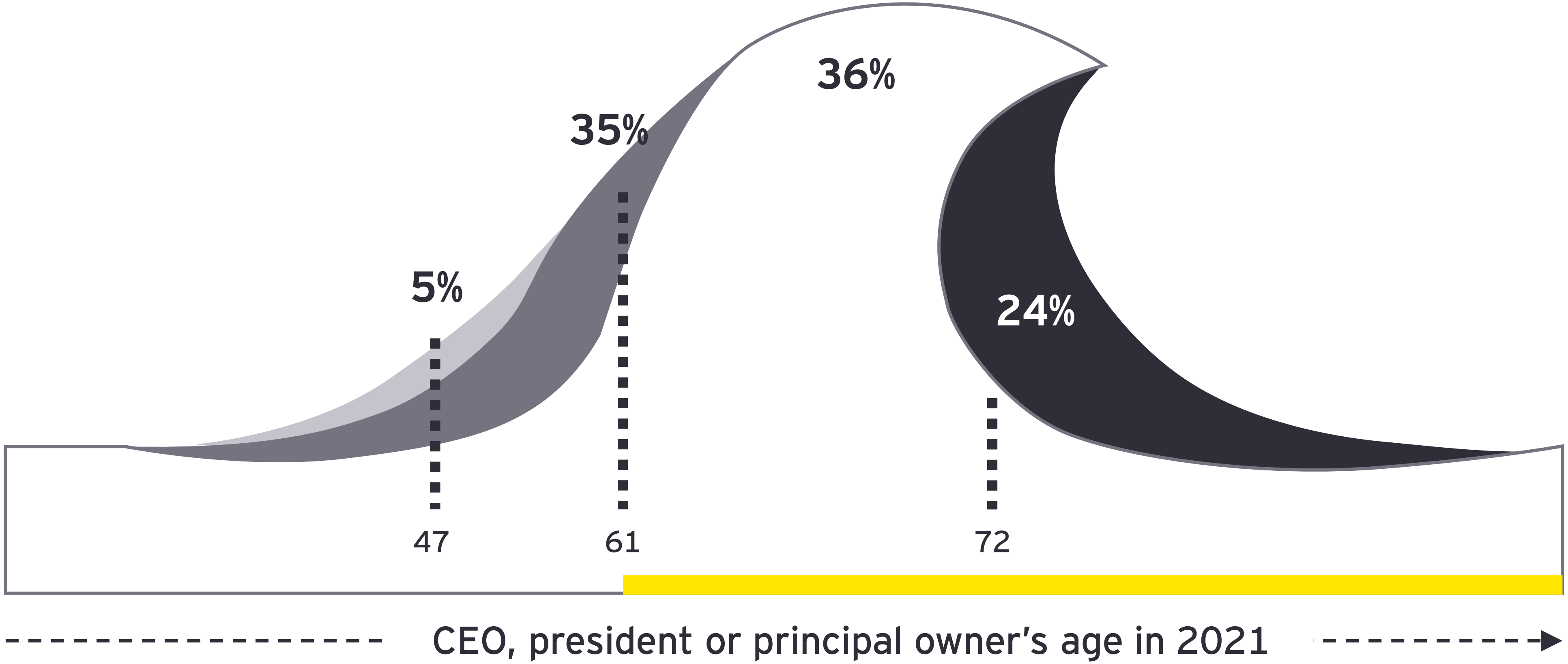
Company capitalization
Evaluating capitalization alternatives to fund business growth and shareholder liquidity needs while respecting family control

Shareholder liquidity
Assessing and designing internal and external liquidity alternatives that take into account future business plans and capital resources

Generational transition
Formulating and implementing successful generational transition processes to create long-term legacies

Risks and disruptors to effective shareholder liquidity management

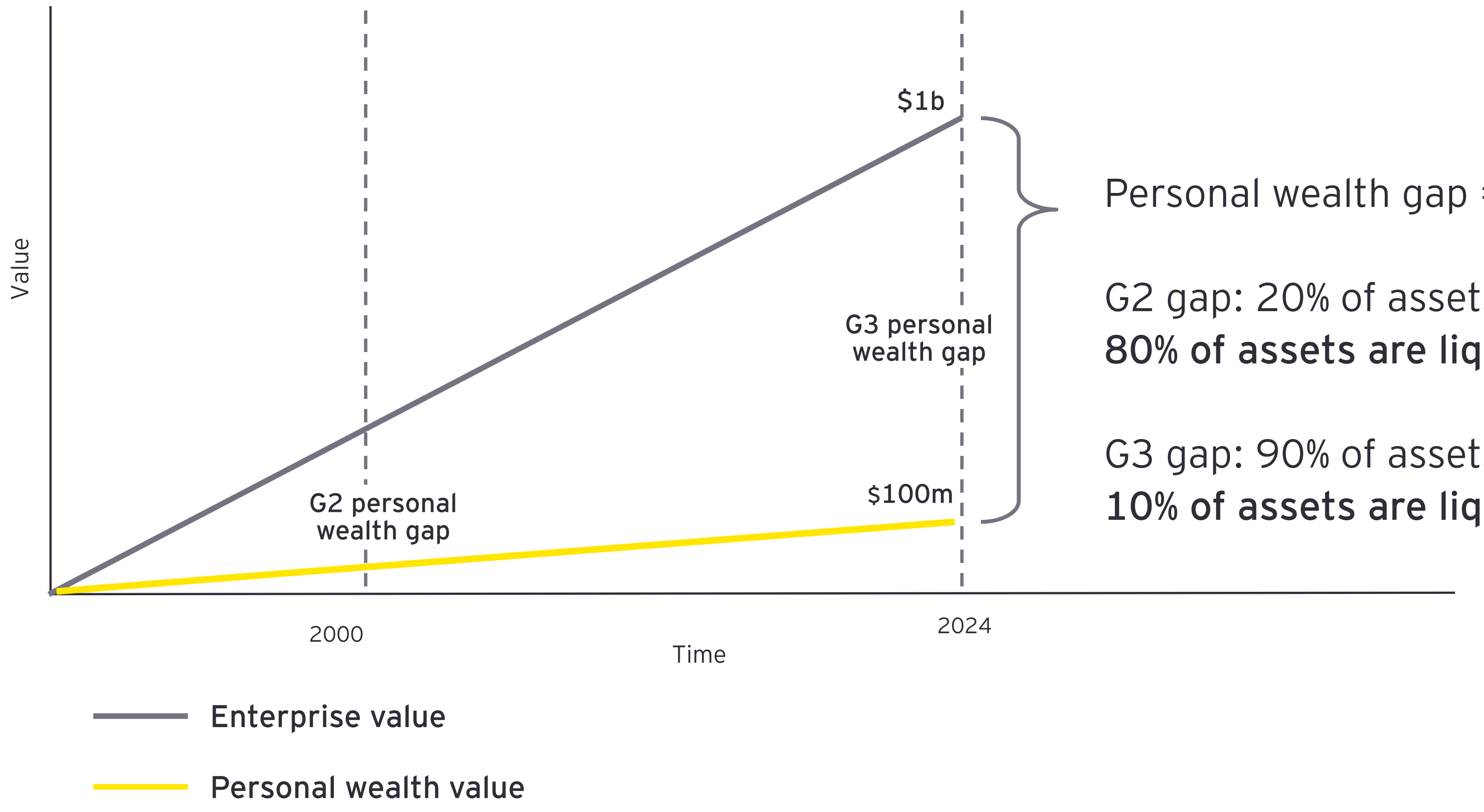
Transition wave disruption



Over 65% of family business owners express a desire to transfer their companies to the next generation, but fewer than 25% succeed in doing so.*

** EY Family Enterprise proprietary database.*

Personal wealth gap – elephant in the room issue



Personal wealth gap = **$900m**

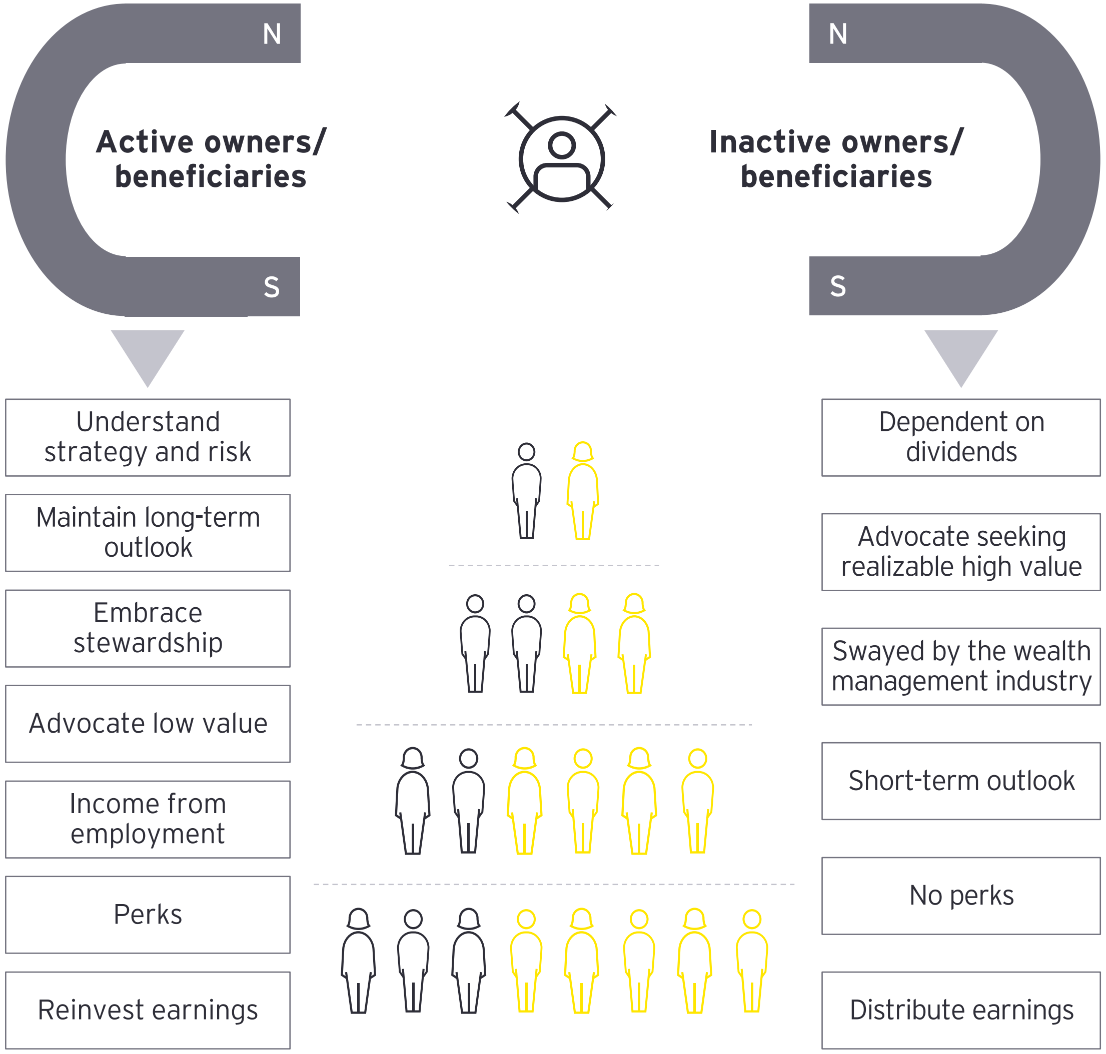
G2 gap: 20% of assets are illiquid;
80% of assets are liquid

G3 gap: 90% of assets are illiquid;
10% of assets are liquid

This slide is an illustrative example and not a cited statistic.

Increasing number of inactive owners/beneficiaries

- Over time, the percentage of active owners/beneficiaries often decreases in a family enterprise.
- Active and inactive owners/beneficiaries often have opposite needs, relative to income and realization of value.



Shareholder liquidity – key dividend/distribution considerations

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Goals and objectives for families seeking balance between family and business needs

Goals

Desired outcomes

1. Preserve family legacies and multigenerational wealth
2. Sustain private family business ownership for future generations' benefit
3. Address evolving liquidity needs of the family in harmony with business strategic objectives

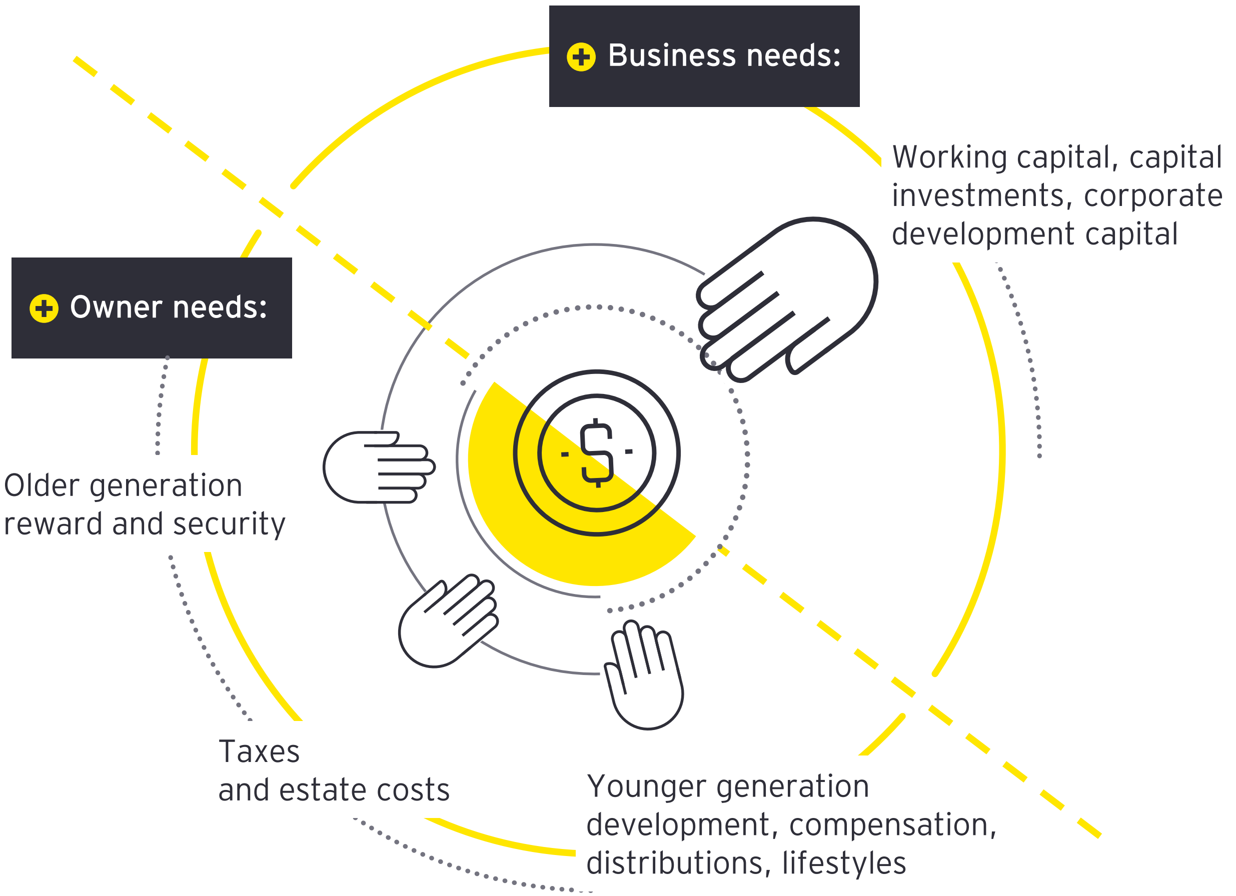
Objectives

What needs to be managed

1. Understand long-term impacts of existing liquidity policies
2. Discover requirements that need to be defined, assessed and organized to support planning for the long-term shareholder liquidity needs and generational transition processes
3. Align shareholder perspectives with wealth preservation and business growth ambitions

Shareholder liquidity

Comprehending and meeting the liquidity needs of the business and the family is a balancing act that is necessary to continue growing the enterprise.



Changes in family demographics

Family member name		Age as of the beginning																				
		2020	2021	2022	2023	2024	2025	2026	2027	2028	2029	2030	2031	2032	2033	2034	2035	2036	2037	2038	2039	2040
G2 Family member No.1	G2	70	71	72	73	74	75	76	77	78	79	80	81	82	83	84	85	86	87	88	89	90
G3 Family member No.1	G3	38	39	40	41	42	43	44	45	46	47	48	49	50	51	52	53	54	55	56	57	58
G4 Family member No.1	G4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20	21	22	23	24	25
G2 Family member No.2	G2	63	64	65	66	67	68	69	70	71	72	73	74	75	76	77	78	79	80	81	82	83
G3 Family member No.2	G3	29	30	31	32	33	34	35	36	37	38	39	40	41	42	43	44	45	46	47	48	49
G4 Family member No.2	G4				C1	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17
G4 Family member No.3	G4						C2	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15
G3 Family member No.4	G3	24	25	26	27	28	29	30	31	32	33	34	35	36	37	38	39	40	41	42	43	44
G4 Family member No.5	G4									C1	1	2	3	4	5	6	7	8	9	10	11	12
G4 Family member No.8	G4											C2	1	2	3	4	5	6	7	8	9	10
G2 Family member No.3	G2	62	63	64	65	66	67	68	69	70	71	72	73	74	75	76	77	78	79	80	81	82
G3 Family member No.3	G3	26	27	28	29	30	31	32	33	34	35	36	37	38	39	40	41	42	43	44	45	46
G4 Family member No.4	G4							C1	1	2	3	4	5	6	7	8	9	10	11	12	13	14
G4 Family member No.6	G4									C2	1	2	3	4	5	6	7	8	9	10	11	12
G3 Family member No.5	G3	22	23	24	25	26	27	28	29	30	31	32	33	34	35	36	37	38	39	40	41	42
G4 Family member No.7	G4											C1	1	2	3	4	5	6	7	8	9	10
G4 Family member No.9	G4													C2	1	2	3	4	5	6	7	8

Age summary		Number of family members in each stage																				
Senior family statesman	>70	0	1	1	1	1	1	1	1	2	3	3	3	3	3	3	3	3	3	3	3	3
Generational transition leadership	56 to 70	3	2	2	2	2	2	2	2	1	0	0	0	0	0	0	0	0	0	1	1	1
Current generation leadership	36 to 55	1	1	1	1	1	1	1	2	2	2	3	3	4	4	5	5	5	5	4	4	4
Next generation leadership	28 to 35	1	1	2	2	3	3	4	3	3	3	2	2	1	1	0	0	0	0	0	0	0
Key development years	22 to 27	3	3	3	2	2	1	1	0	0	0	0	0	0	0	0	0	0	1	1	1	1
Early adult orientation stage	16 to 21	0	0	0	0	0	0	0	0	0	0	0	1	1	1	1	1	1	0	0	1	1
Family assembly orientation stage	9 to 15	0	0	0	0	1	1	1	1	1	1	1	0	1	1	2	3	3	5	5	6	6
Infant and adolescent stage	<9	1	1	1	2	1	2	3	3	5	5	7	7	7	7	6	5	5	3	3	1	1

Liquidity policy – dependent on forecasted cash flow

Understanding the company's historical and forecasted cash flow is key to determining surplus cash available for business growth initiatives and shareholder dividends/distributions.

Examples of key metrics for analyzing future cash flow include:

Historical performance

- How has the company performed over the past five years?
- Was there significant volatility?

Capital structure

- What is the current fair market value of the company's equity?
- What type of debt obligations does the company currently have or anticipate having in the near future?
- What is the company's need for cash throughout the business cycle?

Capital expenditures

- How much capital is allocated year over year; is it typically consistent?
- Has the company planned for any significant projects in the near future?
- Are there any deferred expenses (i.e., maintenance expenditures) that will need to be addressed in the near future?

Creating one version of the truth regarding business expectations and variables to be considered supports fact-based decision-making vs. emotional or opinion-driven decision-making.

Shareholder liquidity – alternatives and solutions

- Privately owned, family-controlled businesses will often need to design and implement liquidity plans for a variety of reasons. If the businesses are growing, they also need capital to fund their development. Therefore, when shareholders need liquidity, plans need to be carefully designed to take into account the financial needs of both the business and of the shareholders.
- There is a range of both internal or external liquidity alternatives

Internal
Liquidity solutions

1. Dividends
2. Family opportunity fund
3. Redemption programs, cash, debt and insurance
4. Internal recapitalization
5. Company-sponsored loan programs
6. Employee stock ownership plan

External
Liquidity solutions

1. **Debt**
   - Bank loan
   - Private or public placement of debt
   - Leveraged recapitalization
   - Institutional mezzanine
   - Private family mezzanine
2. **Equity**
   - Private equity fund
   - Public equity
   - Management buyout
   - Private family equity
   - Private institutional equity
3. **Strategic**
   - Split-ups and spin-offs
   - Strategic partnerships
   - Sale of company

Factors to consider when performing scenario-based modeling to support future liquidity planning needs

Key drivers and inputs

Business

- Entity/ownership structures
- Working capital
- Capital investments
- Corporate development funding

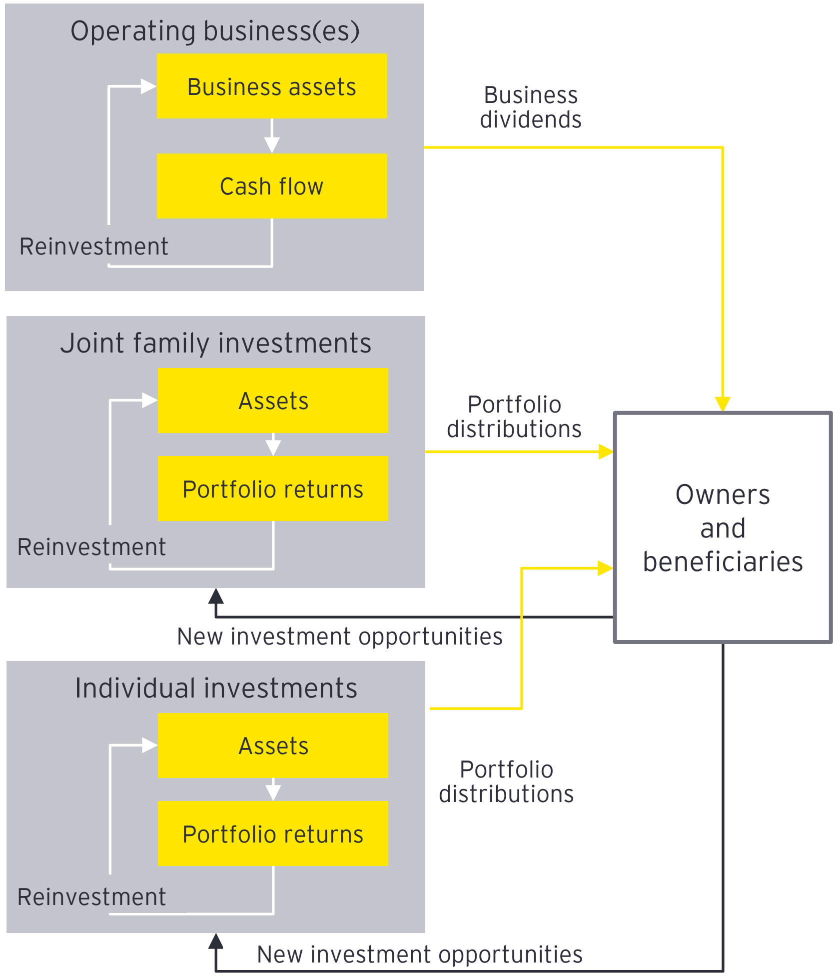
Family

- Long-term vision and goals
- Taxes and estate costs
- Risk appetite
- Return expectations
- Future generations and family demographics

External

- Macroeconomic events
- Market volatility
- Industry forces
- Competition

Scenario-based modeling



Future planning

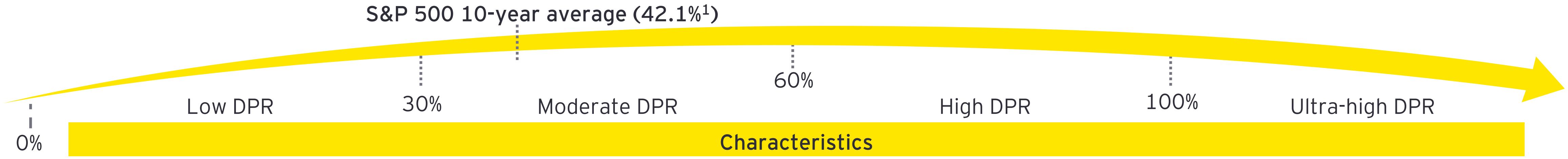
Scenario-based modeling provides a necessary roadmap to support the future planning needs of both the business and the family while enabling key stakeholders to better understand impact and effects on long-term wealth and liquidity.

Liquidity impact factors:

- Business performance
- Investment return
- Operating costs
- Investment costs
- Taxes
- Interest rates and inflation
- Consumption and personal liquidity needs
- Charitable giving

Dividends must be balanced against business needs for reinvestment

Dividend payout ratio (DPR) = dividends/net income



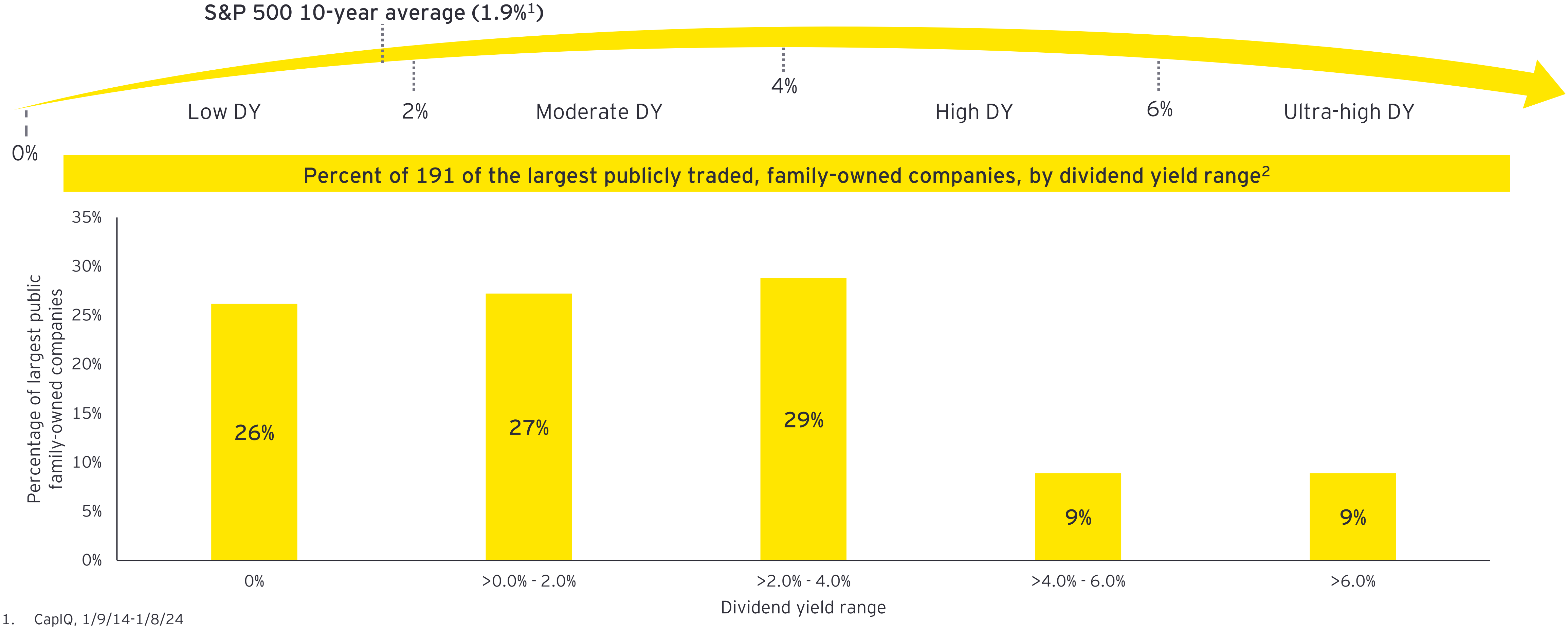
Characteristics

Low DPR	Moderate DPR	High DPR	Ultra-high DPR
‣ Companies typically in a growth phase that require extensive reinvestment ‣ Early-stage companies or high growth industries	‣ Typically, stable businesses with moderate growth rates ‣ Maturing companies or industries	‣ Organizations usually in a slow growth phase or in industries with limited reinvestment opportunities ‣ Mature companies or industries	‣ Unsustainable territory for most companies

1. Source: CapIQ, 1/1/14-12/31/23

Dividend comparison of 191 of the largest publicly traded, family-owned companies

Dividend yield (DY) = annual dividends per share/price per share



1. CapIQ, 1/9/14-1/8/24
2. 2023 EY and University of St. Gallen Global Family Business Index, CapIQ

Liquidity policy decision-making framework

Aligning asset performance and available liquidity with family vision, values and preferences

A liquidity policy should achieve the following objectives …
(family vision, values and preferences)

1. Balance liquidity needs and expectations with the commitment to the family business as a long-term family wealth creation engine
2. Take a long-term view in evaluating benchmarks and performance
3. Allow for maintenance or enhancement of lifestyle income commensurate with inflation
4. Provide for annual tax needs and insurance premiums
5. Provide cash reserve buffer for market shocks
6. Allow for performance-based upside
7. Account for increases in number of family members accessing capital in future years

… but, there are many variables that will affect asset performance and available liquidity.

1. Growth vs. preservation of wealth expectations
2. Business performance
3. Operating costs
4. Return expectations
5. Market volatility and economic shocks
6. Family lifestyle income expectations (i.e., absolute dollar)
7. Asset allocation and mix (income vs. non-income generating assets, liquid vs. illiquid, direct vs. indirect, etc.)
8. Interest rates and inflation
9. Taxes
10. Charitable giving

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Trusts – key distribution considerations

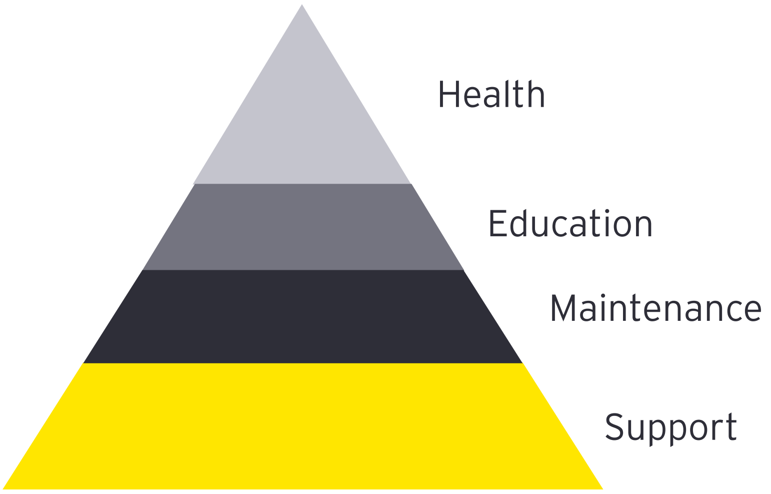
Outright transfer vs. multigenerational family preservation

Outright transfer

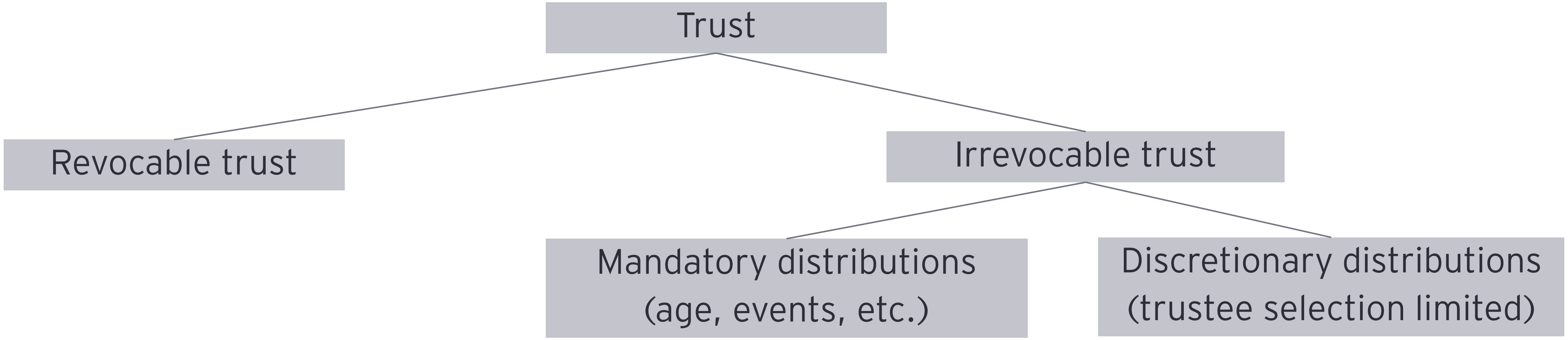
- All assets are transferred by gift or inheritance.
- Assets are not subject to investment oversight over the assets.
- Assets are subject to spending habits of recipient.
- Assets are subject to claims of creditors (including business partners, former spouses, taxing authorities, etc.).
- Assets become estate taxable.

Multigenerational preservation

- Assets trickled out are subject to the health, education, maintenance, support (HEMS) standard.
- Remaining assets continue to appreciate in value.
- Remaining assets are estate tax and creditor sheltered.



Trusts/trustee selection



Type of trustee	Revocable trust	Irrevocable trust: mandatory distributions	Irrevocable trust: discretionary distributions
Grantor	No restrictions	Prohibited	Prohibited
Independent person	No restrictions	No restrictions	No restrictions
Corporate/trust company	No restrictions	No restrictions	No restrictions
Related party	No restrictions	No restrictions	Requires ascertainable standard (“HEMS” standard)

Impact of distributions on growth of trust principal

- Beginning trust principal of $100m
- Assumed growth rate of 7%
- Annual expense ratio of 1%
- Annual tax rate of 35%
- Analysis supports an annual distribution of approximately $3.85m per year to maintain original trust principal for a period of 10 years
  - 3.71% distribution as a percentage of trust principal over 10 years

Average distribution percentage of trust principal	2%	2.5%	3%	3.71%	5%	7%	10%
Change in trust principal	19.27%	13.32%	7.64%	0.0%	-12.60%	-29.35%	-49.10%

Maintain current trust principal for a period of 10 years

Trustee responsibilities

	Trustee duties		
	Investment management	**Administration**	**Beneficiary distributions**
Duties	Trustees have a duty to invest and manage the funds of the trust as a prudent investor would and make the trust property productive while acting with reasonable care, skill, caution and undivided loyalty to the beneficiaries.	Trustees have a duty to administer the trust in good faith and in accordance with its terms and purposes and the interests of the beneficiaries.	Trustees must fully understand the terms and provisions of the trust document, including the level of discretion granted to the trustee regarding distributions.
Examples	▸ Interview and select investment managers for liquid and investable assets ▸ Help develop an investment management strategy framed by the needs of both current and future beneficiaries (an investment policy statement) ▸ Review assets regularly for quality and performance ▸ Schedule transactions to minimize taxation ▸ Provide regular portfolio summaries to beneficiaries	▸ Communicate and respond to all inquiries from beneficiaries ▸ Set up the record-keeping tools ▸ Obtain adequate insurance on insurable assets ▸ Maintain a record of taxable income and the cost basis of all assets ▸ Furnish data for the beneficiaries' tax returns annually ▸ Seek legal and professional advice as needed	▸ The HEMS standard allows a trustee to make distributions to beneficiaries for certain allowed expenses in the three categories. Key benefits of using the HEMS standard are: 1. Distribution discretion – allows for a balance between the prevention of distributions for extravagant purposes and provision for the beneficiary's needs 2. Tax safe harbor, which guards a beneficiary-trustee from estate tax inclusion 3. Creditor protection
Responsible party	Current trustees or family members acting as trustees	Current trustees	Current trustees
Delegation/ execution	Investment advisor and trustees	Family office	Family office and trustees

HEMS standard guidance[1]
Health, education

The ascertainable standard: the HEMS standard. The following are examples of distributions that would be permissible under a HEMS standard:

Health	Education
1. Emergency medical treatment	1. Grammar, secondary and high school tuition
2. Psychiatric treatment	2. Graduate school
3. Psychological treatment	3. Postgraduate school
4. Routine health care examinations	4. Medical school, law school or other professional school
5. Dental care	5. Support of the beneficiary while in school
6. Eye care	6. Support of beneficiary while not in school (between semesters)
7. Cosmetic surgery	7. Studies for the student that make a career out of learning
8. Lasik surgery	8. Technical school training
9. Health, dental or vision insurance	9. Career training
10. Unconventional medical treatment	10. College in Europe as part of a study abroad program
11. Home health care	11. Related expenses, such as supporting the beneficiary not only during the semester but also between semesters
12. Gym memberships	
13. Spa memberships	
14. Golf club memberships	
15. Extended vacations to relieve tension and stress	

[1] Brown, C. D., JD, TEP. (2013), *Discretionary Distributions: A Trustee's Guideline* (pp. 1-16, Tech.), Wilmington, DE, Commonwealth Trust Company. Note: When applying an ascertainable standard, it is important to note that the specific definition of each term within the HEMS standard will vary from state to state as the definition is dependent upon how the specific terms have been construed under the jurisdiction's statutory provisions and case law.

HEMS standard guidance[1]
Maintenance and support

The ascertainable standard: the HEMS standard. The following are examples of distributions that would be permissible under a HEMS standard:

Maintenance and support		
Generally included 1. Regular mortgage payments 2. Property taxes 3. Suitable health insurance or care 4. Existing programs of life and property insurance 5. Continuation of accustomed patterns of vacation 6. Continuation of family gifting 7. Continuation of charitable gifting	**Might be included** 1. Reasonable additional comforts or luxuries 2. Special vacations of a type the beneficiary had never taken before	**Not included** 1. Payments unrelated to support that merely contribute to the beneficiary's contentment or happiness 2. Distributions to enlarge the beneficiary's personal estate 3. Distributions to enable the beneficiary to make extraordinary gifts

[1] Brown, C. D., JD, TEP. (2013), *Discretionary Distributions: A Trustee's Guideline* (pp. 1-16, Tech.), Wilmington, DE, Commonwealth Trust Company. Note: When applying an ascertainable standard, it is important to note that the specific definition of each term within the HEMS standard will vary from state to state as the definition is dependent upon how the specific terms have been construed under the jurisdiction's statutory provisions and case law.

Conclusion and key takeaways

Conclusion and key takeaways

1. Understanding the stakeholders' needs and the company's historical and forecasted cash flow is key to determining surplus cash available for business growth initiatives and shareholder dividends/distributions.
2. There is no one-size-fits-all liquidity policy for family businesses and trusts.
3. Given the long-term view of multigenerational families, we have observed that most families align more closely with allocating capital to growing the operating business and preserving trust assets for the long term.
4. Several variables must be considered when developing a liquidity policy — some of which will impact performance and available liquidity while others simply represent a family's unique values, vision and preferences.
5. A leading practice is to establish a framework for decision-making on liquidity policies and evaluate potential decisions and outcomes through scenario-based modeling.

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