How your shareholder liquidity strategy can be made future-proof

Meeting the liquidity needs of the family and the business is a balancing act that can help continue growing the enterprise

EY
Building a better working world

At a glance

- Shareholder liquidity planning is key as family businesses face disruption from the ongoing transition wave, the growing gap between the perceived value of an owner's interest in the business and their personal wealth, and an increasing number of inactive owners.
- Companies should adjust shareholder liquidity options to their needs, weighing the usefulness of dividends, redemptions, recapitalizations and personal loans.
- The design of a shareholder liquidity plan should reflect the family's needs and values, while accounting for any effects on business growth and performance.

One of the biggest disruptions to the continued growth of family-owned companies can be disagreement over how to satisfy shareholder liquidity needs. The liquidity requirements of family members can be different for each generation participating in ownership, and a shareholder liquidity strategy can help manage the short- and long-term capital needs of both the owners and the business as it continues to grow.

Shareholder liquidity planning is likely to take on increased importance in the near future because of three interrelated factors that can easily disrupt a multigenerational business:

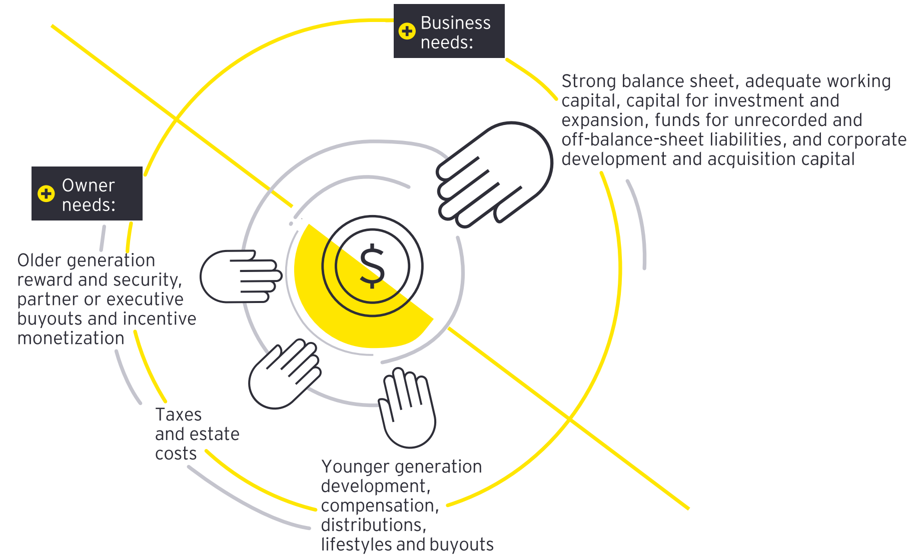
1. **Transition wave disruption.** Three-quarters of multigenerational businesses are owned and led by people who are poised to transfer ownership and control to the next generation, both through planned and unplanned exits.
2. **Personal wealth gap.** Family members who are not direct owners of the business, but rather beneficiaries of the business through trusts or other indirect interests, are experiencing a gap between what they perceive their interest in the business to be worth vs. their available cash or personal net worth.
3. **Increasing number of inactive owners/beneficiaries.** There are a growing number of people who rely on the business for income but are not employed by the business. As a result, they are less likely to understand corporate growth strategy or take a long-term outlook on their investment in the business. They tend to want earnings distributed rather than reinvested in the business.

> Multigenerational families are known for their long-term view. Over the years, we have seen that most families align more closely with allocating capital to growing the operating business and preserving assets.

Bobby Stover, Jr.
EY Americas Family Enterprise and Family Office Leader

Navigating these factors requires balancing the capital needs of a business, such as working capital, major expenses or acquisitions, with the family's financial needs, including lifestyle expenses, retirement expenses and tax liabilities. The challenge is creating a mechanism that does not drain too much money from the business, potentially stunting growth and reducing funds for current and future owners/beneficiaries. This balance requires a well-defined business growth strategy, based on the company's free cash flow and projected capital needs, that supports why money is being kept in the business rather than distributed to the owners.

Financial demands on enterprise profits



Shareholder liquidity options

There is no one-size-fits-all shareholder liquidity plan. Early-stage companies and businesses in high-growth industries or those that require heavy R&D spending will need to reinvest in the business, while market leaders and mature companies should be able to better reward shareholders. Shareholder liquidity options include the following:

- **Dividends** are the most common method of providing liquidity to shareholders. They also can be the easiest to understand for inactive owners and beneficiaries because of their use in the public markets. Dividends, however, may not be tax efficient and may not achieve the goals of those owners/beneficiaries who would prefer to reinvest the money in growing the business rather than receive a distribution.
- **Redemptions** allow shareholders to sell shares back to the business in exchange for cash, putting the decision to access liquidity in their hands. This approach is based on fair market value, often on a discounted basis, and may not appeal to all shareholders.
- **Recapitalizations** are a mechanism where the business can restructure its shares between common and preferred, offering beneficiaries the opportunity to swap their existing common shares for preferred shares. The preferred shares offer a dividend with less opportunity for growth, whereas the common shares offer the potential for greater growth but have little or no dividend. This allows owners to decide on their desired allocation between annual distributions and future growth.
- **Loans** from the business can offer immediate liquidity with the obligation to repay (often at a favorable interest rate when compared with market rates). Repayments can be offset against future dividends.

In brief

Managing shareholder liquidity needs is essential for the growth of family-owned firms and is set to become more important because of ownership transitions, growing personal wealth gaps and a rise in inactive beneficiaries. A well-designed shareholder liquidity plan will strategically balance the capital needs of the business with the financial needs of the family. No plan is one size fits all and may include liquidity options, such as dividends, redemptions, recapitalizations and loans from the business. The plan should be transparent, understandable and justifiable, and reviewed regularly.

Variables to consider

- Establishing a framework for designing a shareholder liquidity plan requires weighing several variables. Some of these will impact business performance and available liquidity, while others reflect the family's needs, values and vision.
- Considerations that can affect business performance and cash available for distribution include the capital needs of the operating business, organic and external growth and return expectations, cost and expense projections, and planning for market downturns. The plan should also account for the largest undisclosed liability on a family enterprise's balance sheet: the future buyout or redemption of shares of a deceased shareholder.
- For the family, variables include preserving wealth, providing a predictable income stream to maintain family members' lifestyles, diversifying their investments (as their interest in the family business is often their largest asset), and growing cash reserves to weather financial market shocks. As the family projects what its financial needs might be over the next 10 years, the family should consider retirement expenses, health care costs, education expenses for younger generations and potential estate taxes.
- Additional considerations to support the design of a shareholder liquidity plan include developing a financial model for the business, developing models for shareholder liquidity needs and, finally, integrating the shareholder liquidity strategy with the business growth strategy and capitalization strategy.
- Once a shareholder liquidity plan is developed, the plan should be communicated to stakeholders. The communication should include a transparent explanation to the family members as to the factors considered in designing the plan and how the plan is reasonable based on the company's projected free cash flow and capital needs. Finally, the plan should be reviewed regularly to consider changes in the circumstances of both the business and the family.

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. 24409-241US

2408-4593675
ED None

ey.com

Authors

Robert (Bobby) Stover, Jr.
EY Americas Family Enterprise and Family Office Leader
bobby.stover@ey.com

James Bly
Managing Director
Ernst & Young LLP
james.bly@ey.com

Sean M. Aylward
US EY Private National Tax Managing Director
Ernst & Young LLP
sean.aylward@ey.com

Gene Peck
Managing Director
Ernst & Young LLP
gene.peck@ey.com

How EY can help

EY Family Enterprise Business Services support enterprising families in their quest to grow larger, more valuable businesses that will last. Leveraging our proprietary methodologies and using our holistic approach to protect, grow and improve your family enterprise, we can work with you to develop and implement a plan for growth, capital strategy, generational transition and shareholder liquidity.

ey.com/us/familyenterprise