

Financial Policy from the Shareholder Perspective

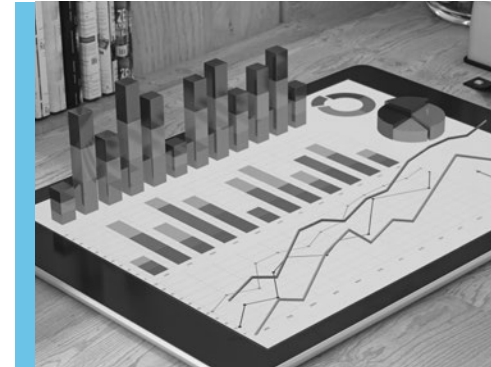
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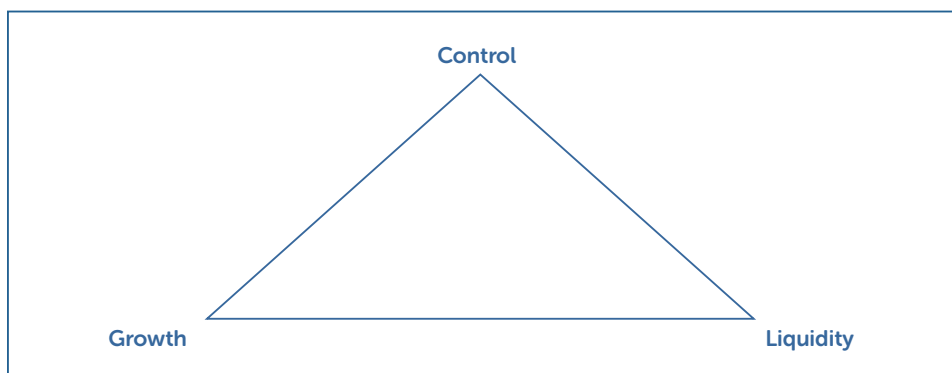
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In a family business system, family members can have very diverse views and level of understanding about the financial strategy of the business. This paper provides a framework to help family shareholders understand the key components of financial policy from the owners or shareholders' perspective. The main goal of most shareholders is to increase the value of their shares over time. In pursuing this goal, shareholders are faced with trade-offs between the following three factors.

The control position carries with it a premium above the position's pro rata share in the business. A controlling stake in a company (one which has strong decision making power) will command a relatively higher value than a non-controlling participation. This is because control of the decisions and cash flow of the company can have direct influence on the future direction, strategy, and value of the company.



At the same time, a higher rate of growth, which generally requires capital for investment, will also contribute to a relatively higher valuation for the company overall. Finally, access to liquidity generally increases value of the shares in the company because shareholders can more easily realize value or sell their position more opportunistically. However, if that liquidity is created by internally generated funds from the company, which would otherwise be used for investment, the impact may be negative.

Hence, there is a necessary tension and trade-off between the three factors. Maintaining a strong control position implies some constraints on growth and liquidity over time. The challenge for controlling shareholders is to balance these factors in order to meet their objectives. The purpose of financial policy is precisely to achieve this balance through integrated decision-making on the key components of financial policy.

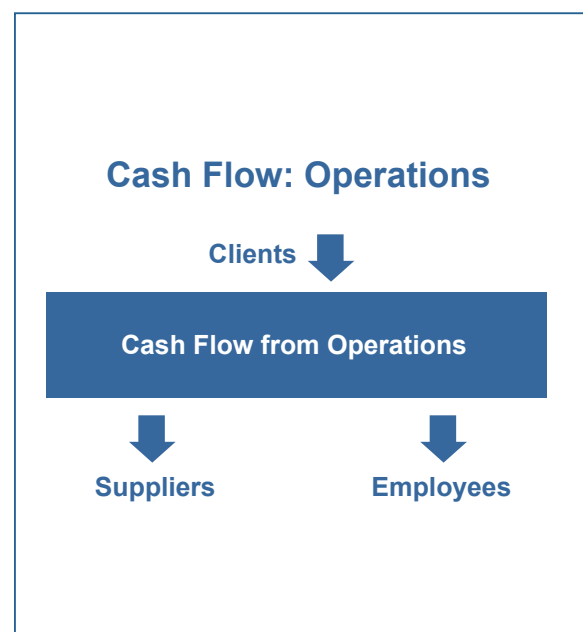
1. Key Components of Financial Policy
2. Cash Reserve
3. Investment Policy
4. Distribution to Shareholders
5. Capital Structure
6. Management Compensation

Shareholders must define what level of cash reserves they want to retain in the business for opportunities that may arise (such as acquisitions, or larger investments). Shareholders must also decide how much

cash to reinvest in the business, versus pay out to shareholders, and how the cash should be reinvested. On a broader perspective, shareholders have to define how quickly they want to grow the business, with what level of risk, and with what source(s) of capital. Finally, shareholders—or their representatives on the board of directors—must decide how much and in what way to compensate business managers in order to align objectives between shareholders and management, and attract and retain talent.

Basic Financial Flow

The very basic financial flow of a business is depicted below: The business receives payment from its clients or customers, and makes payments to suppliers, employees, and service providers.

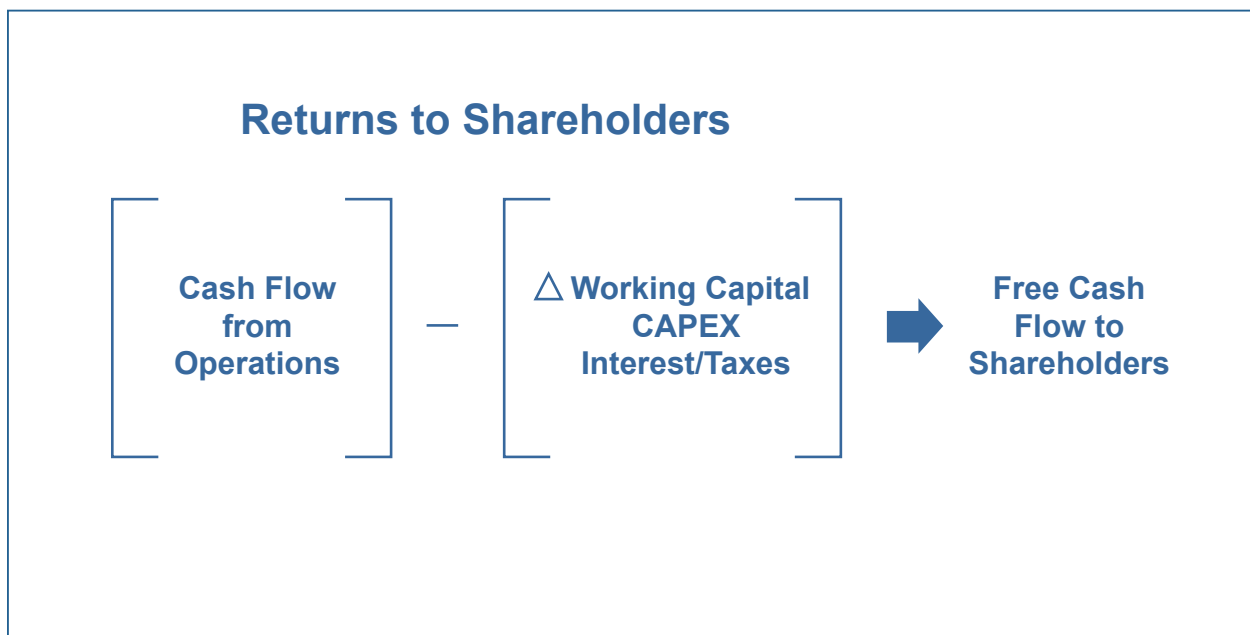


The financial result of this operating cycle is generally referred to as “cash flow from operations.” (In accounting terms, this is equal to the EBITDA plus change in Working Capital). In the beginning of any new business, the outflows generally occur before the inflows, thereby generating a financing need. This initial capital is typically provided by the founders of the business. After a number of years, the cash flow from operations becomes positive and can either be reinvested in the company, or distributed to the providers of capital (both debt and equity).

It is important to understand the difference between accounting earnings and cash flow. Accounting statements show the performance of the business on an ongoing

basis, and use the concept of accrual to match revenues and expenses. Cash flow is the underlying cash movement at the company, based on specific receipts or outlays of cash. Valuation of a business is more closely tied to the cash flows of the business and financial analysts focus more on the cash flow numbers.

The continuity of the business requires a certain level of investment in the business, referred to as Capital Expenditures or CAPEX. The business must also pay taxes and interest. The amount of cash that remains in the business after payment of CAPEX, changes in Working Capital, Interest and Taxes is called the Free Cash Flow to Shareholders.



Valuation of the equity of a business (shares) can be determined by discounting the free cash flows to shareholders (at the equity discount rate) or by discounting the free cash flows of the firm (at the weighted average cost of debt) and then subtracting net debt. The latter technique is more frequently used because it is easier to model and to apply.

In order to be able to focus on the key components of financial policy, shareholders should have a basic grasp of the financial performance of the business (or group of businesses). We have included a brief explanation of the most relevant financial ratios and how they are used to describe financial performance of the company (see Appendix A). These key ratios allow an outsider to obtain a view of the growth, profitability, leverage, and returns being generated by the company, and to compare or benchmark their company against others in the same business.

A. Cash Reserves

The first component of financial policy is how much cash a company should hold on its balance sheet. There is a minimum amount of cash that a company must hold in order to finance its working capital needs—its operating cash. This amount can be estimated by looking at the working capital accounts: Inventory plus Receivables (what your customers owe you) minus Payables (what you owe your suppliers). This can

range from 1% of sales to well over 10% of sales. Another approach is to look at the cost of running the business on a monthly basis (fixed and variable) and decide how many months of expenses should be covered by the cash balance (usually a minimum of 3 months).

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There are at least two reasonable uses of that cash. First, shareholders may want the company to be protected in periods of downturn: companies that have a higher cash reserve will tend to weather a storm or downturn more easily. Another factor to be considered in determining the appropriate cash level for a company is the degree of “preparedness” that shareholders want to have in order to take advantage of opportunities which may arise. Opportunities can arise unexpectedly in the form of discounted prices for capital goods (cranes, machines, equipment, for example) or purchase of new companies or activities.

On the flip side of the coin, having too much cash on the balance sheet can be inefficient and will reduce the overall returns to shareholders (since the returns on investing in short-term instruments are normally much lower than returns obtained in employing the cash in the business itself).

B. Investment Policy

As companies evolve they face more diverse investment opportunities and choices, while at the same time being constrained by capital and other resources. A successful company is one that is able to consistently identify and implement investments with a higher return than the cost of the capital required to implement them.

Shareholders can guide management in navigating the investment choices by establishing clear guidelines for investments. There is a certain amount of investment required in the business to assure that the business continues to grow. This is investment for organic growth. There are other types of investment, involving new product lines or acquisitions for example, which expand the scope of the existing business.

The first guideline is how much capital to allocate for investment in organic growth over a period of time. In normal circumstances, a company will invest at least the amount of depreciation of its fixed assets, or at least half of its Operating

Cash Flow, in order to continue to grow and improve productivity. A second guideline is how much the company wants to invest in expanding or changing its business mix for the future. These are investments in new product lines, vertical integration, or new distribution channels for example. The amount of investment in these types of projects are also “defined” or “constrained” by the other financial policy decisions made by the shareholders.

The third guideline relates to selecting specific projects or investments. In both types of investments described above, the standard approach wherever possible is to apply one or more of the following financial techniques:

(i) Net Present Value of Cash Flows

(NPV) – projects the future cash flows of the project for a reasonable period of time, and then discounts these cash flows back to their present value at the appropriate discount rate (the project’s cost of capital, which is typically the WACC rate for the company).

(ii) Internal rate of return (IRR) – uses the same cash flow projections as above and determines the interest rate or discount rate at which the cash flows equal zero.

(iii) Payback period – measures how long it takes for the cash returns to pay back the initial investment

These measures are one of the main inputs into the prioritization and selection of projects or investments. Most companies

use a combination of NPV and IRR above to rank their projects.

As long as the returns on investment are higher than the cost of capital of the investment (usually equal to the WACC of the company itself), and fit into the strategy of the company, the investments add value to the business and can be undertaken.

There are numerous challenges in applying this approach. The main ones are:

- Measuring the correct investment amount
- Projecting the cash flows accurately – this becomes more complicated when the project cash flows or returns are not easily isolated from the rest of the business.
- Assessing the risk of the investment itself (is it in line with the overall risk of the business?).

C. Distribution to Shareholders

The third component of financial policy is the distribution of cash to shareholders. Shareholders must decide how much cash they want to retain and reinvest in the business versus how much they want to distribute to the owners.

Distribution to shareholders can be accomplished by paying dividends and/or by repurchasing shares. Companies generally have a fairly consistent dividend policy (such as 30% of net earnings, for example), and use share repurchase

programs more sporadically. The use of share repurchase vs dividends as mechanisms for distributing cash to shareholders is determined by such factors as tax efficiency, amounts involved, need to maintain a fairly constant dividend stream, the signaling effect of repurchasing shares.

From a shareholder perspective, the decision on dividend distribution requires balancing the needs of the company, its growth plans, investment needs, with the needs of the family for ongoing expenses, lifestyle, and education. If too much cash is taken out of the business, the business will tend not to thrive: growth prospects will be lower, and management may become discouraged or unmotivated.

In the early stage of a business, earnings tend to be reinvested in order to consolidate the business. The family is smaller and the need for dividends is relatively low. In a more mature stage, there is more room for distribution to shareholders (as the company generates a higher level of cash from operations), but the family has also increased in size and its demands are typically greater—not just because there are more family members but also because other possible uses of that liquidity beyond living expenses start taking a more prominent role. For instance, the family may wish to diversify its own risk by putting some of the money into other investments (stock market, real estate, etc.), or engage in philanthropic activities in a more significant way.

D. Capital Structure

For many businesses, capital can be a significant constraint. The business managers typically find more opportunities to invest and grow profitably than they can fund with internally generated cash flow from operations. Shareholders must first decide whether they want to pursue a higher growth strategy (one that requires more capital) or not. Secondly they must decide whether to fund this growth with debt (bank loans and/or bonds) or with equity (retained earnings and/or outside equity raised in public stock markets or from private partners such as private equity firms or joint venture partners).

This is referred to as the Capital Structure policy or decision. This policy deals with the most fundamental concepts in finance: return and risk.

- **Return** is defined as the earnings received by the capital invested in the company over a period of time (typically one year). The total returns to a shareholder over a given period are the dividends received plus the capital gains accumulated during that period (the price of the shares at the end of the period minus the price at the beginning of the period).
- **Risk** is the variability or volatility of expected results or returns (in this case to shareholders). Since returns are uncertain, risk tries to measure the degree of uncertainty. Volatility can be

captured by analyzing historical results (of earnings) to shareholders and measuring the deviation(s) from the average or mean performance. A high risk business will have greater deviations from the mean; a lower risk business will demonstrate lower deviations from the average or mean performance. The use of variance as a measure of risk was introduced by Markowitz in the 1950s. Variance is the statistical measurement of how widely the returns swing on a financial security. The concept is linked to the mathematical calculation of the mean and the standard deviation around the mean. (Standard deviation is the square root of the variance).

In most situations, the value of a share can be defined in terms of returns and risk. Returns are the estimated free cash flows to the shareholder, and risk is the measure of volatility which defines the risk premium on the discount rate to be applied to these cash flows.

As a business gains critical mass and a historical track record, its access to capital is greatly enhanced. In the early phase of a company, the sources are venture capital or bank debt. As the company enters a middle phase it begins to have access to the basic credit markets (bonds) as well as private equity funds. In the more developed stage, companies have broader access to the full equity and debt capital markets (IPOs, bonds, and hybrid instruments).

As a company begins to have access to debt (especially longer term debt), shareholders must decide whether the business should take on some debt to provide more capital to grow the business, and also to enhance returns to shareholders.

The degree of risk to shareholders increases with the total amount of debt in the business. As a company takes on more debt, it has to allocate a greater amount of the cash flow from operations to cover interest payments and principal repayments on the debt. If the cash from operations suffers a severe downturn, the company may not be able to service its debt obligations.

This is the basic decision on Capital Structure: how much debt vs. equity should a company carry? The framework for tackling this decision is described in the paragraphs that follow.

The equity capital of a company, provided by shareholders, is at the bottom of the “pyramid” in terms of priority of payment. The company must first meet all of its obligations to suppliers, management, employees, taxes, creditors, before it can pay dividends to shareholders. In this sense equity is like an option on the profits of a company above a certain level. The option has value to the extent that the company generates profits. (In a family-owned company, if family managers receive compensation above what would be “market-based compensation” this can be

considered part of the return on their equity in the company).

The essence of equity capital is that it receives variable returns. Unlike debt, in which the returns are predetermined in a contract, the returns on equity depend on the performance of the business. If the business has high growth potential and reasonable risk, the equity value will be higher (as measured by Price/Earnings, for example). If the business is mature, has little growth potential, and average risk, the equity value will be lower. (As we stated above, growth and risk of the future cash flows are the key determinants of value).

Since equity holders are exposed to greater variability in returns (risk) than debt holders, they require (or expect) higher returns. This is borne out by the historical returns to equity holders vs. debt holders. The chart below is a compilation of data from

Ibbotson and provides average annual returns on different classes of securities over a very long period of time: small stock, large stocks, long bonds, intermediate term bonds, Treasury bills and inflation. The chart also provides the degree of risk or volatility of returns, which is expressed by the standard deviation. For example, the average return on small stocks during this period was 16.4% per annum, but the returns could have varied by 33% in any given year, i.e. they could have been 33% higher or lower than the arithmetic mean of 16.4%.

The difference in returns is called the risk premium required on equity returns. As can be seen by the numbers above, the risk premium for equity returns (small company stocks and large company stocks) over fixed income returns ranges from 3% to

6%, depending on the time period and whether the fixed rate is a short term rate (T-bills) or longer term corporate bond rate.

In fact, the cost of debt to a company is even lower than what is suggested above, since interest payments are deductible for tax purposes. The actual cost of debt to a company is therefore the nominal cost minus the tax rate. While interest is deductible for tax purposes, dividends are not deductible and are paid on an after tax basis. (Of course if one looks ultimately at the returns to the individual shareholder or bondholder, this tax advantage is minimized).

Given the lower effective cost of debt, companies seek to take on debt in order to leverage or increase the returns to equity holders or shareholders. Taking on a certain amount of debt helps the company reduce its overall cost of capital, also referred to as the Weighted Average Cost of Capital.

Beyond this level, the increased risk of default or bankruptcy greatly increases the cost of debt, and the overall cost of capital, thereby reducing the present value of future earnings. Hence the value of the equity will drop, as shown in the chart below.

Beyond these risk and return tradeoffs, debt brings about other benefits and costs that also impact equity value. For instance, having some amount of debt can be useful because it introduces a certain degree of discipline in the financial management of the company. The flip side of this is that the controlling shareholders have to comply with certain covenants or veto rights imposed by the banks or debt holders.

The ideal or optimal capital structure from a shareholder's perspective is one that maximizes the value of the equity of a company, as suggested by the figure above. The amount of debt that a company can support before reaching the tipping point depends on its growth stage, the nature of the industry, the point in the business cycle, as well as the appetite for risk determined by shareholders.

One of the well-known characteristics of family businesses across the globe is their propensity to finance their businesses primarily with their own internally generated funds, ie with relatively little debt. Use of outside capital brings some constraints on control, which may be perceived as uncomfortable by family owners. But most importantly, family business owners perceive that debt brings additional risk and tend to want to minimize this risk.

Another source of capital for companies, especially in the mid stage of their development is private equity capital. Unlike debt, this type of equity capital shares in the risk of the performance of the company and

the returns to shareholders. Private equity has come to represent an important source of capital for many companies that have high growth or consolidation plans.

Private equity providers have relatively high target returns, generally in the 20% p.a. plus range, to be achieved over a five to seven year period. They typically look at significant minority stakes, around 15% – 30% of the equity capital of the company.

Finally, they require and exert significant influence on the governance of the company through a shareholders agreement, which normally gives them representation on the board. In addition, the agreement typically gives them voice on a few key issues such as compensation policy, reporting standards, and veto rights on leverage above a certain limit, and very large investments. For many family companies, this influence or participation by private equity firms in the “control” or governance of their business is the biggest challenge.

E. Management Compensation

Over the past decade, boards and managements of companies have increasingly adopted the use of granting shares to senior executives as part of their overall compensation package. This is a key component of the financial policy of a company for several reasons. First, depending on the amount of the grant, and how it is funded (new shares versus

existing shares or treasury stock) there can be a dilution effect on other shareholders. Second, to the extent that senior executives get compensated with shares (or equity performance) their goals will be more closely aligned with the goals of other shareholders. This reduces the “agency cost” of separating the ownership and management roles of a company.

The concept of “agency cost” refers to the potential misalignment between management goals and shareholder goals. Whereas shareholders will generally want to maximize value of their shares, management will typically want to grow the business, expand into new markets, or generally expand the size and scope of their activities without focusing as much on the returns to shareholders.

In order to minimize this agency cost, shareholders and their boards have moved in the direction of compensating executive management with long term incentive programs based on granting of shares or options (for purchase of shares) of the company. The critical element of these programs is that some form of equity is granted to managers, either in the form of actual shares in the company or share equivalents. For companies that do not have publicly traded securities, owners have introduced the concept of “phantom shares” which basically replicate the effect of holding tradeable securities, although the payment to executives is made in cash by the company.

In many family owned companies, it is more feasible to envision programs based on phantom shares, since these do not interfere with family shareholding issues.

These programs have become more widespread and in many companies, senior executives now receive more than 50 percent of their total compensation in equity related instruments which vest over a period of time. These programs typically have a vesting period of three or four years, and the options or shares can be held for another five years after they are exercised or granted.

Depending on the approach of shareholders, nature of the business, and the importance of top management to the success of the business, share based compensation programs can represent up to 10% of the equity of the company.

Appendix: Financial Performance Indicators

This appendix provides a brief overview of the most relevant financial indicators of the operating performance of the business. Financial analysts look at a wide range of ratios in analyzing a company. But from a shareholder perspective the most fundamental ratios are growth, profitability, returns, and leverage.

Growth

Sales Growth – The percent sales growth year to year and the expected growth in the future, two to five years gives a sense of how rapid the business is growing (relative to overall economy, for example), and also whether the business will require more cash.

EBITDA Growth – In addition to sales growth (which relates more to overall growth of the company) it is important to follow the growth of the EBITDA of the business. EBITDA is the accounting measure which most closely captures the operating cash profit of the business. In particular it is useful to know whether the Sales Growth over a number of years is greater than the EBITDA Growth over the same period.

Profitability

EBITDA/Sales – Measures how profitable the business is from a revenue perspective; this is the “operating margin” or the percent of sales that results in operating cash flow to the business.

Sales/Total Assets – Measures how quickly assets are “turned over” or “sold” over the period of one year. Companies with more rapid turnover are using their assets more intensively and more profitably.

Leverage

Banks and debt investors want to make sure that companies have a reasonable amount of “coverage” to make the required debt payments even in times of stress for the business. This is generally measured by

3 or 4 ratios: Net Debt/EBITDA, Gross Debt/EBITDA, EBIT/Interest, Debt/Total Capital. Banks and rating agencies use a scale of these ratios, in addition to other criteria, to establish credit ratings and spreads or pricing. Below is an illustrative chart which is typical of how banks or rating agencies will price loans or bonds.

Returns

EBITDA/Net Operating Assets – Measures the cash return from operations on the net operating assets, i.e. excludes excess cash. This is the main measure of operating performance of the business (independent of decisions by shareholders on how the business is financed), and is the ratio most widely used to determine compensation of executive managers.

Total Invested Capital/Equity – Measures how much total capital exceeds equity, i.e. how much debt is in the total capital structure.

Net Earnings/Equity – Measures the return to equity holders (Return on Equity or ROE). Net Earnings is equal to EBITDA minus depreciation, interest and taxes.

From these ratios (plus information on depreciation & investments) the shareholder can understand how the overall cash profits flow to providers of capital (debt holders and equity holders).

The higher the margin on sales, and the higher the turnover of assets, the higher the returns on net operating assets,

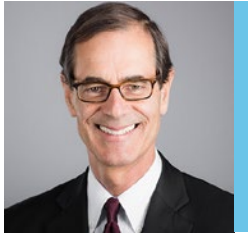
which can also be seen as the return on net invested capital in the business.

Assuming Net Operating Assets equals Total Invested Capital (excluding excess cash) in the business.

(The higher the returns on net operating assets, and the higher the amount of debt or leverage, the higher the returns to equity – see below as well).

Finally, the Net Earnings divided by Shareholder Equity is the Return on Equity of the company.

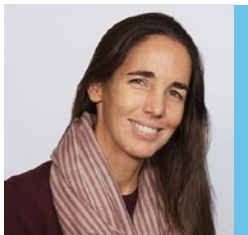
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Eduardo Gentil is an advisor to multigenerational family enterprises on issues related to family and ownership governance; ownership strategies; shareholder agreements; establishing or strengthening boards of directors; financial planning for families, family offices, and businesses; succession planning; and next generation talent development. He is a frequent speaker and instructor on family enterprise best practices. Since 2000, he has led the São Paulo office of Cambridge Advisors to Family Enterprise, a global advisory firm serving business families, where he is Senior Advisor and Associate Partner.



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About Cambridge Family Enterprise Group

Cambridge Family Enterprise Group (CFEG) is a global advisory, education, and research organization that serves family enterprises with growth aspirations—enabling them to flourish across generations. As a go-to trusted partner for the world's enterprising families, CFEG offers a wide range of services to navigate changing times, build pathways for continued growth, and achieve lasting success. Its pioneering thought leadership, strategies, and programs are used by families, family businesses, and family offices worldwide. Since its founding in 1989 by Professor John Davis, CFEG has advised and educated thousands of families from more than 70 countries.