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OUR THINKING

Unique insights to drive your family and family office forward, authored by Family Capital Strategy

Many Families Will Sell Their Business – That's a Good Thing

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Years ago, at a wedding reception, I was speaking with a car dealer from the Midwest about the stock market and investing. This dealer was explaining that while he knows he should diversify his investments, every dollar he invested into his rapidly growing business was generating a 14%+ return annualized. He was hard pressed to see the attractiveness of investing anywhere else but his core business with those sorts of economics.

It has been remarked that the secret to building a fortune is concentration and non-recourse leverage. Concentrating your efforts on a single thing, when successful, is much more likely to produce a significant amount of wealth vs. Investing in a diversified format only. This car dealer was a great example of that. When you can apply non-recourse leverage, those returns are super-charged and can generate a substantial windfall (not investment advice).

Yet as much as that is the case, the more concentrated a family's wealth is and the larger it grows makes it more and more difficult to continue to take risk. Embedded gains that are not actually in real cash can have a chilling effect on families who begin to self-limit their risk, so as to not risk

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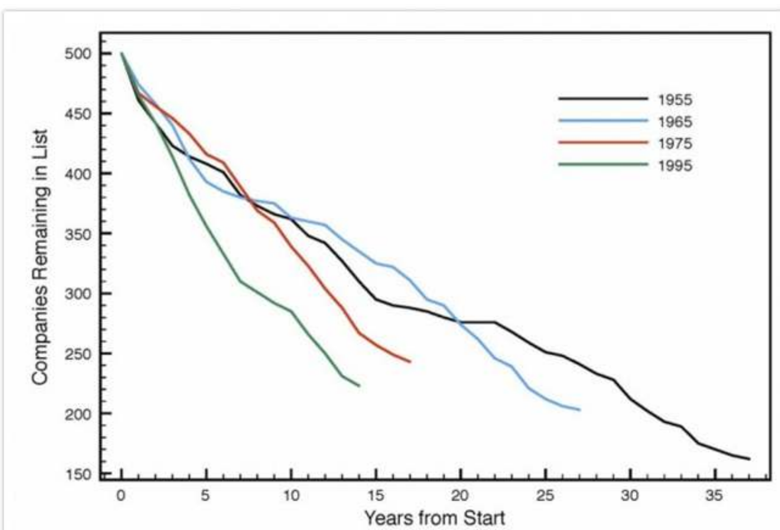
As well, technology and the rapidly changing environment means that it is less likely that a family will continue to own and operate the same business for generations without end. While there are amazing examples such as Zildjian cymbals or Kikkoman soy sauce which have operated the same business, in the same industry, for hundreds of years, such families will be the exception rather than the rule.

A favorite chart of mine is below. It shows the turnover within the Fortune 500. Below is a separate chart that looks at a similar calculation for the S&P 500. **Both reach the same conclusion, namely, creative destruction continues to accelerate**. Even these largest and most successful of companies experience misfortune (and go out of business) or find strategic rationale to be acquired. Case in point, just look at Amazon's purchase of the nearly 100-year-old MGM Studios this week.



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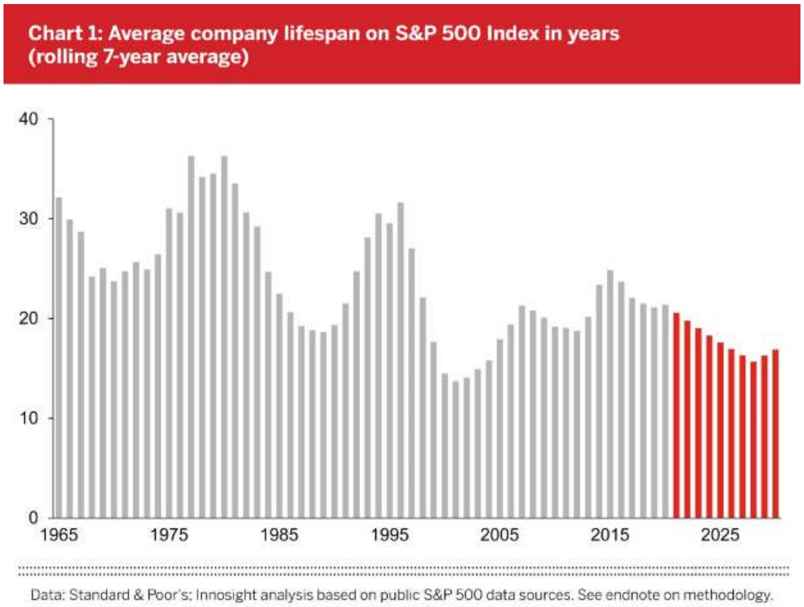

https://www.innosight.com/insight/creative-destruction/

In speaking with several advisers, families, and investors in the past few weeks, a common theme has emerged, **the deal environment is off to the races in 2021**. A strong economic resurgence as COVID slows domestically, combined with an uncertain tax regime coming in the Biden Administration, and a glut of private equity dry powder, has provide a strong impetus for deal making.

So, whether resulting from a desire to diversify the family's risk, creative destruction, being offered a great deal, or some combination of the above, there are many reasons why an exit may make sense. It is not surprising that many families will likely find themselves harvesting the work of prior generations and realizing the financial gains that accompany such work. Yet in my experience, it seems a common place sentiment among business-owning families that selling the business is somehow a negative thing, a type of failure for the family.

Instead, I would offer the message to not fear the 'exit.' Much like the law of conservation of matter, the capital of the family is neither created nor destroyed in a liquidity event. Instead, that capital which has accumulated over time with hard work, instead behaves more like the relationship between kinetic and potential energy. At the time of exit or harvest, the kinetic energy of the family's capital that has been deployed into a singular pursuit, returns to a potential form. From there, the onus falls on the family to use the stored energy in ways that further the development of the family.

Liquidity events can be massively catalytic in the life of the family – offering the chance for new goals to develop, new leaders to emerge, and for the weary, a change of pace. Handled carefully with strong communication, this event can mark the start of a new chapter in a family's story, not the end of the book.

← The Value of Investment Advice vs. Its Cost

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