Caught in the Family Wealth Evaporation Trap? Here's a Roadmap

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If you want to avoid falling into the family wealth evaporation trap, you should treat your family business as an investment class. This was one of the main takeaways from a webinar, The Family Wealth EvaporationTrap, that George Isaac, founder of George Isaac Consulting, recently gave for the Opal Financial Group.

A critical mistake that Isaac sees is a misalignment in how families view the family business. There is a tendency to focus on how it operates, without perceiving it to be an actual investment.

Isaac explains that a family may believe that they have a well-diversified wealth portfolio, with stocks and bonds, real estate - whatever they may be. But, when you add the family business into the mix, the portfolio's composition will look completely different. He points out that the value of a family business is often 50% or more of your wealth - which is basically one asset class that is concentrated and illiquid, where the value isn't realized.

"You have all of these assets tied up in your family business and it's a huge exposure," says Santa Barbara, Calif.-based Isaac. "You would never design a portfolio like that. So that kind of sets the stage for the problem and how you get around solving it."

He furthers: "What we're doing for clients, is we are working on different ways to be able to 'untrap' that family wealth by realizing on a regular basis part of the wealth as it is being created over time."

It's a three-step process when examining family goals, he points out. Wealth creation, realization and preservation. But, Isaac contends that realizing wealth is a sort of missing link - and an area his firm heavily emphasizes. It is important to talk about the alternatives, one of which is to sell your family business, or to partially sell it.

It's familiar territory, too, because his family sold their nearly 100 year-old fourth-generation business, The Isaac Corporation in 1997, "fortunately during a good market to sell businesses," he says.

"In hindsight, If we [knew of the different] family strategies, we would never have had to sell our family business and would have had it available for the next generation," says Isaac. "Various family members wanted a liquidity event - they wanted to realize some of the wealth that was created."

One of Isaac's goals is to help families examine the alternatives to selling. This is partly driven by the significant capital gains taxes that families have to pay when a business gets off loaded.

"When you sell, you end up having less money to reinvest in lower returning assets," he says, adding: "It's not necessarily the first choice, unless there's a strategic reason to sell the family business. Just to sell it from a liquidity and diversification desire isn't the best alternative."

Last December, Isaac created The Family Wealth Road Map, a consultative tool to help families understand the complexities of their family business as an investment. He uses private equity managers as a benchmark. "They get this; they understand how to maximize returns on investment and manage their investments in the company - as it truly is an investment. And "realized" return on invested capital is a primary driver. The family businesses quite often don't look at it that way."

Isaac makes clear that his own family did not when he ran his family business. "While we were very focused at returns on invested capital from the corporation's perspective, growing our business six fold over eight years, we did not focus on shareholders 'realized' returns on their equity capital," notes Isaac.

He began to develop this concept after leaving the family business, spending time in the capital markets as a senior executive and the board member of a public company, and then partaking in private equity investing.

"I started to realize that there is a fundamental flaw in the way most family offices and family businesses are managing their family business asset and that we need to come up with some approaches for them to improve investment performance but also equally important reduce their exposure to tail risks ," he says.

This tail risk clearly points to the recession. But it also refers to things like new competition, that could hurt the value of your company, product liability exposures, new regulations, catastrophic events to your facilities, family feuds, loss of senior family leadership and so on.

Isaac underscores the first step in his Roadmap for a family business is to first understand the company's cash generating capabilities; how volatile and secure they are and what the capital requirements are for the family business. To address this, he recommends a project team approach comprised of the company's senior management with an outside family business consultant "to bring together the internal knowledge of the business augmented with independent and objective experience in implementation," he says, adding that down the road, the project team is often expanded with outside counsel (estate and tax) and investment advisors.

The next critical component is to determine what the business' capital needs and the needs of the family stakeholders are. Once agreed upon, the next task is custom designing special purpose entities with specific shareholder agreements, ground rules on how those entities are going to invest in funds, what the purpose of using those funds are and distribution objectives for the shareholders. "This step is the 'art' of The Roadmap," he says.

Once you've done that, then you can look at all of the different assets that you have in the portfolio, including the family business assets and the special purpose entities they are being invested in and rebalance the entire portfolio. "That's where you get the significant benefits, says Isaac.

Isaac summarizes: "The core of all of this is protecting the Golden Goose - protecting the family business while trying to meet short and longer term family member needs."

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