Operating Businesses

A means to create & sustain wealth

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Operating businesses: A means to create and sustain wealth

Even well before the Great Recession, America's popular perception of prosperity has been undergoing a gradual, nevertheless, sustained shift back toward generating value through direct business ownership. Silicon Valley entrepreneurs and founders, rather than Wall Street fund managers, are the new "poster children" for outsized riches— consider Facebook's Mark Zuckerberg. Since 2006, two-thirds of institutions investing in private equity funds are now also actively conducting their own direct investments.[1] And a similar willingness is also observed among family offices and ultra-high net worth individuals as returns from conventional fund models have diminished. Taken together, it is clear that the current economic zeitgeist in America places a *renewed* emphasis in investing directly in operating businesses. We qualify this evolution as a resurging trend because it is not a novel phenomenon. Instead, as further elaborated below, ***actively investing as an owner should be considered a return to an enduring strategy for wealth creation that not only is a growing national approach, but a rising global trend.***

The utmost wealthiest Americans invest directly

Despite the lack of comprehensive data on the financial interests of wealthy persons— a consequence of the private nature of this demographic— several points indicate that ***holders of outsized wealth typically trace the origin of their net worth to active ownership of operating businesses, with many continuing to own enterprises directly.*** A first cut analysis that examines the Forbes 400 list, widely regarded as the definitive directory of top-tier wealth in America, illustrates this point. Consider that 85 percent of those listed in 2011 *originated* their wealth from an operating business rather than investing passively. Of this significant share, 80 percent trace their wealth to a non-financial business like the Waltons' Walmart, while 20 percent are linked to a financial company like Buffet's Berkshire Hathaway.

The Forbes 400 list further suggests that *sustained outsized wealth* almost always originates from and typically involves continued exposure to operating businesses. Since its inception in 1982, only 102 families have remained on the list. Within this group 97 percent originated their wealth in an operating business[2] and 85+ percent continue to tie up a significant share of their net worth wealth in closely-held companies. This latter observation is even more pronounced among families on the list in which wealth has already passed on to succeeding generations. ***As a result, we can conclude that a wholesale commitment to passive investments has neither been a dominant strategy for achieving unrivaled wealth or sustaining it.***

While this analysis reveals the significance of operating companies in wealth creation, the Forbes 400 is only illustrative of the most *extreme* wealth. Having remained on this list over the past three decades implies extraordinary gains. Consider that the minimum net worth required to form part of the list in 1982 was $75 million, approximately $200+ million in today's dollars, while the entry benchmark is currently about $1 billion. Thus, to evaluate the role of

[1] Pignal, Stanley. *Direct approach challenges private equity.* Financial Times, June 24, 2012

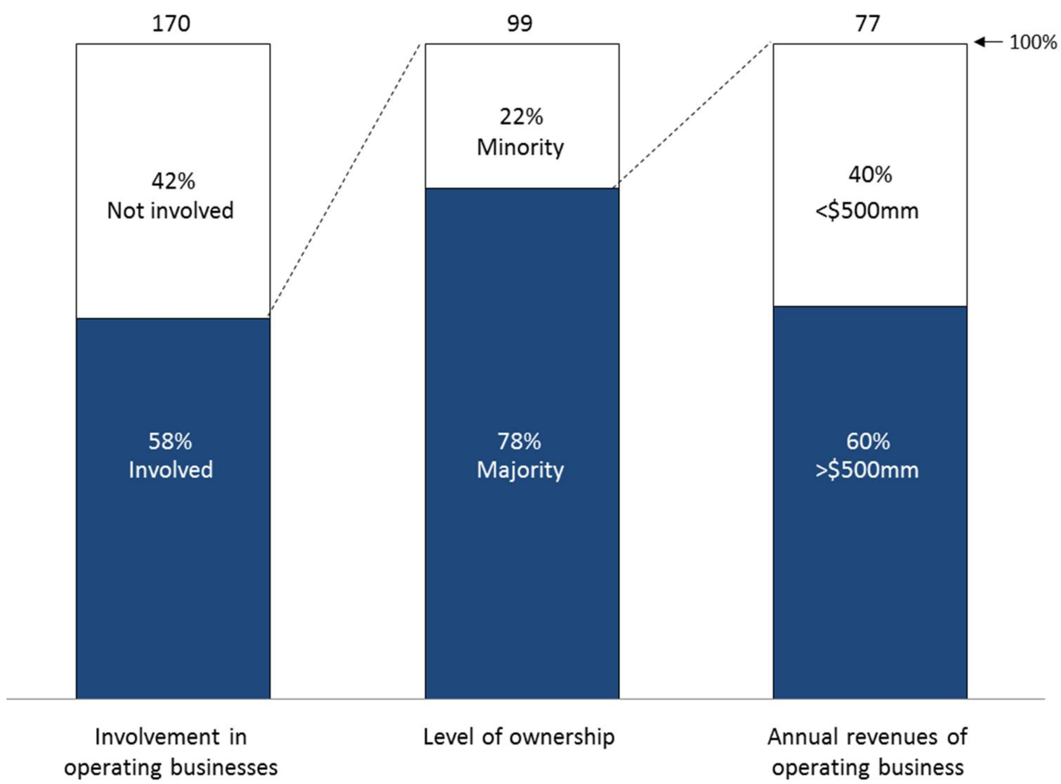
[2] 95 percent are non-financial businesses and the remaining 5 percent are financial companies

direct ownership across a broader distribution of wealth, we turn to examining the space of family offices.

Family offices follow suit

A survey of 650+ U.S. family offices with an aggregate net worth of more than $2 trillion under management[3], notes that ***"an equity stake in a very successful firm was the most common path (95%) to exceptional wealth."*** Reasonably assuming that such a lucrative equity stake is typically associated with the founding or active management of a company would suggest, consistent with the Forbes analysis, that wealth typically stems from success in directly operating enterprises. Moreover, a Wharton survey[4] of 170 single family offices around the world with a minimum net worth of $100 million finds that a majority—58 percent—of respondents maintain exposure to operating businesses. The level of family involvement and wealth exposure in this sample is often significant. The survey found that 78 percent of the families involved in operating businesses were *majority stakeholders* and 60 percent of these families with controlling interests held businesses reporting of over $500 million in annual revenue.

Decomposition of single family offices worldwide surveyed by Wharton Global Family Alliance, 2009



[3] Prince, Russ Alan & Grove, Hannah Shaw. *Inside the family office: Managing the fortunes of the exceptionally wealthy.* Wealth Management Press, 2004

[4] Amit, Raphael et al. *Single Family Offices: Private Wealth Management in the Family Context*. Wharton Global Family Alliance, 2009

A global trend

The exposure of family offices to operating businesses is universal across geographies. A follow-up Wharton survey breaks down the share of single family offices involved in operating businesses across regions.[5] It finds that approximately 50 percent of the families interviewed in the Americas invest in closely-held operating businesses, while the same figure is 58 percent for those surveyed in Europe and 88 percent among families interviewed in the rest of the world.

The higher level of family involvement in operating businesses observed in the latter category, which primarily includes developing and emerging market countries, is part of a broader trend of concentrated corporate ownership seen in these regions. For example, a study of 3,000 public companies across 9 countries in East Asia found that some two-thirds of public corporations have one controlling shareholder, often representing family ownership.[6] Similarly, in Turkey, business groups are typically organized around a holding company owned by a family. There, 72 percent of the 100 largest listed firms were controlled by families with an average ownership of 52 percent of voting capital and 24 percent of financial capital.[7] Likewise, an analysis of Brazil's leading stock exchange (Bovespa) revealed that 90 percent of firms had one shareholder, typically founding families that owned more than 50 percent of the voting capital. On average, this dominant shareholder controlled 76 percent of the voting capital and 54 percent of the financial capital.[8]

Conventional thinking suggests that concentrated corporate ownership is a phenomenon of the developing markets because of weak legal protections and inefficient capital markets. Investors are thought to overwhelmingly deploy capital as owners, rather than passive subordinate investors, where legal systems provide poor minority shareholder rights that expose outsiders to the risk of having their value diluted or expropriated through common strong-arm tactics.[9] These include salary manipulation, intra-firm transfers, and squeeze-outs, among others. Additionally, the typically illiquid and inefficient nature (i.e. unfavorable securities laws which provide insufficient insider trading protections, etc.) of less-developed financial markets provides little alternative for locally amassing wealth than through outright

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[5] Amit, Raphael et al. *Benchmarking the Single Family Office: Identifying Performance Drivers.* Wharton Global Family Alliance, 2012—Nearly half of the 167 SFOs in this sample locate their headquarters in Europe. Another 44% are in the Americas and 5% are located in the rest of the world (RoW).

[6] Claessens, Stijn; Djankov, Simeon & Lang Larry H.P. *The Separation of Ownership and Control in East Asian Corporations*, Journal of Finance & Economics, Vol. 58, 2000 – 9 East Asian countries include Hong Kong, Indonesia, Japan, South Korea, Malaysia, the Philippines, Singapore, Taiwan, and Thailand

[7] Demirag, Istemi & Serter, Mehmet. *Ownership Patterns and Control in Turkish Listed Companies*, Journal of Corporate Governance, Vol. 11, 2003

[8] Carvalhal-da-Silva, Andre & Leal, Ricardo. *Corporate Governance, Market Valuation and Dividend Policy in Brazil, Federal University of Rio de Janeiro, 2003*— Sample consists of 225 firms listed in Bovespa, which represent about 45% of the number of firms, and approximately 70% of total market capitalization of exchange

[9] La Porta, Rafael, et al. *Corporate Ownership Around the World*, Journal of Finance, Vol. 54, 1999

ownership of assets and companies.[10] In this context, traditional private equity cannot serve as a suitable alternative to address the shortfall in public markets since the finite lifespan of its investments are predicated upon a secure exit environment. And to the extent investors do participate, these funds demand handsome discounts to valuation. Consequently, those in a position to own assets indefinitely prefer to achieve significant returns as cash flow investors, harvesting recurring earnings from directly owned enterprises.

These theories, however, are at best partially true since there are regions where there are robust legal systems and developed markets and, yet, we still witness concentrated ownership stakes in operating businesses, as suggested by the Wharton survey. While comprehensive data on corporate ownership structure of private companies is unavailable, here again, publicly listed companies can serve as a good proxy to demonstrate this point.

Let's first consider Western Europe. Throughout the region it is common for public companies to have a controlling shareholder with an ownership stake of at least 25 percent—this individual is generally a founding family member and/or a current operator of the business. The share of public companies in Germany, Italy, and Sweden that fit this profile were 83 percent, 66 percent, and 64 percent, respectively.[11]

A similar pattern is evident in the United States. A recent analysis of over 400 publicly listed U.S. firms across varying industries found that half of the time a family was the largest shareholder.[12] Other similar studies of the S&P 500, have observed that family ownership is both widespread and considerable. For example, family firms constitute over 35 percent of companies on the exchange between 1992 and 1999, with families, on average, directly owning nearly 18 percent of their firm's outstanding equity.[13]

Thus, once we control for differing structural contexts, ***it is clear that families invest directly in strong numbers and that they continue to play a significant role in the direct ownership of operating businesses worldwide***. Further, as elaborated below, recent data suggest that these trends are only increasing.

A growing trend

Recent trends point toward continued and increased exposure to direct investments, particularly among family offices. A survey by Coller Capital, one of the leading global investors in the private equity secondary market, notes that the share of total investors engaged

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[10] Nenova, Tatiana. *A Corporate Governance Agenda for Developing Countries.* Revista Contaduría y Administración, Dec 2005

[11] Becht, Marco. *Reciprocity in Takeovers*. European Corporate Governance Institute, Working Paper No. 14, Oct 2003

[12] Holderness, Clifford G. *The myth of diffuse ownership in the United States.* The Society for Financial Studies, Oxford University Press, Dec 2007

[13] Anderson, Ronald & Reeb, David. *Founding-family ownership and firm performance: Evidence from the S&P 500.* Journal of Finance, Vol. 58, 2003

in direct investing—via either a club deal or direct ownership— has increased from 35 to 50 percent between 2006 and 2010. Moreover, willingness to further increase exposure over the next three years has jumped from 25 percent to 41 percent over the same period. Similarly, a 2010 survey among family offices by McNally Capital, a merchant banking firm that serves as a leading advisor to family offices, revealed that 83 percent are planning to increase or maintain their exposure to direct investments.

What's driving this movement?

The willingness to invest directly stems from a combination of psychographic and financial motivations. To date, research on the direct investment asset class has largely considered only economic motives, excluding nonfinancial concerns.[14] Yet, many investors are motivated by a variety of emotional rationales, particularly when considering direct investments. These psychographic reasons include the desire to: (1) preserve control, (2) remain active, (3) educate their family, (4) achieve social impact, and (5) secure wealth across generations. Each is described in turn.

Typical wealth management structures are forever vulnerable to the classic principal-agent dilemma—fundamentally, fund managers seek to maximize their fees, rather than investor returns, despite efforts to align the two interests. McNally survey cites family offices are motivated to increase exposure to direct investments to regain control, as 60 percent are dissatisfied with the private equity fund fee structures they are faced with. In the same vein, anecdotal evidence suggests that perceptions of fairness and a desire to reap the benefits of their own efforts are often important considerations.

Additionally, investing directly provides an opportunity for successful operators to continue to apply their skills, if they seek "not to retire". This is particularly relevant for the operator that opportunistically exits their original business. Selling ones business does not have to mean "being put out to pasture." As described in our whitepaper, *Home field advantage: Leveraging your family's strengths to maximize risk-adjusted returns,* successful operators have valuable skills that can be applied to new ventures in their respective fields.

Direct investments also provide two tracks for a family's professional development. First, portfolio companies can provide direct employment to family members and enable the "trade" to be passed down to later generations. Nevertheless, this approach is only sustainable if members are held accountable to rigorous performance standards and expectations. Second, and perhaps more importantly, direct investments allow operators to pass down a general business skillset and ownership mentality that future generations can apply to other ventures that are valuable independent of the course of the original family business. (See our whitepaper, *Direct investing: A pathway to family stewardship,* for fuller treatment of these issues.)

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[14] Lubatkin, M. H. (2005). *A theory of the firm only a microeconomist could love*. Journal of Management Inquiry, 14(2), 213–216.

Investing directly also provides a greater opportunity to maximize social impact. The line between for-profit businesses and philanthropy has been blurring as social impact investments have shown that a financially sustainable business model can achieve far greater impact than charity, given its ability to scale. Consider for-profit companies like MinuteClinic and ZocDoc that are improving healthcare access, while ZipCar has the potential to take millions of cars and their emissions off of the road.[15] Unfortunately, there currently are not many suitable passive investment structures to confidently source and fund promising social investment opportunities, underscoring the importance of direct investments in this space. Such ventures are typically overwhelmed by good intentions and, therefore, need the business savvy, as well as the capital, of a seasoned operator. Ultimately, strong businesses can be active contributors in their community and provide a platform for engaging in corporate social responsibility (CSR) initiatives. In this context, the business itself, not just its giving, can be a "force for good" that provides families an opportunity to create a strengthened sense of purpose and to leave a more significant social legacy.

Finally, and certainly not least, ***direct investments allow scope for unmatched financial returns***— even if you do well as a pure financial investor, all else equal, you can do better by accreting the additional returns associated with directly adding value. To this point, McNally Capital finds that 67 percent of family offices in their survey are motivated to increase exposure to direct investments because of the prospect for greater returns. ***For the already well-established, this economic motivation is clearly rooted in the desire to achieve family wealth sustainability.*** While passive returns may be enough to provide for a generation, as discussed in *Direct investing: A pathway to family stewardship*, the strong real financial returns offered by direct investments are necessary to overcome the triple threat against preserving family wealth.

[15] Baldinucci, Gabriel et al. "Entrepreneurship in the Family Office." *Family Office Association.* 2011

About the author:

David McCombie is Founder and President of McCombie Group, LLC— an innovative advisory firm supporting family offices and ultra- high net worth individuals across their direct private investments and operating businesses. Its professionals serve as transparent fiduciaries, objectively representing clients' interests from A to Z—from initially selecting, analyzing, and consummating an investment, all the way through continued monitoring and performance improvements.

David is a former McKinsey & Company management consultant—A specialist in corporate strategy, he managed multiple client teams across a variety of industries to quickly develop strategic recommendations within complex, uncertain environments. In 2009, he was selected as a McKinsey Global Institute Fellow to further develop the firm's regulatory capabilities (approximately 10 of 10,000 McKinsey consultants selected/ year). Prior to joining McKinsey, he briefly worked as an associate within the financial institution group at Citigroup Global Banking in New York.

David graduated from Harvard Law School where he focused on corporate law & negotiation strategy, and also did extensive coursework in corporate finance at the Harvard Business School. His thesis, "Hispanic Private Equity: A Cultural Approach to Achieving Superior Investment Returns" was published in the Harvard Latino Law Review. He graduated Phi Beta Kappa from the University of Miami with a degree in Economics/Finance, where he was a Cuban American National Foundation Mas Scholar. A committed member of the South Florida start-up community, David serves as a venture mentor at both the University of Miami and Florida International University entrepreneurship centers. He is a licensed Florida attorney.