Money talks - financing the family business

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Access to finance is a key issue for family firms. Therefore, it is important that sufficient consideration is given to financial decision-making in every family business.

Like most businesses in Ireland, family firms primarily finance their businesses using internal funds and bank loans - profits are retained and reinvested in the company.

A feature of family business financing is the willingness to wait for a return on investment and the term "*patient capital*" denotes this long term investment orientation.

Deciding on the type and source of capital to raise is by no means unique to a family business, but the decision is made more complex due to the variety of both financial and non-financial goals involved.

As both the family business and family unit evolves, so too does the financing considerations, and for many family businesses this means there will come a time when the involvement of external capital providers may become inevitable to reach the next stage of growth.

The combination of family and financial considerations can often create a potential for conflict within a family as various family members bring different perspectives on the most suitable funding strategy for the business. To avoid such conflicts, a proactive approach to the financing of the family business is critical to ensure there is a clear set of values and objectives when raising capital.

Some key issues related to funding decisions that should be consider by every family business include:

Funding partners, not providers

Access to funding should be not merely seen as a means to an end. Focus should be put on gaining longer term funding partners who can add value over and above just the financial capital they are providing to the business.

Access to expertise in the form of non-executive directors, international business contacts, and industry expertise are just some of the non-financial contributions capital providers could provide.

While hard financial criteria (e.g. the cost of finance) are important in funding decisions, other softer criteria, such as the alignment of funder and family values, risk preferences of the family, and the experience of the capital provider with family businesses should all be taken into consideration.

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Timing

Funding decisions can often come at critical junctures in the development of a family business - for example, during expansion or succession phases - and often the financing element can take on a secondary importance when such decisions are being made. Such decisions can be time sensitive, yet rushing funding decisions can have longer-term implications for the family business well beyond the current milestone being achieved.

Major funding decisions for a family business should not be completed on a reactionary basis and ideally, a funding strategy for the business would be discussed within the family well in advance of it being needed with agreement on broad principles being reach. This could include the view of the family on outside equity capital being raised, the role of dilution of control in any future fundraising and the level of acceptable debt the business can take on.

External capital influences

Reliance on internal funding is a common strategy for many family businesses to limit the amount of reliance on external parties and the subsequent dilution of control. However, for many family businesses there will come a stage where external funding may be required to grow the business. The involvement of external capital providers, be it new equity or new debt, comes with significant considerations beyond just the financial considerations.

Although access to bank finance for Irish business has improved in recent years, Ireland has the joint second highest interest rate for small loans at 4.4%, according to the European Commission Small Business Fact Sheet Ireland (European Commission 2018) and the cost of borrowing for small versus large loans is still significantly above the EU average.

External funding brings with it a dilution of control, either directly if new equity is raised, or indirectly via banking guarantees, and an expectation of professionalism and increased transparency which can result is significant changes within a family business.

Whilst, Irish SMEs identified high costs, in terms of high interest rates, the greatest barrier to getting financing in 2017, loan guarantees were considered the biggest barrier to future financing of firms (European Commission 2018).

Capital providers can often look for more formal governance structures to be put in place – for example, having non-executive directors on the board - and more regular reporting requirements in terms of financial results. Any new providers of equity capital (e.g. venture capital firms) will also be interested in a future exit so they can realise the returns of their investment and this will need to be considered at the outset as to how this would be achieved.

Other key issues to consider

The variety of business funding available in Ireland has increased significantly in the past decade with over 40 financial support measures introduced to deliver more credit to SMEs. In 2019, the Department of Business Enterprise and Innovation (DBEI) will launch an independent online business advisory hub for SMEs that will including financial planning tools, business finance, information of sources of financing available as well as government support. With all these supports it makes sense to do some preparation and seek advice.

The traditional decision between bank debt and taking on new shareholders has evolved substantially with many new and innovative sources of finance such as peer to peer lending and invoice finance now becoming more popular with SMEs. This added choice provides more scope for family businesses to choose a funding partner that fits their company's objectives and values.

Prior to any fundraising, the family firm should consider how their relationship with any external capital provider might operate. For example, the creation of a family council to ensure a single voice is one possible route to ensure consistency of message for key decisions. Shareholder agreements can also be another more formal avenue to ensure consistency amongst family members.

The relationship between the business and family wealth is something that must also be looked at and managed carefully. New funding could create restrictions or limitations on the ability to, for example, pay out dividends to the family in the future. Furthermore, families must also consider the concentration of family wealth within the family business and whether changes to the business funding structure could help them diversify some of this risk.

Key takeaways

• Look for funding partners who understand the dynamics of family businesses – not just capital providers.
• Consider the relationship between the finances of the family business and the family's own finances.

• Consider the longer term outcome of this funding – if raising new equity capital, the investors will want a future exit opportunity.
• Assess the broader impact of the financing on the business – for example, restrictions on dividend policy which may limit the funding of family expenses.

Conclusion

Funding decisions for all businesses can be complex, but even more so for family businesses. Such decisions can come at critical junctures in the life of a family business and can significantly change the dynamic of how a family business is managed. Ensuring sufficient preparation and planning is undertaken to find suitable funding partners that align to your core values as a business and as a family

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