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Portfolio principles

Wealth Management Research

Planning for liquidity events

From entrepreneur to wealth manager

A comprehensive look at the professional, personal and financial challenges of business sales.

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This publication was first produced in 2012, while the world was still in a recovery phase following the 2008 financial crisis. While the overall message in this booklet entitled "*Planning for Liquidity Events From Entrepreneur to Wealth Manager*" is also appropriate today, we appreciate that some of the examples given may seem dated. We believe there is great value in discussing these principles and how, for example, they align with your goals and objectives today and in the future and we welcome the opportunity to be part of this important conversation with you.

UBS WMR's *Portfolio principles* provides investment recommendations and guidance for sophisticated investors, with a focus on the unique issues related to managing significant personal wealth. As such, this report is not suitable for all investors. Please consult your advisor if you have any questions as to whether this report is appropriate for you.

Dear Reader,

Is there a "perfect time" to write a report about planning for liquidity events?

Recent years, following the debt crisis of 2008, have resulted in many business owners putting their plans on hold – awaiting better times and better valuations. But then, even as the market environment stabilized, fear remained on the horizon and many business owners continued to ask the question: Is now the "perfect time"? Economic conditions, market timing and risk tolerance aside, it's never too soon to plan for the inevitable, to best prepare for the future and to ensure that you create and realize the highest value for your efforts.

For one thing, this is a topic that cannot wait for more favorable market circumstances. About 53% of baby-boomer business owners in the US intend to exit their businesses in the next 10 years, but only one in 10 have prepared a formal plan. Two-thirds of owners over 60 years old have no exit plan at all. More than half of all entrepreneurs want to sell their company to a third party, 20% want to sell it to the managers and only 14% assume they will hand it over to a family member.[1]

Planning is the key word in this report. We cannot emphasize enough that a successful liquidity event like the sale of a business needs careful planning. It is a complex process that requires management across three dimensions. The first is the professional dimension: the actual sale, merger or IPO of a business. Most experts and business owners focus predominantly on this dimension when planning for liquidity events. However, there is also the personal dimension of a liquidity event, which can often be even more important than the professional dimension. The emotional challenges of giving up control over a privately owned business and transitioning into a new role as "ex-entrepreneur"– whatever this new role may look like – requires reflection about one's identity and about other family members.

Finally, there is a financial or investment decision. A liquidity event can turn the merely wealthy into the very rich almost overnight. This could create both emotional and financial challenges. Managing very large amounts of money requires different skill sets than managing a successful business.

This report is not about mergers and acquisitions or IPOs. It focuses on the challenges that must be met before and after the sale of a business. It shows how the professional, personal and financial dimensions are inter-linked, and how they can be integrated for the best results. While we do provide some detailed guidance on the professional dimension in Chapter 1, the personal implications in Chapter 2 and the financial consequences in Chapter 3, we focus throughout on the integrated process. Finally, we offer an overview to guide the years directly before and after a liquidity event in Chapter 4.

While you may not plan to sell your business today, it is certainly wise to begin thinking about that day. Careful planning now will allow you to take advantage of opportunities promptly when they materialize. With a plan in place, you will be ready to act when you want to. We sincerely hope that this report provides you with guidance, and inspiration, for any liquidity event.

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[1] White Horse Advisors study, 2008

Defining a liquidity event

Highlights of Chapter 1
Most liquidity events are composed of both "conversion" and "transition" features. Conversion refers to the conversion of one form of wealth – an illiquid asset, a business, a building – into a liquid form such as cash or marketable securities. After conversion, there is a need to reinvest the cash. The conversion is a financial event. Transition is a less appreciated aspect of liquidity events. Almost all transitions have very personal implications for individuals and their families and can lead to substantial changes in their situations. Usually, transitions result in greater wealth, and managing significant investments becomes a focus.

Introduction

If you reach the point where you are facing a primary liquidity event, usually the sale of a business, you have already defied enormous odds. Reaching a point where you can attract a buyer, or perhaps even multiple buyers, and command a premium price puts you into even more rarefied social categories: successful entrepreneur, prominent citizen, wealthy family.

However, among these accolades themselves and intertwined within the process of selling a successful business, lie complex and sometimes easily over- looked issues. One of the most overlooked problems that successful business owners may face is the assumption that their success implies a commensurate level of ability in all other spheres of life.

Unfortunately, experience with wealthy families has shown that conflicts within a family are often the root cause of major financial disruptions later on. An exaggerated focus on intricate investment strategies may leave an investor exposed to a wide range of risks that could have been easily uncovered and hedged.

Selling a business is perhaps one of the most complex events a person can go through. The personally owned firm is already a multifaceted entity which involves more than just a business, but also a complex and unique owner and any level of family and outside involvements – sibling partnerships, first, second, third or even longer generational structures, in-laws, and finally outside partners as well. Yet a fundamental approach to liquidity events is also as important – if not more so – than a focus on the latest merger and acquisition (M&A) technique. Only by using a holistic approach that breaks a liquidity event into its component parts and seeks to understand the nature and role that each play in the ultimate process can an owner, and his or her family, manage the event in its totality and with the necessary regard for their unique situation, personal characteristics, needs and goals.

This chapter will look at the first of what are, in our view, the three critical dimensions of a liquidity event. The first is the professional context, which is the business itself. The second dimension, discussed in Chapter 2, is the personal, which includes the situation of the owner and the family in relation to the business and liquidity event. Third is the financial or investment dimension, covered in Chapter 3.

Defining a liquidity event

Any event, particularly a transaction, that leaves someone with a large amount of cash, is a liquidity event. Depending upon the scale of wealth involved, these transactions may involve a high degree of complexity both financially and personally. There are three primary types of liquidity events:

1) Sale of a business or liquidation of a position in a business or partnership. This report will focus on a primary liquidity event, the sale or partial sale of a business.
2) Sale or disposition of a concentrated or illiquid asset. The sale of concentrated stock positions, real estate or other holdings may also amount to a liquidity event, usually when the asset in question represents a primary or majority share of net worth.
3) Financial windfall. A less frequent form of liquidity event occurs when an individual receives a large financial position that significantly alters his or her financial state.

The liquidity events usually share two primary features: conversion and transition. First, the sale of a business or a concentrated or illiquid asset is a conversion event, where one type of wealth position is exchanged via a sale for a more liquid, or completely liquid, position that usually requires further asset allocation. The conversion can be understood as a financial and legal transaction, where the timing and structure of the deal is paramount, and where advisors with specific expertise will be needed to carry it out. Planning, timing and structuring the deal are the necessary tasks, and drive the information and advisory needs of the owner. External economic conditions such as the business cycle, as well as the nature and needs of the business itself, are of primary concern when considering the decision to sell.

A financial windfall is not a wealth conversion, but it shares the complicating features of liquidity events: All are transition events that cause the person or family to make significant changes at the psychological, social and family levels.

A transition event is more personal and its exact nature, challenges, and characteristics will be unique for each individual or family undergoing it. The transition event marked by the sale of a business, a sudden change in economic status or the challenges that come with managing a very large investment portfolio also share another factor: for most people, such an event will occur only once in a lifetime. While there are cases of serial entrepreneurship, where the "raison d'être" for the individual is the constant development and sale of new businesses, they are rare. In general, a liquidity event involves selling a successful business, and it marks the crowning achievement of a lifetime of work. Because of this, the ownership role may be deeply linked to the owner or family's self-perceptions and identities, causing unexpected challenges if this is not recognized beforehand.

Understanding a liquidity event: a framework

Joachim Schwass, Professor of Family Business and Entrepreneurship at IMD in Switzerland, has developed a framework to help understand the main interrelationships at stake in family businesses. It is a useful starting point for the analysis of a sale, succession, or other kind of exit event. He identifies four dimensions, two each in the business and personal spheres (see Fig. 1.1).

The business can be understood in terms of:

1) The owner and the issues related to the ownership role in the business.
2) Management, which considers management by the owner (where ownership and management are comingled) or management by outsiders, a stage that a business may or may not reach.

This is the quantitative side of family wealth, where either the hard assets or investment portfolios, or a business must be managed or operated.

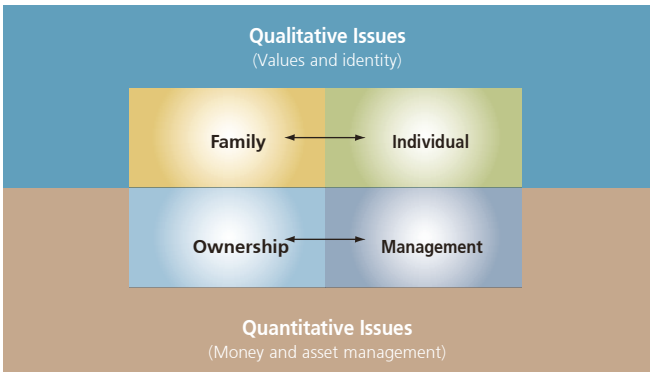
On the personal side, there are two dimensions:

1) The individual (often the owner), where their personal and financial needs and goals are considered.
2) The family, where the needs and goals of individual family members, different generations, or the family as a whole are considered.

In the latter case, each member of the family needs to be understood not only as an individual but also in terms of the role that they play within the family, and within the business. Likewise, for the owner, there are multiple roles that they occupy within the scope of the business and within the family. This individual/family dimension is the qualitative side of affairs, where personal values, individual needs, and family as well as individual identity or legacy issues reside.

This four-quadrant framework is useful for a wealthy family even after the sale of the primary business. For example, ownership and management issues will still be at hand with regard to the family's financial wealth.

Fig. 1.1: The dimensions of family interests



Source: Schwass (2005), UBS WMR

External versus internal contexts

Optimizing a sale – choosing the right time to sell a business, liquidate stock options or sell a concentrated asset – depends upon balancing real-world conditions with the owner or family's needs, goals and desires. These real-world conditions are the sum total of economic, industry, tax and regulatory or other business specific conditions, now and in the relevant future. These constitute the objective framework within which the decision to sell takes place, or which may on their own motivate a sale. As such, they are also relevant for all competitors, potential buyers, and other market participants.

What is perhaps most difficult to appreciate in the life of an individual, a business and a family is the long periods over which planning must take place. In the next section, we will explore the relevant cycles that affect business development and exit planning. The most significant hurdle is dealing with the innumerable uncertainties and variables that must be accounted for, often during very early stages. Individuals must counteract the inertia inherent in planning over decades, making conscious efforts to think in terms of these rather long time frames.

Just as markets and economies will undergo both cyclical changes as well as longer-term developments, the same is true for an individual and for a family. In the end, no liquidity event should be undertaken or understood without due consideration of the personal or internal environment of the owner or family. Although financial circumstances are important, personal needs and goals should be given significant weight in any decision. Ultimately, an optimal sales event will unite the best financial circumstances with the most favorable personal timing. Often, achieving this ideal outcome will not be possible and tradeoffs on one side or the other will be necessary. Initiating a regular, formal review process of the various elements – within the business and the family – increases the chances of achieving the best result.

The key internal environment factors include (see Fig. 1.2):

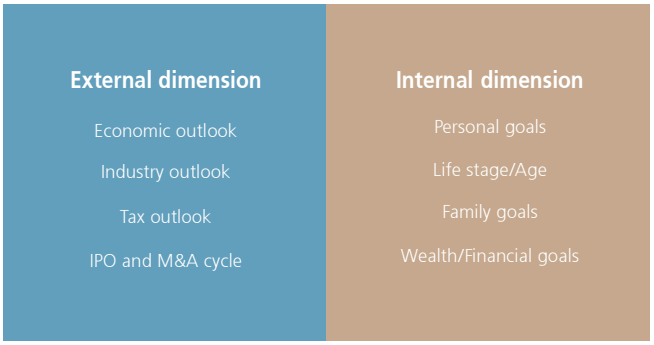
Personal goals: Personal considerations about business ownership are likely the largest contributor to the decision to sell or keep a business. The role the owner has played in the business, the status they have achieved in their community, as well as the personal stress and responsibility they have carried on behalf of the business and its employees may all shape the personal needs and goals of the owner. These considerations will form the overall context for the decision to sell, the subsequent deal-structuring and the new wealth management process.

Life stage and age: Often, a business sale is motivated by another major event: retirement. However, the age at which one sells a business or experiences a major liquidity event has implications for the investment portfolio and the opportunities available to the individual after the sale. The age of relevant family members and the generational structure of the family may also be important elements of the transaction and post-deal investment structure: This may involve the continued role of older family members in running the business; in other cases, it may involve influencing the need for and the choice of appropriate trusts or other portfolio or philanthropic structures, such as a foundation.

In terms of assessing the need for a liquidity event, the two most important cycles are the lifecycle of the owner and the development cycle of the business.

Family needs: More complex issues may stem from the competing needs and wishes of various family members or the family as a group. These considerations are probably more of an issue for families where the company is already held by the second or third generation and who face choices about the future leadership, management, and ownership of the business or the distribution and management of assets after a liquidity event. The dispersion of authority, wealth, and even just the growth of the family over time increases the risk of conflicts, further complicating decision making. Conflicts may also arise during or after the deal, when issues commonly arise relating to the effect of wealth on children, the cooperative or joint management of assets, and estate planning.

Fig. 1.2: External and internal dimensions of a liquidity event



Source: UBS WMR

Wealth goals: Wealth goals may overlap with personal goals but for our purposes are better understood as strictly financial. Monetizing a business at the optimal time in terms of valuation may take priority for some business owners, while others may set a higher value on business continuity and their role both preceding and following a sale.

Timing: When will your liquidity event occur?
We have defined a liquidity event and the major dimensions involved in each unique situation in the first part of this chapter. We now analyze one of the most critical questions: When should a liquidity event occur? There is, of course, no universal answer, but there are several useful distinctions to be made. Every business owner or family will have its own unique development track, needs and goals, which must then be considered within the overall economic and business context. What do you want? is the first question to be answered. What can markets and buyers offer you? is another.

One way to understand the timing of liquidity events is to consider them in the context of several unique cycles. Cycles form a benchmark against which unique situations can be judged. In economic terms, cycles that can be determined from historical data, and thus forecast, can provide crucial guidance to the business owner in determining when an optimal valuation or credit cycle may be developing that could lead to a higher sale price or more liquid markets for the business or asset in question. In terms of assessing the need for and timing of a liquidity event, the two most important cycles are the lifecycle of the owner and the development cycle of the business. The personal lifecycle is the general context for personal financial development and succession planning. Try as we may, no one escapes life's inevitable cycles, which broadly fall into three distinct stages. The first is youth and education (birth to age 30), followed by the active earning and career phase, which includes the peak earning years of age 40–54, and finally retirement (age 60 until death).

A lifecycle is not fixed, nor does it necessarily represent the lifecycle of the business owner. General changes in the lifecycle include far longer education periods than previously seen, longer retirements as longevity increases while the retirement age remains stable at around age 60, and higher frequencies of divorce. A multi-million dollar sale event at age 25 – common during the dot-com era – created an entirely new type of freedom and distanced the individual from all but the biological conditions of the lifecycle. At the other extreme is the business owner who never relinquishes the business and never retires. In general, life paths tend to be extremely varied among the business-owner group, which may in turn lead to unique financial needs.

The development cycle of the business
The development cycle of a business is also well known but again serves as a useful benchmark against which the unique features of a specific business are best measured. There are five phases in the typical business development cycle:

1) **Pioneer phase:** The owner begins the business, taking on most or all of the risks and responsibilities of the new firm. Failure rates are high, and financing sources are friends and family, or are driven by the relationships and salesmanship of the entrepreneur. Operating losses are common as investment in production capacities or product development is necessary to establish the concern.
2) **Growth phase:** This begins once the business begins to show a profit. Expansion includes a growing employee force and expanding capital needs, often financed through venture capital and/or a private placement of shares to specialized institutional investors. The first outside investors may become part of the ownership structure, increasing the complexity of the business.
3) **Strategic positioning:** The strategic positioning phase occurs as the firm grows and its capital needs and ownership structure require more specific growth or expansion strategies. A public offering, the sale of parts of the business or merger and acquisition activity may all be considered during this phase of the business's growth because it now has a significant track record upon which outsiders can base their evaluations. The owner may be reaching a stage of life when personal needs may also drive restructuring or sale considerations.
4) **Consolidation:** As the business matures, the consolidation phase occurs. The business mix may need to be fine-tuned and non-core assets spun off. The industry is constantly changing and there may be an opportunity to acquire a competitor, adding further capabilities. A sale event is a possibility, either in total or in part. Other types of buyout or conversion structures, such as a sale to employees or restructuring, may occur in part to address looming succession issues. Retirement may also be a primary concern if the development of the business has occurred in line with the aging process of the owner.
5) **Succession:** All businesses are faced with succession events related to their ownership or management. A founding owner may deal with his/her own succession by the sale of the company to an external investor, or by transferring ownership "internally" to family shareholders. In the case of an internal succession solution, family shareholders can stay in management or appoint external management. Sometimes, the death of the owner marks the ownership succession event but this eventuality, too,

must be carefully planned for in order to assure continuity for the business, liquidity for surviving family or succeeding owners who may face estate tax liabilities, and financial security for survivors.

Fig. 1.3 shows a schematic of the business development cycle, with a good overview of advice needs throughout the cycle.

Different businesses, different cycles

The business development cycle described above is a generic one. Depending upon the specific nature of the business, there may be differences in both the nature and timing of the business cycle that each owner must be aware of. For planning purposes, owners should always ask, "What kind of business am I in? How is it likely to change? What are its economic fundamentals, the stage and state of the industry? How vulnerable is it to specific product and innovation cycles? How do I measure up against the critical success factors of the industry? How do I develop/grow my business to where I want to be?" The answers to these questions are important to the timing of a sale, the need for specialized strategic positioning, or the management of product and innovation initiatives.

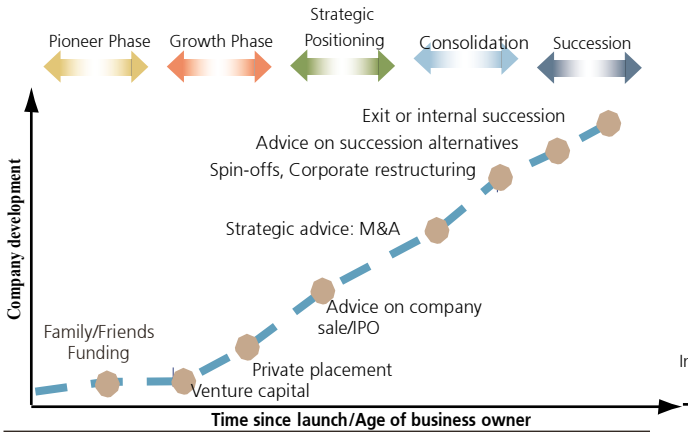
One of the business factors that may influence whether or not one should sell a business concerns is the product lifecycle. A frequently repeated notion in the popular press is that the product innovation cycle has increased in speed since the mid-nineteenth century. Technological progress and globalization, which have increased the number of competitors in any given market, are two of the reasons for this perception. However, academic experts who have looked for empirical evidence of such a change have found little support for it. They agree that there are many changes to business, including the faster application of new knowledge, the introduction of a greater number of products at any given time than in the past, and a decrease in the time between innovations. These trends do not necessarily mean that the product lifecycle across all industries and products has been similarly affected. General pronouncements may be too broad, but it is necessary to understand the specific nature of the business and to monitor changes in the overall business and the innovation climate.

The classic product lifecycle is shown in Fig. 1.4. The timing in question is the length of time between the introduction of a new product, at point B, and the eventual decline and withdrawal of the product, at D and E. Where once a business could be developed around a specific product or service and could anticipate – with reasonable effort and a bit of luck – to continue indefinitely, the likelihood of similar long-term success in today's business environment may be more limited. However, this depends upon the individual business, product and industry.

One example of a relatively static technology was the plough, which did not change for several hundred years.[1] While such an enduring technology (or lack of innovation), where it still exists, makes a multi-generational business more feasible, faster-paced environments do not rule them out altogether. Business owners who aim for a family enterprise may just have to accept the greater difficulties and risks involved in managing a business in a highly competitive, fast-changing environment.

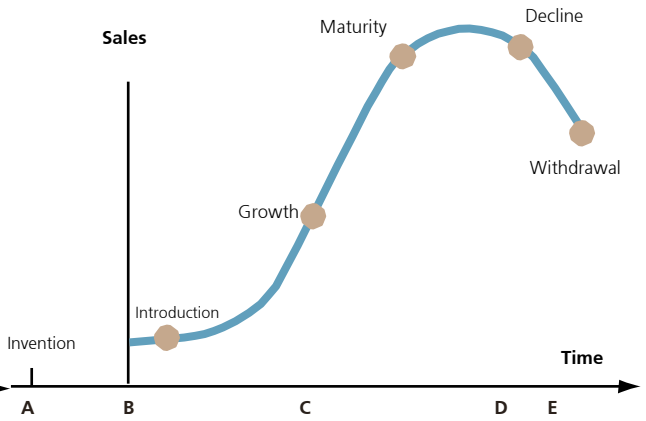
[1] De Botton (2004).

Fig. 1.3: Business development cycle



Source: UBS CAG, UBS WMRSource: UBS WMR

Fig. 1.4: The classical product life cycle



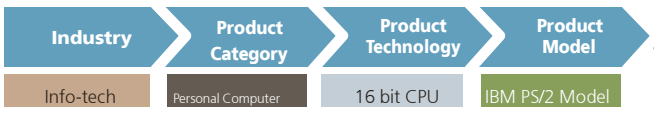
In today's consumer- and service-oriented economy, there are likely more opportunities for new businesses, but their natural life span – and the opportunity for growth and profit – may be shorter. It all depends upon the specific industry and the nature of the business. Fig. 1.5 shows the different levels of product markets against which any given business may be evaluated. What is the overall maturity level of the industry, for example? Is it a fundamental activity, likely to be needed in some form by most people? Or is it an industry that may at some point become obsolete? One obvious candidate for obsolescence and substitution is the conventional energy business. Any business that depends on major fossil fuel providers may already be considering ways to change or diversify. Beyond the industry level, the product category, innovation or technology underlying the product, and finally, the product model itself need to be understood in terms of their longevity and prospects.

A shorter product or service life cycle means that business owners must more carefully understand the dynamics of their business and the way it relates to the economic outlook. Of course, personal preferences about the business take priority, but the opportunity to sell it, based on external factors, may come less frequently than in the past, or may be increasingly driven by market and consumption trends. Another implication of a faster product life cycle is that owners who opt to keep a business and grow it may face greater pressure to innovate and to find new markets, or they may diversify into unfamiliar but more profitable businesses. While some may welcome this additional competitive stress, others may find it an incentive to exit the business and turn to other opportunities.

Is there a market cycle for selling a business?

Another important external cycle is the market for businesses. There are better and worse times to sell a business; a good proxy for the "appetite" of the market- place for companies is the initial public offering (IPO) and merger and acquisition (M&A) cycle. Past history and certainly the current crisis show very clear periods of high IPO activity followed by several years of low activity. Fig. 1.6 shows the monthly IPO deal flow for the period 1960–2011.

Fig. 1.5: Level of product markets



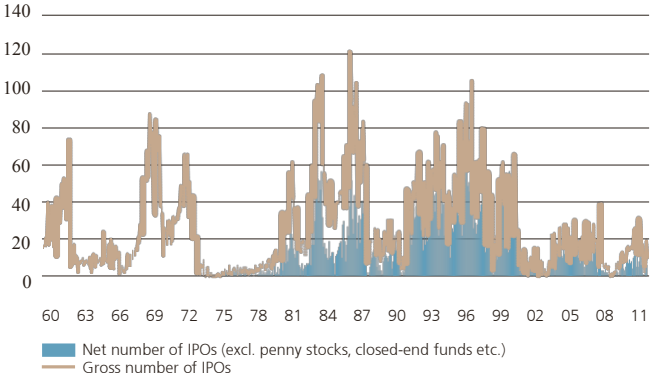
Source: Bayus 1994

While it is clear that that there are times of peak activity, owners should also be aware of emerging trends in corporate finance and sales activities. Private equity and sovereign wealth funds have developed into important purchasers of companies, which was not the case 30 or40 years ago. Strategic investors from the same industry or with a complementary business model, however, remain equally important as buyers. Well-financed firms have used the aftermath of the recent financial crisis to seize attractive acquisition opportunities to gain market share, expand geographically, or realize operational synergies. This has presented some interesting possibilities for business owners willing to sell their firm at a time when financial investors still face tight credit conditions. Thus, while the financial crisis has reduced overall M&A and IPO activity significantly, there are still a number of interesting opportunities for sellers of a business.

Low IPO activity does not conclusively show that one must sell a business when such IPO activity is high but, like stock market cycles, it does correlate with better credit conditions, higher risk appetite on the part of buyers, and generally higher valuation multiples. The credit crisis brought EBITDA multiples in Europe down very significantly (see box on page 10/11 for more details).

Fig. 1.6 shows IPO activity in the US from 1960 through 2011. Of course, predicting future IPO or M&A cycles with any certainty is impossible. However, they do occur with some regularity, and for owners with the ability to wait for the best financial outcome, it may be possible to prepare a sale well in advance and wait for the cycle to peak in their favor before initiating the process.

Fig. 1.6: The IPO cycle



Source: Ibbotson et al. (1994), updated data as of 2011

Family business and the debt crisis: "The game has changed significantly"

Stéphane Oury from the UBS Corporate Advisory Group and Yvonne Vértes von Sikorszky from family advisory discuss risks and opportunities in the wake of the financial crisis.

How do the debt and euro crises affect the valuation of family businesses?
Yvonne Vértes von Sikorszky: Transaction valuation multiples for small-cap transactions (> USD 250m) are down from the highs in 2007. The average EV/EBITDA transaction multiple achieved in 1H 2011 was 6.6x in comparison to 8.7 in 2007. We are back to average multiple levels seen in the period 2001–2003.

Generally one can say that the ability of corporate buyers to consummate mergers and acquisitions (M&A) transactions has seldom been as good as today, as company cash levels are high and debt levels have fallen over the past few years. Since margins are peaking and organic growth is likely to become harder to achieve, there is a strong strategic rationale for corporations to invest in M&A. On the other hand, confidence is falling, which may deter planned M&A moves. The uncertainty has an impact on new activity, especially public stock market deals.

Can one make valid general statements, or does it depend on the individual situation of each company (sector, market)?
Stéphane Oury: Deals occur across many different industries. In 2011, the sectors most active in M&A in Europe were Industrials, Financials, Telecom, Energy, Healthcare and Consumer Products. We expect defensive industries to gain importance in the coming months and in general, consumer-oriented companies will be more affected by the anticipated decrease in consumer consumption.

Overall, one can say that each company has its special situation, depending on factors such as quality of the management, business models and financial situations.

How much does the uncertainty of the economic situation weigh on planned sales of businesses?
Yvonne Vértes von Sikorszky: Solid, family-owned companies are still in high demand. As explained above, strategic buyers have the necessary means to make significant M&A moves if the right company becomes available. Private Equity companies also have "dry powder" from recently raised funds, which needs to be deployed, albeit with less potential to leverage their transactions than they had in the past. Financing is still available, though more expensive and difficult to obtain. The mid-cap M&A segment, with transactions ranging up to one billion euros, is less dependent on credit markets.

What one can say, however, is that we are experiencing less of a seller's market. Therefore transactions have to be better prepared and marketed to meet the criteria of sophisticated buyers in terms of superior investment case, transparency and strong management. If a company has issues, they need to be addressed up front in pre-marketing, and frequently the principals are engaged in transaction discussions and pre-marketing much earlier.

The current environment creates opportunities for strategic investors able to invest anti-cyclically. Businesses that were not available before may now be open to a discussion of joining forces with a strategic partner.

In this environment, is it easier to sell a business privately than through an initial public offering (IPO)?
Yvonne Vértes von Sikorszky: Exit alternatives are becoming more limited for shareholders. The currently large pipeline of postponed or canceled IPOs demonstrates the difficulty of raising capital or exiting investments through the equity capital markets. The sale of a business may be the more realistic exit alternative at the moment.

Do a lot of people reconsider their plans to sell?
Stéphane Oury: We see cases of clients who have decided to put the process on hold until the credit market restarts and the window reopens. In other situations, owners take the decision to move ahead, as there are strategic or financial investors with funds available and strong interest. We also see distressed sale situations, when shareholders have little option but to seek a strong financial or strategic partner. Given the current market uncertainty, the role of an advisor is even more important. Before launching a

sales process, a careful analysis is critical to assessing likely buyer interest, availability of funds, company-specific situations, sector outlook and shareholder objectives. Based on these factors, a realistic view of the sales process can be developed.

What do you advise people to do in this environment?
Yvonne Vértes von Sikorszky: For companies with a solid war chest, it may well be an interesting time to reassess the business model, and if possible, take advantage of competitors' potential difficulties by buying assets at discount prices that would make strategic sense. If an owner plans to sell his/her company in the future, now is a good time to work on fine-tuning the investment case. Industries are constantly changing and there may be a need or an opportunity to acquire a competitor, adding additional capabilities. The entrepreneurs may also need to reshape their companies to cope with a significant decrease in activity levels, retain key staff and manage the company out of the down- ward cycle.

Are there a lot of people willing to buy now?
Stéphane Oury: As we mentioned above, each sector and company-specific situation has to be addressed individually. There are industrial companies with good cash reserves that profit from the current crisis to acquire competitors that were not approachable before, or to complement their product portfolios. Private equity funds still have appetite for good acquisitions, and have "dry powder" (available undrawn equity). Many of them are currently focusing on man- aging their company's portfolio and shaping them to enter the turbulent time ahead. But whether it is an industrial or a financial acquirer, future acquisitions will be done with reduced debt level ratios, which in turn will affect transaction prices paid to exiting shareholders. In any case, the period ahead of us will create opportunities for selective and long-term oriented investors.

Stéphane Oury* leads the team of the Corporate Advisory Group in Geneva. In his 14 years in the field of corporate finance, with PricewaterhouseCoopers and UBS, he has acquired solid experience in advising entrepreneurs in the process of divesting their stakes in family-run businesses, and has specialized in valuations and M&A processes for small to mid-size companies (enterprise value CHF 10 to 250 million).

Yvonne Vértes von Sikorszky* works in family advisory in Zurich. She has more than 20 years of experience in corporate finance transactions, working in many European countries. Prior to joining UBS in 1995 she worked for Booz Allen Acquisition Services for nine years in Paris and Munich.

* These authors are from units outside Wealth Management Research. These units are not subject to all legal provisions governing the independence of financial research. The "Directives on the Independence of Financial Research," issued by the Board of Directors of the Swiss Bankers Association (SBA), do not apply.

Factors related to the timing of a sale

There are cycles that affect a business and the business owner. Yet, while they may provide direction and guidance about what an owner must monitor as the business grows and a sale becomes a desirable scenario, these cycles cannot be relied on to provide the final advice on timing. In fact, markets and buyers will often have more control over the exact timing of a sale than an owner ever will.

An unplanned or forced sale is a worst-case scenario that sometimes cannot be avoided. It may often be driven by the unexpected death of the owner, a principal partner or major shareholder. Unexpected personal financial stress may also force a liquidity event, raising the importance of and the linkage between the business and the owner's personal affairs. Without a carefully designed personal plan that has taken the business position into account (and worked to keep it separate) when investing personal assets, a market crisis can cause losses that end up forcing an owner's hand regarding the dis- position of the business. In almost all cases, any type of unplanned or forced liquidity event will reduce the final valuation obtained and limit the range of options for both the owner and the business.

As we will discuss next, one of the most important strategies for any business is planning for the unexpected, or for different scenarios that have variable likelihoods of occurring in the future. The objective is to reduce unplanned events to a minimum by actually planning for them. While this may seem obvious, we are often surprised to hear that basic planning gaps still affect even the most successful business owners and their families. Nevertheless, planning will only go so far, and even the best-prepared businesses and families may still encounter situations that require unexpected strategies, or which may not result in the best outcomes.

Planned sales and exit strategies ideally begin years in advance – in our view, on the day the owner starts a business. Control over the timing of the liquidity event and achieving the best-possible sale terms – a combination of the best valuation and the best-fit sale as the owner sees it – are usually maximized through thorough preparation. Yet timing will ultimately be driven by any number of factors, determined by the owner to the extent that he or she can (see Fig. 1.7). Some of the timing factors include the following:

1) **Personal wishes:** For some owners, wanting to get out of a business may override all other financial or even family objectives. The trade-off will likely be a lower sales price or a sub-optimal deal structure. In the view of many deal advisors, it is buyers and the market that control timing of sales more than the seller does. Personal needs can and often do change quickly, becoming the primary reason for the nature and timing of the sale event.
2) **Tax optimization:** Certain liquidity events, in particular divestiture of stock options, often involve contractual obligations that require action within a certain time frame, or external factors like tax or legal regulations may require a sale or dispersal by a certain time. Impending changes to tax, legal or compliance regulations may also create conditions that necessitate a sale, open a window of opportunity, or close one, so owners and their advisors must monitor the overall regulatory landscape for such situations.
3) **Interest rates:** The interest rate environment is critical to timing because it affects buyers' ability to generate return on investment (ROI). The lower the interest rates, the lower the cost of most financing and thus the hurdle for positive ROI. Low interest rates generally correspond to weak economic conditions, but premium buyers – those with strong financial balance sheets and the ability to access capital – often take advantage of poor economic conditions to grow.
4) **Buyer timing:** Public companies actively seek acquisition candidates in order to deliver profits and strategic growth opportunities demanded by shareholders.

Micro-timing

There can be many questions related to the big-picture life or family context. These include: "Will I (ever) sell the business? Does the family need to sell or does the business need capital?" The need of the owners will usually crystallize into one of three outcomes:

Fig. 1.7: Cycles and timing: Understanding your unique development context

Source: UBS WMR

1) Keeping the business, where subsequent decisions involve managing owner or investor-owner options.
2) Open up to outside shareholders, resulting in an IPO, a merger, or a financial or strategic partnership.
3) A complete exit from the business.

Once the decision is made to seek a sale or liquidity event, the issue of timing needs to be considered. Here, we look at the timing related to 100% sale of a business via an M&A transaction, or the partial sale event via an IPO.

The process typically includes several phases (see Fig. 1.8). The preparation phase includes due diligence investigations of both the seller and bidders. An information memorandum or another type of selling document is created, and data processes and documents are created and reviewed for completeness. Confidentiality during the sales process is also considered and secure guidelines of communication and information control are implemented. In general, preparation can last from six to eight weeks.

After the preparation phase, an information memorandum is distributed to potential buyers. The focus here lies on finding the right potential buyers while preserving confidentiality. Typically, M&A consultants and investment banks have the necessary intelligence and expertise to identify appropriate strategic buyers or potential financial investors. These potential buyers are then presented with the information memorandum and asked to provide indicative bids for the business.

The business for sale will then be screened in a second phase in a full bidder due diligence process in order to assess the validity of the bids. In this phase, which typically lasts six to eight weeks, both sides can get a better insight into the potential deal. The buyer in particular will be able to assess the opportunities and risks of the acquisition target and will eventually have to decide whether they want to offer final bids for the business and enter the negotiation phase.

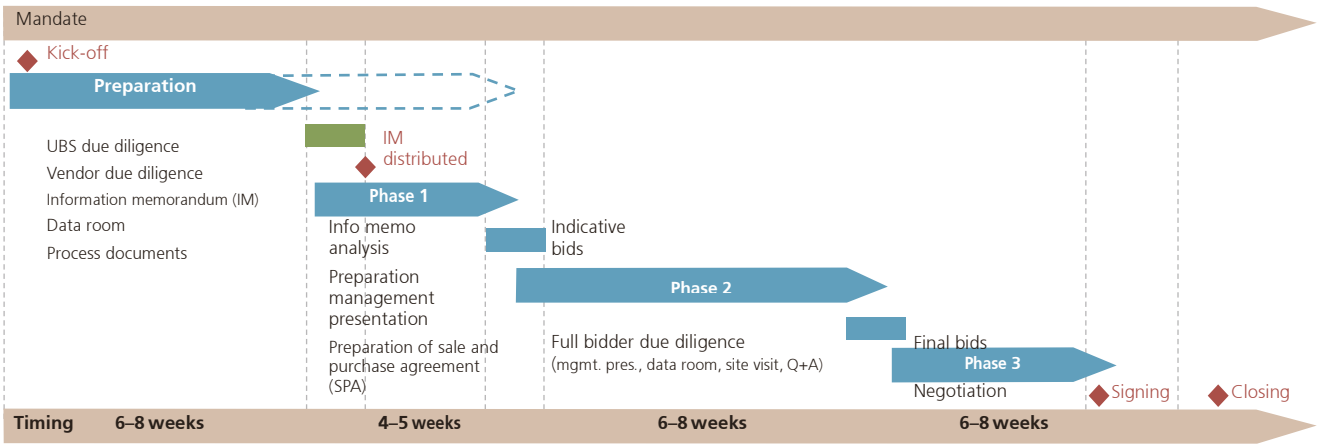
The final stage, then, is the actual negotiation between seller and potential buyer(s) with the aim of signing and closing the deal. The overall process typically lasts about six to eight months but may take much longer in some circumstances. The use of professional advisory teams is highly recommended throughout the sales process because of the high degree of complexity and the specialization needed in today's business and regulatory environment. Experienced advisors may well be able to find the most suitable buyers and negotiate the most favorable terms of sale for the business owner.

From the beginning, the owner should be prepared to consider a sale.

Preserving choices through prudent planning There are two ways to view a liquidity event. One is to consider only the possible financial outcome; another is to consider the personal utility perspective, which considers the degree of overall personal benefit as uniquely defined by the individual or family involved. Combining the two perspectives is the goal of every transaction. More often than not, there will be trade-offs between personal needs and optimal financial value.

Preparation for a liquidity event should focus on preserving choices and flexibility that in the end maximize opportunities. At its core, preserving choices is about timing.

Fig. 1.8: M&A structured disposal process



Source: UBS WMR

Almost any type of wealth transaction, theoretically at least, has a larger range of choices and options the earlier it is considered. While the eventual course of affairs will necessarily hinge upon any number of events, the biggest mistake that owners and families make is not considering what they could lose by simply waiting for an event to become a high probability before they begin planning for it.

Exit planning at entry

Potential exit strategies can play a role at the outset of a firm through the choice of the business's form. Factors important to the business-form decision include its capital structure, liability protection, tax structure and flexibility, management and control. The last thing on a business founder's mind is usually an exit strategy or a sale, although a growing trend among younger business people is a shorter time frame for the business, or a "serial entrepreneur" mentality.

The "what if" approach to business development and risk management

Our primary planning message is that no matter how remote the sale event may seem, the potential for an exit must always be a part of managing the firm. From the beginning, the owner should be prepared to consider the likelihood of a sale, establishing a special review processes that asks a central question: "How would X (a tax process, ownership structure, financing arrangement, compensation or benefit scheme) affect a sale?" Most business owners consider exits when setting up insurance packages or buy/sell arrangements designed to handle unforeseen circumstances such as the death of an owner. However, the focus on growing a business often pushes contingency planning to the side. One way to avoid this is to include a sale, merger, IPO or other liquidity event scenario in a comprehensive risk management framework. Especially as a business grows, developing a rational process to assess myriad internal and external risks and opportunities is essential. Risk management creates and reviews a system of controls that poses questions about a variety of potential scenarios and considers all aspects of business operation in light of them.

Comprehensive risk management will go beyond the business and include the owner's perspective and eventually the family's perspective as well. The owner will have to undertake similar scenario planning with regard to both business and personal financial affairs. A considerable problem for family businesses is the eventual intermingling of the family's financial affairs with the business's finances. For example, it is not uncommon for the tax and legal experts used by the businesses to end up having a central role in the personal finances of individual family members. While this can work for a time, it can also be a complicating factor in a liquidity event and may even cause conflicts between family members or with company employees.

From a negative risk perspective, this is a good example of the what-if planning mechanism we advocate. The mixing of personal and business affairs is almost a necessity for a single-owner business, especially when the business is young. But a risk-management review framework would already recognize the issue as a potential problem. By identifying the condition as a risk, it can be monitored and mitigated or dissolved once its usefulness has passed or its risks have increased. Any number of scenarios could be managed under the risk-review framework; ideally it should be built to suit the unique needs of the business and the style of the owner. Its primary task is to buy time for the owner by flagging potential issues well before they become problems that demand urgent responses. In fact, a risk management approach strives to minimize ad hoc planning as much as possible, although uncertainty will always remain. More often than not, the development of risk- review processes is driven reactively by bad experiences (the small business owner begins to scan checks only after first losing a batch in the mail, for example, or employee risk is managed only after the first lawsuit has been filed). This not only wastes a critical resource, time, but reduces rather than preserves choices.

For some businesses, an annual strategy session, where risks and opportunities are reviewed in a rigorous manner, might be all that is needed. For others, or based on findings in a yearly review, consultants may be needed to help owners understand their options or suggest new strategies and techniques.

Consider the issue of the M&A cycle and the business valuation. Since a sale is often dependent on external conditions, meeting with an M&A advisor who has extensive knowledge of the markets and who may also be able to suggest the potential valuation of the business can provide an owner with valuable information. While no decision may yet be at hand, the owner should gain timely information about the marketability of the business and the current conditions in deal-making and finance.

Confidentiality

There is one essential element that applies to almost all aspects of a liquidity event: confidentiality. This is clear from a business perspective; competitors, employees and managers all have their own vested interests. Information leaks at any stage can harm the business, either competitively or at the relationship level with employees, suppliers and customers. Once a sale has begun, information control mechanisms must be an integral part of the process. However, during the pre-sale period of a business, information related to, or that could be perceived as indicative of, a sale must be carefully controlled.

One of the reasons for the importance of confidentiality and the tension between it and the type of risk management we advocate is that each business phase can demand conflicting strategies. For example, when developing a business, tax minimization is generally a clear priority. Often, this requires presenting financial statements and asset values at their lowest market values. However, when selling (especially when estate tax issues are important), showing the highest values is obviously preferable. As important as it is for business owners to assess what the realistic market valuation for their business is on a regular basis, a formal valuation document should be the basis for a tax liability (see box on page 16).

Conclusion

A liquidity event of any kind is a complex matter that involves a full range of personal, business, wealth management and family concerns. Striving to balance and harmonize every detail of an event – from its timing to its structure and finally to its overall impact – should be the goal, acknowledging that full control of every detail is probably unachievable. Preparation and planning are absolutely essential to the successful execution of a major liquidity event. The earlier a business owner undertakes the thoughtful preparation and planning of potential exit scenarios, the better the outcome will be, even if it is many years in the future. Uncertainty and surprises will remain the hallmarks of both business and personal life. Education, preparation and communication, in the context of a sound risk management frame- work for the business, and eventually carried over to family governance and communication structures, can help business owners negotiate the complexities of a deal and achieve their personal goals.

Skeletons in the closet: planning for exit while focused on growth

Building a business into a valuable functioning concern takes years. Yet the strategies, contracts, and relationships that were critical to developing the business can become the proverbial "skeletons in the closet" at sale. The perceived value of a business by a demanding buyer may be at odds with the perception of the owner, especially one who has been deeply involved with its creation (see the discussion of the endowment effect in Chapter 2 for more on the behavioral underpinnings of ownership). Any business, however, can suffer from issues that, although insignificant to the daily business and ongoing management of the firm, may seriously complicate sale negotiations, leading a potential buyer to demand a lower valuation or purchase price.

As a business grows and becomes more complex because of its increasing scale, whether in terms of its operations or more diversified ownership, the risks of problems at exit also increase. Preparation for a sale, through the scenario analysis and risk management techniques we describe, is one way to ensure that there is a solid exit plan, or that specific issues have been managed with regard to the possibility of a sale. Once a sale is initiated, the due diligence process will help discovery and control of issues, but options by then will likely be more limited.

The nature of specific legal and ownership matters depends upon the domicile of the business. In addition, each business has its own unique circumstances. However, to help owners gain a general understanding of what to look out for, we spoke with Jordan E. Dolgin, a partner at Wilson Vukelich LLP in Toronto, Canada, who has extensive experience with mergers and acquisitions as well as business sales at all stages of the business development cycle.

He underlined several critical legal issues that he has seen impact business sale events, either leading to a lower selling price, a more complicated negotiating process, or even the failure of the deal itself. The issues relate to three distinct areas: ownership, control, and financial or tax concerns. Dolgin has encountered a variety of problems in these areas, including:

- Share issuance to outsiders (former employees or consultants, for example) who cannot be located at sale, causing prospective buyers to worry that they will be unable to purchase the entire business.
- A lack of shareholder agreements with minority owners that contain provisions allowing majority owners to force a sale, again resulting in a purchaser being unable to buy 100% of the firm.
- Lack of separation of real estate assets from a holding company when the sale of the holding company is desired, but the sale of the real estate is not.
- A failure to secure ownership of intellectual property developed by external or independent consultants.
- Former employees who see a sale or merger as an opportunity to bring lawsuits against the firm.
- Tax issues that were appropriate in the context of the business many years ago, but that may lead to tax liabilities under the audit conditions required at sale.

We stress that early awareness of these issues and adequate preparation for an eventual sale could have prevented or at least mitigated their impact. Even at sale, several options usually remain to help improve the situation, but flexibility is maximized when the business's management has maintained a long-standing exit preparation as a parallel initiative. As a part of preparing for the legal aspects of a sale or disposition event, Dolgin recommends eight best-practice steps. He advocates firm control of:

1) Share capital
2) Key contracts
3) Assets
4) Corporate structure
5) Tax risk
6) Opportunistic litigation
7) Regulatory issues
8) Legal and compliance risk

Source: Dolgin (2007)

The *personal aspects* of a liquidity event

Highlights of Chapter 2
For a business owner, the transition after selling a business not only hinges on the sale and its details, but also on personal and emotional challenges. Questions about family interaction and identity also emerge.

In this chapter, we focus on the personal dimension of liquidity events that often may dominate professional or financial considerations. We focus on the problems of moving from one identity to another, how emotions may run high and interfere with the transition process and how family members may be challenged to adapt to new circumstances after the sale of a business.

Introduction: Be prepared for the unexpected
John Lennon of the Beatles famously dropped out of his business, recording, to spend five years with his young son. His song "Watching the Wheels" cannily describes the common reaction of others to the famous musician leaving his passion behind: "Surely you're not happy now…" captures how not only personal identity but also the perception of others often play a central part in the liquidity event transition. These issues are central to the personal dimension of the event. Anyone who encounters a liquidity event will naturally develop their own way of handling the personal aspects of transition, but almost everyone will benefit from taking the time to carefully consider the potential impact of the wealth event on themselves and on their family. In our experience and the experience of family governance and M&A experts, more problems stem from family and personal issues than any part of the professional, deal, or investment aspects which are usually the top priorities of the business sale process.

The succession of a family business does not follow a predefined pattern:

- **Pleasure:** F.W. is in his mid-forties. He started a business almost 20 years ago and now feels like doing something else. He and his partner decide to sell their IT business.
- **Father and daughter:** The owner of a trading company, 69, which the family has owned and managed for six generations, sees his future plans shattered when his only child, a daughter, falls in love while studying abroad, decides to marry and not return home. The father never talked about succession openly with his daughter. Now he has to find another solution and has to do so rather quickly.
- **Destiny:** The manager of a watch company started by his grandfather dies suddenly in his forties. His father, who made a big business out of a small one, had always planned that his son would take the company to an even brighter future. Now the family sells the business because there is nobody in the immediate family who can lead it.

These examples show how plans for an enterprise succession cannot always be realized. For the people involved, and their families, it is important to openly communicate at an early stage what one expects or hopes. Implicitly assumed scenarios very often create misunderstandings or stress for all concerned. Talking about possible scenarios creates a clearer picture and gives everyone involved a chance to contribute to solving issues and conflicts in an optimal way. Indeed, early communication may forestall problems from the outset.

Most founders of successful firms want to bequeath their business to the next generation. However, there are instances when this is not possible, as our examples show. The business could reach a stage where the family is no longer the best option for its continued growth, or children may not be able to or be interested in taking over the business, or there are no children, or there is a health issue.

While entrepreneurs may wish to hand over their company to family members, in reality this happens only in about half of cases. In Germany alone, there will be 110,000 small and medium enterprises (SMEs) up for

succession each year between 2010 and 2014. In less than 44% of the cases, the succession is realized within the family, according to the Institut für Mittelstandsforschung in Bonn. Similarly, a survey by White Horse Advisors in the US recently showed that 53% of US baby- boomer entrepreneurs plan to exit their business within the next 10 years.

Selling your family business is a once-in-a-lifetime event. You are dealing with the work of a lifetime or even beyond, if you inherited the firm from your parents. It is thus all the more surprising how many entrepreneurs do not gather in-depth information on the question of succession. According to a survey by the IMD business school in Switzerland, in half of the cases where succession is an issue, the question is not tackled in a timely manner. In the US, according to Peter Christian, founder of the Exit Planning Institute, 75% of all company owners have no succession plan. A study carried out by White Horse Advisors and Vintage International in 2008 saw 96% of baby-boomer company owners admit an exit strategy was important, but 87% did not have a written plan.

A study in Switzerland concludes that annually 3% to 4% of the 310,000 SMEs (9,000 to 12,000) are dealing with the question of succession either in the management or the ownership sphere, or both. These figures show that even if few people are dealing with the question of succession now, sooner or later a lot of them will be facing the issue.

In Switzerland, in half of the cases where succession is an issue, the question is not tackled in a timely manner.

In this chapter, we focus on an often underappreciated dimension of succession: the personal impact a liquidity event may have on a business owner and his family. Because many business owners and their families often do not put enough emphasis on dealing with psychological and emotional stress before and after a liquidity event, many business transitions have failed and companies as well as families have been severely damaged.

Thus, the personal dimension of a liquidity event is important. We first focus on the business owner and show how a business transition may start a process of defining identity and untangling the different roles a business owner inhabits. Only if these roles and the identity of a business owner have been made transparent can the process of transition (from business owner to retiree or wealth owner, for example) be structured in a way to simplify and support the formal sale of the business. Within the role-transition process, the ceding of control over the business is a common problem that we will focus on in some detail. Finally, we will analyze the challenges faced by family members of the business owner and how they are personally impacted by the liquidity event.

Begin with yourself: The question of identity

Business, entrepreneurship, deal-making. These terms all conjure up images of finance and money. It is rarer that they are associated with well-being, personal satisfaction, and personal identity. Yet a business is never just a financial enterprise, though the most important sign of success is generally financial viability. A business provides a product or service, jobs for both employees and suppliers and in most cases becomes part of the fabric of the community where it does business.

Yet for the owner or founder of a business there is also something more fundamental: The business often plays a large role in personal identity. Work is a central part of any individual's life, but for a business owner, these ties can be much stronger, more personal, and more profound. A business activity may provide far more than wealth; it is for many a passion, and therefore makes the business owner closer to an artist than to a paid professional. Successful entrepreneurship may also bring significant personal status and even media attention, to both good and bad effect.

The experts and advisors we interviewed in the course of researching this study all talked about the personal side of a liquidity event as the most neglected by the owner or family. Although elation and feelings of freedom and success often follow a successful sale, it can also leave individuals suffering from depression, lack of direction, or with no clear outlet for their skills and energies. The effect of the change from overseeing an enterprise with a generally high annual rate of return to now overseeing even a large personal fortune opens up issues related to personal competency and the effects of wealth on children, among other topics. Of course, if the owner was pursued by business brokers beforehand, every type of money manager will be calling now. The role of social networks and the selection of advisors are also part of the transition process.

Everyone has a unique approach to a liquidity event, through the combination of the deal's structure, wealth and investment needs, and family relationships. While planning and preparation are important, it is also important to create a process that fits your personal style and that of the family. What is for one person a

well-thought-out sales process that includes psychologists, wealth coaches, family counselors in addition to financial advisors, is for another an over-engineered process that does not work for them. Because of the rarity of successful businesses relative to the number of initial startups, and thus of wealth-owning families, each one is essentially different. There are no one-size-fits-all services or structures, processes or strategies. That said, business owners and families have no better resource for understanding the range of issues than other business owners and families (see interview on pages 20/21 for the view of one successful entrepreneur).

Identity: Self versus societal expectations

Who are you? This simple question frames the depths of human experience, but we are not suggesting that everyone must write a philosophical text about themselves. Some business owners and business-owning families may even find the idea to explore their identity in-depth intrusive. Yet the centrality of identity cannot be dismissed as part of the liquidity event process. Like it or not, the role of business owner, entrepreneur or chief executive has been mythologized in nearly every culture – one could even argue that entrepreneurs have reached a zenith of social status in recent years. However, the stereotype is not necessarily universally favorable; the entrepreneur is seen as multi-faceted, with positive attributes offset with less favorable characteristics. Fig. 2.1 shows visually some of the major qualities often associated with business owners. As researchers have written, "the entrepreneur is a complex figure in our cultural mythology: part adventurer, and part misfit, part benefactor and part exploiter, part genius and part fool."[1]

Wealth and business success are not only personal processes of the individual, but also social processes that include group or role membership, status, and expectations. The transition from a business-owning individual or family to a family of significant wealth is not merely semantics, but deeply transitional – at many levels – for all involved.

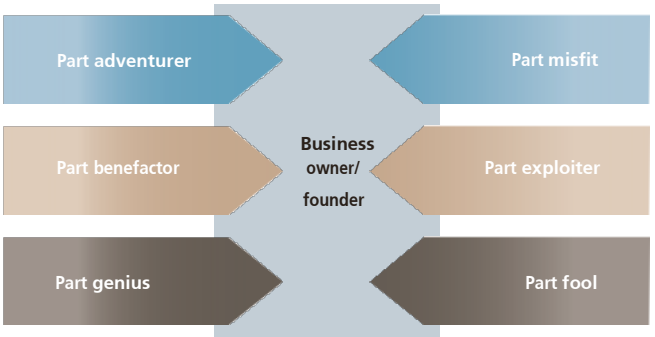
So, who are you? A business owner might answer: "I am a business owner, I am an important member of my community, I am an innovator, I am an employer," and so forth. Each answer defines a role and an identity. Identity is partly a personal construct, but also created by the perceptions and expectation of others.
For the successful business owner or executive, a central issue is the status they have achieved. Even if, at the personal identity level, the individual remains his "true" self, society will make its own assessment, often publicly. A side-effect of significant business success is personal fame and media attention, which brings its own risks. Among other unwelcome consequences, it can lead to increased personal security risks for the family. Business success can also potentially skew a healthy self-apprecia- tion, a development captured in the adage "don't believe your own press."

Success magnifies the issues related to transition, and therefore a personal assessment can be a part of the liquidity event process. It is up to the individual how formal or professional they want to make it. Psychologists who specialize in the needs of the wealthy could be considered, and many extremely successful business people and executives make use of them, but for others, considered reflection on the issues of identity and self may be enough. Discussions with family members, close associates, or other business owners who have been through a business exit or liquidity event may also be beneficial.

Role relationships: Untangling the business, family and ownership web

A well-respected framework for helping business families understand the nature of their intertwined roles and relationships is the "three-circle" model, developed by Renato Tagiuri and John Davis at Harvard in the 1980s. It can help at any stage of business and family development, none better than during change of control or management events such as the sale of the business.

Fig. 2.1: Cultural mythology of the business owner/founder



Source: Gersick et al. (1997)

[1] Gersick et al. (1997).

"When I turned off the light it fully hit me"

F.W. is happy he sold his business, but there are some things he would do differently.

How did you build your business?
F.W.: I started a company in 1990 building special equipment that processes voice and video. We developed software and network management.

How many people worked there and what was the revenue?
F.W.: We employed about 400 people and revenue was in the USD 50 to 70 million range.

When did you start thinking about selling your business?
F.W.: One year before I sold it, in mid-2007.

How did you proceed?
F.W.: For quite some time I had been getting a lot of calls from different brokers. I ignored them. However, at some point I decided that I wanted to do something else. So I returned the calls. That started the process.

How did you choose the broker?
F.W.: He was working for our bank, which has a specialized division dealing with the sale of businesses. They already knew our business. They helped us put together the documents describing who we are, what we do, who our clients are and what our financial situation looked like. They looked for potential buyers and selected the ones that were possibly interesting for us. The bankers organized the meetings and sup- ported us during our presentations. With their help, we made a few adjustments and finally got a few offers. We looked at all the papers and picked the best offer. This was not the highest offer, but the one my partner and I thought would best match our philosophy, and be the best for our employees.

There is the financial side of the deal. You had to determine whether your business would sell at a price you wanted. And then there was the emotional aspect of it. Were you ready to sell your business?
F.W.: The funny thing is that I thought I was ready. It took some time to close the deal. But when I realized that we were about to close, and I happened to be the last person to leave the office one night, I turned off the lights and it fully hit me that I was going to leave. Frankly, I got very emotional. At first it was hard, but since then I have moved on.

What was the hardest decision you had to make in the whole process?
F.W.: It was the ultimate decision – whether to stay in the business or not. I did not want to stay, but it is hard to leave a business you started and developed successfully. At the same time, my partner and I could have sold the business at a higher price if we had waited a little longer, but I was ready to go.

Looking back at the whole process, are you satisfied with the way it worked?
F.W.: Absolutely, I am satisfied. However I would work closer with a business partner and sell the company to a strategic partner who already knows us and the company. This way, the transition would have been much smoother. There would have been fewer surprises and the due diligence process would have been easier.

What would you recommend to someone in a similar situation?
F.W.: I really would recommend looking for potential buyers who know you, because the less time you have to spend telling them who you are, the better the chance that you will get a good deal. The deal has a lot to do with risk management. The buyers are putting the price in relation to the risk they are taking. If the buyer knows and trusts you, both parties end up with a better deal.

Would a management-buyout be a valid option?
F.W.: If you have managers who are able and willing to buy the business and who can raise the money, then it is definitely an option. However, in the current environment, it is difficult to secure the financing. We did the deal right before the credit crunch became an issue and it was almost an all-cash deal with only a small part as an earn-out. A stock deal is too risky. However, every case is different.

Are you still attached to your business?
F.W.: No, I am not. I made a clean break. I see some former employees once in a while. But my new challenge is to start another business.

Do you already have something in mind?
F.W.: Yes, I am very aggressively pushing a business now. It keeps me busy. I prefer to start my own business and not buy an existing one.

Are you more involved in managing your wealth?
F.W.: I am much more involved in managing my financial assets. Before the sale, the assets were mostly invested in my business. Now, it is a completely different matter.

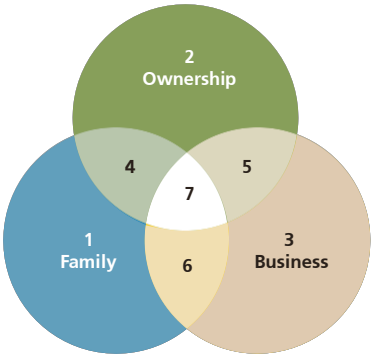
As Fig. 2.2 shows, the three major aspects of a family business are the spheres of the business, the family and of ownership. Any individual can quickly be role-defined, depending upon their activities and the development stage of the business and the family. In a single- owner situation there may be no family, at least for a time. By the time of a major liquidity event or restructuring, there are usually much more complex, and communication issues at the root of most conflicts.

Consider the different role relationships for various members of a family or employees of a business. The owner or founder who manages the business inhabits zone 7 and has the roles of shareholder, family member, executive and employer. A member of the firm's management team who may also own shares would be in zone 5, where the roles of ownership and the business overlap. An in-law who marries a family member and works in the firm is in zone 6 if they do not have any ownership stake.

This model is particularly effective when tough decisions need to be made either by the family or the business. Tagiuri and Davis suggest that the three-circle framework helps identify the lines of influence each role may have on an individual's point-of-view, thereby helping others better understand the nature of their position.

Role identification can also help individuals "change their hats," that is, enable them to understand how things might look when viewed from different positions. This can be especially relevant for founders. They must balance the needs of the business, those of family, and employees and management, with these dimensions often intertwined. One case fairly common for founders relates to their children's employment and performance in the business. With a parent's hat on, one wants to ease the path for offspring. Viewed from the position of company executive, difficult choices must be made when objectively evaluating whether a child is a benefit to the firm. Hats must be changed yet again to assess the potential hiring of a child or family member from the point of view of employees; will they accept the individual or will the hire be perceived as nepotism?

Fig. 2.2: A family business interest framework



Source: Gersick et al. (1997)

Role exit: Stepping out of one role while defining the next

Life transitions such as those associated with a liquidity event have been analyzed by sociologists in terms of an overall process labeled "role exit." Role exits also apply in situations such as divorce or retirement, as well as more unusual situations, such as a nun or priest leaving their religious order.

Role exits have several phases. In a series of interviews with people who had undergone different role exits, it was found that people initially experienced a stage where they first began to doubt their current role and their commitment to it.[2] For the business owner, first doubts may be triggered by changes in the business or business environment, or personal changes such as burnout or perhaps divorce. For some, a general sense of wanting new and different challenges may produce the first impulses to sell a business or otherwise exit the role of business owner or chief executive. Psychologically, these doubts begin unconsciously and only gradually manifest themselves into tangible realizations. Emotional conflicts can be acute at this stage, as different needs and responsibilities begin to conflict: How can I abandon my employees? What will my family think? What will I do next?

In stage two, individuals become aware of some options and choices available to them as potential "exits" from the current role. For a business founder, family succession and sale often emerge as legitimate alternatives. Succession may be the business owner's preference and the sale option only manifests after family members reject succession, or are not in a position to take over the business. Emotionally, many people begin to feel significant relief at this stage, as they sense the real options they have. The focus on a "life beyond" grows and helps begin the psychological adjustment to new roles after the exit event.

In the third stage of role exit, a turning point is reached. Awareness increases that the old role is no longer fulfilling, and the individual comes to acknowledge this with some degree of finality. The new opportunity challenges the individual and focuses their energies. For business owners, closing the deal or receiving the liquid funds usually marks the clear shift from the personal identity "before" and "after" the event. The sale is a symbolic event and serves three functions for individuals: It reduces cognitive dissonance, or the conflicting thoughts or tensions regarding the transition; it presents the opportunity to "go public" with the role exit or decision to others; and it helps mobilize the psychological and personal resources needed to exit from one important stage of life and identity to another.

The final stage of the exit process is the creation of an "ex-role" status. Someone who has built a business and sold it is now identified by the world at large as an "ex-CEO."

Every transition event is unique for each individual. For some, personal fulfillment will actually involve numerous transitions; for others, the transition itself is fulfillment. However, for most people, the sale of a business, or any other major liquidity event, will be a once-in-a-lifetime occurrence. The full meaning of the experience will be theirs alone, but the unique nature of the transition process will be shaped by no less than 11 core parameters of the role exit process:

1) **Reversibility:** Does the sale of a business result in an irreversible transition for the owner or the family? A business owner who can create a subsequent business has greater exit reversibility than one whose sale is related to aging. The less reversible the role exit, the more difficult it can be psychologically or from a personal perspective.
2) **Duration:** The duration of a role exit process encompasses the length of time from the first doubts to the actual exit event and on to the adjustment to the new status. Role exits that are less reversible tend to take longer than those that are more reversible.
3) **Single versus multiple exits:** How many roles does the exit event involve? In the case of a business owner, there are probably several roles at stake, including that of owner, CEO, and community and family leader. A business exit, as opposed to a liquidity event that only involves selling a concentrated asset, is significantly more complex at the psychological level.
4) **Individual versus group exits:** If the exit event includes a group of people, such as the buyout of a management team, or, in the case of an extended family, the exit process can be positively affected. "Cohorts" can be a sounding board for members and broaden the perspectives available on the impending transition.
5) **Degree of control:** Exit processes are also affected by the degree of control the individual has over the exit event. An unplanned liquidity event may therefore be more disturbing or arduous than one where more planning has been done or where the timing and nature of the event is not unexpected.

[2] See Ebaugh (1988) for more details and background on role exit.

6) **Social desirability:** Role exits are social phenomena and therefore the role identity is partially shaped by external (societal) definitions and expectations. The social desirability factor is the degree of social approval, or disapproval, of the particular role exit. The more successful a business or the more well-known an entrepreneur, the more external pressure or expectations there may be for the individual. In general, liquidity event transitions do not suffer from social undesirability compared to other exits, such as divorce or illness.
7) **Degree of institutionalization:** As with desirability, the degree of institutionalization relates to how extensive society's expectations of a particular role are. Retirement by a certain age is a societally institutionalized role exit; a widow who wears black for a set period after her husband's death participates in an institutionalized role adjustment process.
8) **Degree of awareness:** This refers to how aware the individual is in fact of exiting a current role and moving to another. This may be an important factor for business owners who focus on the business deal side of the sale of a business or a liquidity event and fail to consider the personal transition that is also at stake.
9) **Sequentiality:** The sequence of certain events along a path of role development can trigger commitment doubts and begin the role exit process. Such a sequentiality may occur for the business owner with regard to the specifics of their business development. Capital financing and changes to the ownership structure over time – for example, where a firm has brought in minority interests or gone public – may trigger events that create doubts in the owner about his or her role in the company and may ultimately lead to a sale.
10) **Centrality of the role:** The importance or priority of the given role plays a significant part in how difficult an exit may be for the individual or family. An owner who has dedicated herself or himself 100% to the business, and whose primary identity is linked to it, may find the role exit process more difficult and should, therefore, do more to prepare for this transition. The same is true for a family that has been linked to the business for several generations – the longer and deeper the connection, the more central the role to identity, either personally or as family.
11) **Voluntariness:** Similar to the degree of control, the voluntariness of the role exit plays a significant part in the difficulty or ease of a role transition process. A good example would be a family business sale where a cooperative decision to sell overrides individual desires of particular family members who would not sell if the decision were theirs alone.

Preparation for the role exit process involves "becoming aware of and anticipating as many consequences as possible."[3] Business owners, or anyone else anticipating a liquidity event, should consider the process in terms of the personal issues related to self-identity and personal needs; the family dimension of how both the group and individuals will be affected; the financial and wealth management implications, both before and after the event; and finally, the business dimension.

The difficulty of giving up control

For an entrepreneur, looking for a successor, selling the company that in many cases he or she founded, and dealing with liquid wealth from the sale of the company are all unfamiliar tasks. The retiring or selling entrepreneur also has to deal with the fact that "his" company is not his anymore and that he may have no authority to shape the future development of the business, nor guarantee the jobs of his former employees. The probability of conflict with someone over these questions is even higher if the successor-owner or manager is a family member. Family relationships persist, while "strangers" are more easily removed from the picture again. "In most cases, it is challenging for them to let go once they are no longer involved." says Jenny Tresch from UBS, who frequently consults wealth owners on family governance and strategic planning. "Their interest in the former business, as well as in the industry in which they used to operate, usually remains very high, even after several generations." (See interview on pages 24/25). This view is confirmed by a study of German business owners by the Institut für Mittelstandsforsc- hung (see Fig. 2.3). The inability to further control the company and fears about the future are by far the most prominent causes for a lack of succession planning.

Fig. 2.3: Reasons entrepreneurs often ignore the question of succession

Not being able to let go	38.4%
Fear of the future	33.7%
Repression	19.8%
No alternative occupation after retirement	11.6%
Misjudgment of the time it needs to realize a succession	7.0%
Lack of trust in the successor	4.6%

Source: Institut für Mittelstandsforschung

[3] Ebaugh (1988).

"For the next generation, it is crucial to define goals"

Jenny Tresch discusses the challenges of adapting after the sale of the family business

In your experience, how do entrepreneurs react when they sell their businesses? Do they ever run into problems adapting to their new situation?
Jenny Tresch: It very much depends on the life cycle of the entrepreneur and the importance of the business to him. For instance, a young entrepreneur who sells the business at age 35 or 40 is usually less attached to it than a founder in his 60s or 70s who has built the business from scratch and managed it for his or her entire adult life. Moreover, an entrepreneur running a multigenerational family business often has an even stronger attachment to it due to its place in family history, making it yet harder to sell. While the personal circumstances vary, the underlying challenges are similar. Entrepreneurs are frequently reluctant to think about the day when they will no longer be running the company. The process of selling a business is often all-consuming, so personal interests can get overlooked. Entrepreneurs often fail to decide in good time what they want to do next, and thus find themselves unprepared for life after the sale.

What do young first-generation entrepreneurs look for?
Jenny Tresch: Young first-generation entrepreneurs are often seeking new business opportunities and ways to manage their liquid wealth after the sale. Set- ting up a family office can help them achieve both objectives – managing the sale proceeds in the short term and finding new ventures to provide long-term growth. It has become increasingly common to run a family office as an investment company with external investors, or even set up a family-owned multifamily office. Such family offices do not just invest in financial assets, they usually acquire direct stakes in other companies as well, often in the same industry as the family business used to operate in. A family office can also play a vital role supporting the entrepreneur in the search for, due diligence and establishment of new business projects. It can provide a trusted talent pool as well an operational base for tackling new opportunities.

What about families that have owned their businesses for several generations?
Jenny Tresch: Families selling the business several generations later often find the sale process difficult because of the importance of the business to them. In material terms, it usually represents their largest asset and primary source of income. Beyond this, it is also a source of personal worth and family tradition. Family members are usually proud of being associated with the business, especially if it carries the family name. Such sales can be emotionally charged, especially because family members with different roles often have differing views on the best way forward. After a sale, these families have to look for new means to keep the family together, to continue its legacy and preserve its wealth over generations. This is often a reason to set up a family office to create a platform to manage joint family activities, such as philanthropic projects or family investments. Often special projects, such as new ventures, can reactivate the family's entrepreneurial spirit.

Can most of the entrepreneurs let go, or do they still want to know everything about the state of their former businesses?
Jenny Tresch: In most cases, it is challenging for them to let go once they are no longer involved. Their interest in the former business, as well as in the industry in which they used to operate, usually remains very high, even after several generations.

What is most important when planning for "after sale" life?
Jenny Tresch: It is crucial to define the goals and vision – not only for the entrepreneur but also for the next generation, and the whole family. Thinking about future plans, be it a new career opportunity or retirement, and discussing the impact of involved family members is important. How will they manage their personal wealth? Do they want to keep working together, investing jointly and building a family legacy? How can they keep the entrepreneurial spirit alive and pass it on to future generations? Prudent planning requires setting clear objectives, agreement with the core family and strong family governance structures.

Are there patterns in how business owners go on to live their lives?
Jenny Tresch: Selling a business is time-consuming. In most cases – and quite correctly, I have to say – the focus lies on a successful completion and maximizing the value of the transaction. However, as a result, entrepreneurs and their families often do not make concrete plans for their "after sale" lives before the sale actually takes place. Their actual plans vary as much as their unique personal circumstances. One entrepreneur I worked with sold his business at age 57 and decided to simply enjoy his life: He had no problem spending the majority of his fortune during his lifetime, passing only a small portion of his wealth on to his children. Another owner, a second-generation entrepreneur in his 40s, decided to set up a family office that served as a professional investment company. Almost his entire fortune is invested, and only a small spending portfolio is maintained.

How do the liquidity event and the sudden wealth affect families?
Jenny Tresch: The sale of a business implicates a sudden change, from managing the business to managing the sale proceeds. There is a complete reversal from having the majority of family wealth locked in the business to being almost completely liquid. Wealthy families, especially the ones that sold their business a couple generations ago, know how challenging it can be to keep the family together based on shared wealth instead of a business. In these cases, laying down basic principles to ensure family continuity and wealth preservation is fundamental. A well implemented family governance structure, including clearly defined formal guidelines, holds particular importance for multigenerational families.

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* This author is from a unit outside Wealth Management Research. These units are not subject to all legal provisions governing the independence of financial research. The "Directives on the Independence of Financial Research," issued by the Board of Directors of the Swiss Bankers Association (SBA), do not apply.

Family office

A family office is a professional organization dedicated to the continued prosperity of a family or group of families. Some try and take a purist view, insisting on a controlling interest by a family or group of families, seeing anything else as a camouflaged asset manager. Others are happy to accept the hand of commercially interested third party at the tiller and point to the rise of the commercial multifamily office or even the large multiclient family office platform.

When looking for family office types, broadly speaking the options are:

- **Single family office** – The classic formulation. A vehicle for the benefit of a single family, which is primarily owned and controlled by the family. Providing the highest level of customization, exclusivity and confidentiality. This is also the highest cost option.
- **Multifamily office** (family owned) – A co-operative venture for the benefit of a small group of families (5 or 6). Owned and controlled by the founding family(ies). There is less scope for customization and individual expression for each family but it is more cost-effective due to pooling of resources and economies of scale.
- **Commercial multifamily office** – A commercial service provider targeting the family market. Third party ownership and control. The platform is usually provided to a limited number of families (10–50) but more than a family-owned multifamily office. More rigid service offering and less opportunity for customization.
- **Commercial multiclient family office** – Commercial venture seeking to engage a large number of families (50+). Much more rigid service offering and very limited opportunity for customization given the number of clients.

Family offices offer the following services:

- *Investment* – specialized investment and wealth management
- *Administrative* – financial control and reporting; tax and legal; fiduciary services (trust and corpo- rate); complex administration (insurance, collecta- bles like art, aircraft etc.) and business services (sup- port of new ventures, due diligence, transactions); special projects
- *Family management* – philanthropy governance, education, property management, lifestyle and concierge services
- *Hybrid*– a combination of the functions
- *Full service* – all of the above

The source of the confusion around the family office label is twofold. Firstly, this is not a homogeneous group, these are highly individualized entities often as unique and idiosyncratic and as the families they serve. Secondly, with no clear agreed definition, the usage in the market can be radically different and can serve a variety of agendas.

Family offices should not be confusing, they are what the family concerned wants them to be. The important aspect is working out exactly what it is the family really needs.

Jason Hobday
www.ubs.com/familyadvisory

However, the complexity of succession management for the business itself, commingled at every instance with personal, family group and individual family member issues, usually needs professional assistance by expert advisers, who can help devise and implement prudent planning. To reduce fears about role exits and the unknown future, we recommend reflecting on the roles of every family member, their identities and their personal needs, wants and wishes, as we have outlined above. Jenny Tresch recommends that the "after-sale life" consider the goals and visions, not only for the entrepreneur, but also for the next generation, and the whole family.

Giving up an emerging market business

The difficulty to cede control over the business is especially pronounced for business owners in emerging markets. Business owners in emerging markets face different business succession challenges than do business owners in Western Europe or the US. Some of the more common challenges entrepreneurs face in emerging markets are:

- Since many entrepreneurs in emerging markets are still young, their children may still be too young to take over control of the family-owned business, or may never have been trained to do so in the first place.
- While opportunities for business owners and professional managers abound in many emerging markets, there is a general shortage of qualified professional managers. As a result, business owners often face difficulties finding a potential CEO with experience in the required industry who could take over day-to-day management of the firm.
- Capital markets in some emerging markets are still small, underdeveloped and may lack transparency. Though these markets develop fast, it may still be difficult to find enough buyers for company stock in an initial public offering (IPO). Furthermore, there is a lack of venture capital firms in many emerging countries to finance buyouts.
- In some countries, for instance in former communist countries like Russia, capitalism and private businesses are relatively new phenomena. Thus, there is a general lack of experience with the difficulties of a business sale or business succession.

These factors can lead to frustration for business owners who want to sell their business in order to retire or engage in new ventures. As a result, owners of private firms often end up handing over formal control of the company to salaried managers without transferring actual control. Instead, emerging market business owners often retreat to a position of major shareholder of a holding company or director of the company, but in reality remain involved in daily decisions about corporate activities. The new management has only limited influence over the company, but formally is held responsible for the results of the firm. Some entrepreneurs prefer such an outcome because it allows them to retain power while at the same time unfavorable developments can be blamed on a CEO who can then be replaced, if necessary.

The long-term results of such a "pseudo-succession" for businesses are generally a high turnover in management, with additional costs to find qualified professionals as replacements, a lack of transparency and weakened investor trust. These factors can ultimately hurt both the profitability and growth of a business. A study of 228 Taiwanese firms has shown that increasing influence of family members on company boards leads to declining return on capital expenditures and assets, as well as lower price-to-book and sales-to-invested capital ratios over time.[4] All these factors together limit the price appreciation potential for the company's stock and weaken its competitiveness.

Strengths of entrepreneurs can become weaknesses of investors

As we have seen, the emotional and psychological challenges for business owners when they sell their business may be significant. But successful business owners have learned to deal with a complex and uncertain environment and to make difficult decisions throughout their business lives. While these skills may help running or selling a business, the typical cognitive make-up of entrepreneurs may lead to difficulties in the task of man- aging wealth after the sale of a business is completed.

The vast literature on behavioral finance has uncovered a large number of behavioral biases and heuristics – mental rules of thumb used to simplify a complex environment – that influence financial decisions. It appears that certain heuristics can give entrepreneurs a sustainable advantage over their competitors and can be a key ingredient of their success.

The endowment effect and the sale of a business

One of the most powerful biases that affects entrepreneurs during preparation for the sale of their business is the so-called "endowment effect." The endowment effect describes the differences in value that are assigned to a good by those who already own the good versus those who do not. Business owners frequently overestimate the value of their companies when they

[4] Filatotchev et al. (2003).

want to sell. The result is that these owners may be reluctant to accept an offer for their business that was derived based on an objective assessment of the cash flows and profits their business is able to generate.

M&A advisors and potential buyers are trained to look at a business objectively and focus on the numbers only. As a result, they frequently calculate valuations that are too low for business owners to accept. Consider an experiment[5] where future owners of businesses were asked whether they would be willing to sell their company for USD 11.25 million if a business valuer suggests the owners have a 10% chance of selling the business for more than USD 12 million, a 40% chance of selling it for USD 11 to 12 million, a 40% chance of selling it for USD 10 to 11 million and a 10% chance of selling it for less than USD 10 million. If the future owners were told that, to become owners, they had to first work in the business during their spare time, weekends and summer breaks, the respondents of the study were less likely to accept the USD 11.25 million offer for the business than if this effort was not required for ownership. Similarly, the reluctance to sell the company increased if a pre-requisite for taking control of the firm was prior good performance in school, in managing their own financial affairs, or if they had to invest all their private savings in the company to buy into the firm.

Thus, we recommend that business owners seek the advice of professional M&A advisors. These professionals not only have access to potential buyers, they can also guide the owner during negotiations and assess a reasonable market valuation of the business while acting in the owner's best interests. Good advisors can

[5] Shepherd and Zacharakis.

The Russian IPO

Two Russian entrepreneurs started their retail business in 1999.[6] One of them occupied the role of CEO of the company, being responsible for day-to-day management of the firm and operational decisions. His partner became head of operations and managed the most important projects of the firm. Decisions about major investments were taken jointly.

The business grew rapidly, reaching the USD 1 billion sales mark in 2004, when the firm had moved into selling mobile phones and accessories. In order to fund future growth, the firm decided to float a minority stake in the form of an IPO. A minority stake in the company was sold to an investor prior to the IPO who suggested establishing a board of directors and hiring a salaried CEO. The founder-CEO subsequently became the chairman of the board of directors, while his partner became a member of the board. The board appointed an external CEO who had sales and marketing experience at an international company but no formal business education or experience as a CEO. Nevertheless, he was a trusted choice, since the new CEO had over three years of business relations with the founders from his previous position.

The company continued to grow after the transition, but the actual roles of the founders are very different from the intended governance structure. The founders kept their offices and continue to work all day in the firm. Furthermore, they remain responsible for all-important external relations, including dealing with investment banks, suppliers and the government. The hired CEO accepted his limited responsibilities since he believed the owners should be responsible for all major operational decisions. The chairman of the board of directors, on the other hand, was unwilling to cede any control of the firm's daily activities. He was often seen at company stores giving orders to staff and even firing them without consulting management. He thought, "It is unrealistic to expect a hired executive [...] to care about the firm as the owners do. Whatever the titles are, this is my company and I have to manage it."

This is a classic example of a failed business succession where the sale of a business has not led to a change of control over the daily activities. The advantage of such an arrangement is that the company continues to profit from the expertise of the founders, but the risk is that lack of transparency and any eventual disagreement between management and owners may hurt company performance and lead to high management turnover over the longer term.

[6] This case is adapted from Shekshnia (2007). Please refer to this document for more details.

help the owner achieve the highest reasonable price for the business while tempering the endowment effect that could undermine negotiations due to excessive demands of the seller.

Potential behavioral biases of entrepreneurs
Besides the endowment effect negatively influencing the sale of a business, entrepreneurs often exhibit other behavioral biases that may be detrimental to investment performance once they retire as entrepreneurs and become managers of their wealth. We want to focus on the most common cognitive traps, together with some simple tips on how to mitigate these pitfalls.

1) **Overconfidence:** As one observer has noted: "Looking out at the world through completely rational eyes, entrepreneurs might well never get started – the odds would appear, realistically, far too daunting."[7] In fact, compared to what an objective assessment might indicate, almost everyone is overly confident in their own abilities. Entrepreneurs face high uncertainty about the potential success of their business, but still feel confident about their own skills to be successful. This is one of the key characteristics that drive entrepreneurs to surmount obstacles that "normal" people find insurmountable. However, excessive self-confidence may cause entrepreneurs to believe, for example, that they have superior skills in picking stocks. As a result, entrepreneurs often start to trade too much, which increases trading costs, often without improving performance. One study suggests that overconfident, overactive investors may underperform the average investor by 2% per year.[8]
2) **Over-optimism:** Successful entrepreneurs often think that bad things never happen to them, but only to others. This optimism cements their faith in their business ventures even during difficult economic times, but it may prove excessive when they evaluate stocks as an investor. This can result in portfolios concentrated in too few stocks that have excessive risks, leading the portfolio to incur severe losses if one of these companies gets into trouble. We recommend a well-diversified portfolio, investing in different asset classes – stocks, bonds and non-traditional asset classes, perhaps through funds or index-trackers – and to complement this core selection with more speculative but limited-in-size satellite investments, say, in stocks. Another option would be to limit the downside risks of a concentrated portfolio position through the use of protective put options or zero-cost collars, as we have explained in previous a *UBS key insights* report.[9]

Fig. 2.4: Behavioral biases of entrepreneurs

Entrepreneur	Behavioral bias	Investor
Belief in one's ability helps overcome difficulties	Overconfidence	Increased stock picking activity and excessive trading costs
Keep faith in business during difficult times	Optimism	Overly concentrated portfolios with excessive risk
Owners have power to control business operations	Illusion of control	Portfolio trades at the worst moments in time
Spot new opportunities from few recent observations	Representativeness	Trend following

Source: UBS WMR

3) **Control illusion:** This bias is evidenced by an optimistic belief that the individual can control the out- comes of uncertain events. Entrepreneurs frequently control, or significantly influence, crucial success factors in their business environment. However, as investors, control over the markets is quite another matter. This particular bias can lead entrepreneurs- turned-investors to intervene in their portfolio as soon as it deviates from predicted outcomes, with often negative long-term effects. We recommend focusing investment decisions on a long-term strategic asset allocation based on an investment policy statement that can help investors keep a cool head, even during volatile stock markets.
4) **Representativeness:** Entrepreneurs often extrapo- late from a few observations about new market trends and business opportunities. This emphasis on a small number of recent events that are deemed to be an appropriate representation of a long-term trend is known as "representative bias." This trait certainly helps successful entrepreneurs spot new trends earlier than their competitors. However, as investors, this bias may unduly emphasize short-lived market trends and lead to trend-following behavior – buying stocks after they have gone up in price and selling investments that have recently declined. As an investment style, trend following is likely to cause severe under- performance in investors' portfolios. A better strategy is to seek out companies that have solid fundamentals but are available at a reasonable price. Warren Buffett has become one of the world's most successful investors by adhering to this philosophy of value investing.

The above biases, a selection of the most common mis- takes entrepreneurs make as investors, are summarized in Fig. 2.4. We will have more to say about managing investments in the next chapter.

[7] Baron (1998).
[8] Odean and Barber (2001).
[9] Klement (2008).

So far, we have focused on the personal challenges an entrepreneur faces before, during and after the sale of his or her business, or other liquidity event. However, such an event also inevitably impacts the family of the owner as well. While the family strongly influences the external perception of the identity of the business owner, the entrepreneur influences the identity of his family members, too, who may define themselves through their relationship and proximity to the business owner. In some extraordinary instances, the identity of the business owner can overshadow the identity of subsequent generations, for better or worse. How would you react if somebody introduces themselves as "John Rockefeller," "Paris Hilton" or "Jennifer Katharine Gates"? In every instance, the name itself and the associations linked to it trigger different emotional reactions and different behavior from people outside the family. Society defines much of the identity not only of a business owner but also his family members. The personal challenges of a liquidity event to different members of the entrepreneur's family are at the center of the final section of this chapter.

The ramifications of a liquidity event are profound for the owner, but are more nuanced for the family.

Focus on the family

The ramifications of a liquidity event are profound for the owner, but are more nuanced and generally more complex for the owner's family. Everything will depend upon the unique family situation of the owner, which may run the gamut from the classic first-generation business-founder situation, where the family is the owner, to more complex situations involving multiple generations, founding sibling partnerships, or perhaps founding consortiums that may in turn involve several families. While each case will hinge on the details, they do have commonalities, and almost all families will find some benefit from established family governance techniques. The emerging field of family governance has merit for all wealth-owning families, and can be adopted at any stage of the family or the business's development. A liquidity event is often, belatedly, the catalyst for discussion of family governance matters, usually because these events bring issues to the surface, as conflicts arise among the needs of different individuals or the family as a whole.

- Family A is young in all respects. The husband and wife are an entrepreneurial team who met in college and began a business soon thereafter. They have two children, both under the age of five, and are both in their early thirties. They will net USD 80 million after the sale of their business.

- Family B is a second-generation business owned by five siblings ranging in age from 45 to 55. There are three sons and two daughters, and the founder and patriarch has recently died. Two of the siblings have been divorced and have remarried, and there are 14 grandchildren between the ages of two and 18. The sale of the business is likely to generate close to USD 1 billion.

The contrast between these two families is significant, yet they both face similar challenges, including how to raise children in the midst of wealth; whether to create structures like trusts or foundations; and whether to pool and manage funds collectively, or instead distribute them individually and let family members go their own way. This is particularly relevant for Family B, since they are farther along in the development process. However, it is noteworthy that Family A may already be considering the same issue when thinking about the future for their children, who, though too young to be involved now, will likely inherit significant wealth at some point.

Family governance – a blanket term that covers the many different aspects of helping wealthy families understand and manage all aspects of their wealth – can be initiated at any stage. In order to help those unfamiliar with its role and its benefits, we will first outline some of the major challenges faced by families and their members. Then we will summarize the most important family governance guidelines, and show how they can help families manage the challenges created by wealth and liquidity events.

Founders and inheritors face dilemmas

A liquidity event, by definition, may transform the "merely wealthy" into the extraordinarily rich. This can be challenging as it probably involves a significant psychological transition. A family wealth advisor and a psychologist have explained the different transitional stages of wealth for wealth-founders.[10] These differ substantially from the issues faced by inheritors, primarily the children of individuals fortunate enough to acquire great wealth.

[10] Jaffe and Grubmann (2007).

Wealth acquirers generally ascend the ladder of social and economic status, but do so with personalities and characters that have been formed in lower socio-economic circumstances. This is often an advantage. Key personality traits are largely in place by the ages of 12 to 18, giving acquirers a strong foundation with which to negotiate the transition to high levels of wealth and social status. While the transition process may be gradual, even imperceptible, for someone who builds a business over a lifetime, a liquidity event can accelerate this process. Actual net worth might not change – if the business had a value of USD 300 million and now the owner has the equivalent in liquid wealth – but personal and social stresses certainly may.

The dilemmas for acquirers include new roles, situations, social, family and perhaps personal expectations, and responsibilities. A windfall effect may occur; a successful business may produce solid returns and significant income for many years, yet the owner and his or her family may not be perceived as exceptionally wealthy within the community or even by themselves. (A surprising number of owners are not aware of the true value of their firms, especially those who sell during market peaks). After a liquidity event, the world may be radically different, with the community, family and friends projecting both the good and bad stereotypes of wealth on the owner and his or her family.

The major psychological advantage of wealth acquirers is that material wealth is the result of their own efforts. Thus, it is more likely to feel deserved and psychologically justifiable. The skills, diligence, and hard work translate into self-confidence, which in turn eases coming to terms with even great levels of wealth. Acquirers must integrate wealth into an already existing personality, a process shaped by the time it took to create the wealth, the age at which it was achieved, the number of social rungs they have ascended, and the financial personality of the acquirer. One study notes that a liquidity event, retirement or the sale of stock often force an individual to confront the reality of their wealth:

> "'Realizing' a capital gain in business has both a financial and psychological meaning at the moment that a signature is put to paper. First-person narratives often describe the remarkable emotional moment when years of hard work, risk, and deprivation are finally transformed into wealth, leaving the business owner and spouse rich but lacking an out- side identity, with the loss of social contacts, no place to go everyday, overwhelmingly diverse investment decisions, and loss of purpose in life. Liquidity is both heady and disorienting."[11]

Inheritors' dilemma

How are other family members affected by a liquidity event? Most owners will have a central worry: the effect of significant wealth on their children, which has been called the "inheritors' dilemma." Unlike their parents, the children of the affluent do not have the means to create an identity outside of the context of money. For them, affluence will be part and parcel of the environment in which they are raised. Their challenge is to develop self-confidence, self-identity and healthy relationships in spite of the wealth, and often under the purview of very strong, even dominant, and successful parents. The study puts the issue thusly, "the Inheritors' Dilemma [is] how to create an effective individual identity strong enough to separate from, yet integrate with, the massive power of wealth." For some individuals, this process may raise few challenges; others may encounter more difficulties. In any case, there is a growing body of research on the issues of inheritors, as well as a number of strategies in family governance that can provide opportunities for heirs and successors to more effectively negotiate their maturation process.

A central theme for inheritors is the often contradictory messages of wealth. On the one hand, it brings freedom in the choice of lifestyles and occupation, but it also may create a sense of obligation to society to repay the "debt" of great wealth. Society may simultaneously accord special status to the wealthy, while at the same time negatively stereotyping wealth-holders.

When it entails a quantum leap in wealth level and social status, a liquidity event can be pivotal for a child and for a family. Because it is also often a one-time event, there is no experience of generational wealth transfer for the family or the parents to draw upon, nor a tradition of raising children amid wealth. Family governance techniques are a way of consciously considering the identity issues and legacy of the family; a well- thought out plan can help create family traditions where there were perhaps a loose set of activities. By helping create structures and processes that by them- selves help reveal the strengths and weaknesses of a family, family governance can facilitate more effective communication among family members and set a framework for younger family members to identify with as they mature.

[11] Jaffe and Grubmann (2007).

Defining family governance

Family governance need not refer to a formal set of procedures or rules. Especially in the first generation, or for a founding business owner, it may initially take the form of casual dinner conversations, where business and financial issues may be discussed with children. However, when wealth or business complexity increase, and particularly in cases where wealthy families grow beyond the first generation, more formal communication and wealth management arrangements often become necessary. This is especially the case in liquidity events, where the nature of the decisions to be made and their potential consequences for those beyond the owner often create the first substantive challenges to family cohesiveness.

For large business-owning families, the relative difference in communication needs before a liquidity event may be very different from what is needed during and after such an event. One of the most potent examples of weak family communications and lack of clear governance structures was the Bancroft family's suboptimal sale of its Dow Jones Company holdings to Rupert Murdoch's News Corp in 2007, which we examined in the *UBS key insights* "Wealth: Value and Values" in 2008. Perhaps no case better illustrates the need for families to implement some form of family governance early on. Of course, if family governance has not been established well prior to a liquidity event, it is of limited benefit during the process of the event itself.

In recent years, family governance has grown more formalized, and there are now experts who can help a family create a custom-tailored family governance plan. No single plan works for all families, of course. In general, however, there are several key elements of family governance that should help a family understand, create and formalize its unique identity and values, establish clear lines of communication, establish separate roles for different family members or for different branches, and improve the family's wealth management.

Optimal wealth management is, of course, crucial. One of the first questions to be answered as a liquidity event unfolds is how the proceeds will be distributed and managed. In a case where it is clear that family members wish to go their separate ways, little or no family governance may be needed. (However, we advise even small or first-generation families at least to explore the potential benefits of a governance plan.) When families choose to combine assets and proceed with family office wealth management arrangements, it becomes imperative to have more formalized governance structures in place.

There are numerous family arrangements that may come under the scope of family governance, but, in general, the primary components include:

- A family analysis.
- An initial or regular family meetings.
- Governance bodies such as family councils or boards.
- A family mission statement or constitution.
- Organizations such as foundations, family trusts, or holding companies.

In most cases, family governance will begin with an analysis that can be either formal, supervised by an outside expert, or more informal. This will depend on the size and complexity of the family and its perceived needs. The analysis should help identify major strengths and weaknesses of the family and to establish the central values of the family. This is often important for families who face a liquidity event in the form of a business sale. The analysis should help to establish the central "story line" for the family. Without careful stewardship, many families lose touch with their core values and traditions over time. One of the primary tasks of family governance is to discover and preserve this central identity, especially to help provide guidance to future generations, who will be more distanced from the family's original wealth creators.

Often the family analysis will be part of a family meeting where the family governance plan will be discussed and its processes initiated. Regular family meetings are often a part of a family governance plan, and they form an important part of family communications. Families such as the Rockefellers, who are entering the seventh generation and have more than 100 members, gather each year at the family's estate to share important financial and business information. However, they also include several ceremonial traditions, created by members of the third generation, that help family members get to know each other and celebrate the achievements of younger family members. Along with regular family meetings, other communication techniques include e-mail, and some families have used web pages as communications tools, in part as development exercises for younger family members.

For large families, governing bodies such as family councils or boards may also be necessary to efficiently man- age decision-making and communications. In smaller groups, the logistics and scheduling difficulties of bringing large families together can be limited. Families with multiple business, wealth and philanthropic concerns may have different boards to help oversee the various facets of their operations.

These may also have trusted outside advisors or managers on their councils to bring outside expertise or an objective view to discussions. Perhaps most central to family governance, in our view, is the creation of a family mission statement (FMS). An FMS is similar to the investment policy statement used by professional fund managers. The primary benefit of both documents is not necessarily the statements they contain, but the deliberative process behind them. To create either, the family must gather together, discuss and then formulate its own unique philosophy. This then becomes a guiding document to help sort out priorities in the family or wealth management activities. Both documents should allow for some flexibility so that they can be revised as needed. The review specifications are often spelled out in the documents themselves. Another benefit of an FMS is that it begins to create a family history that future generations may use to remain in contact with the values of the founding generation. Keep in mind that families such as the Rockefellers often employ a family historian, but often do so very late in their history. Generally, one motivating factor is the desire to have some control over the family's legacy and to influence media coverage. Not every family will require this, but it again demonstrates the need for foresight, as it could be relevant for future generations even if it is not necessary now.

The personal aspects of a liquidity event get the least attention, yet account for most of the major challenges that these events cause.

Finally, wealth management is directly related to family governance through trusts, holding companies, or philanthropic structures that are often necessary to establish. Without some idea of how the family wishes to manage its wealth and set its priorities, it may be difficult to create the best kind of structures for wealth to serve two purposes: the tax efficient preservation of wealth and the family's specific needs. These two goals may conflict, and tradeoffs between the two are often necessary. With family communication structures in place, this process can be more efficiently managed and the likelihood of conflicts can be minimized.

Liquidity events and family governance

For families who are facing a major liquidity event, and who have not previously explored family governance, we recommend meeting with a family governance expert. Such experts can assess the needs of the family and offer objective advice as to what should be considered in the future. Advisors can often play an important role throughout the entire liquidity event process, both with planning prior to the event, and afterwards. Their expertise is based on experiences with other families in similar circumstances, and they can also offer objectivity, which may be missing among family members.

Conclusion

The personal aspects of a liquidity event get the least attention, yet account for most of the major challenges that these events cause, either during the process or well after. An awareness of the deep implications the sale of a business and the entry into the ranks of the very wealthy have on the self and on the family – perhaps most critically, children – begins the process of helping individuals and families deal with these challenges. Some may find these issues manageable and thus wish to keep such affairs entirely private. For others, there may be great benefit in engaging family governance experts or psychologists who are specially trained to deal with the unique needs of the affluent to help guide the processes involved in family governance. The objectivity they can provide can go a long way towards ensuring that the individual and family groups impacted by a liquidity event do not find personal challenges standing in the way of either effective wealth management or the enjoyment of the result of many years of effort.

Investment implications of *liquidity events*

Highlights of Chapter 3
This chapter explores the investment dimensions of liquidity events. We focus particularly on the following key decisions that wealthy families may face:

- Business owners often start thinking about the structure of their wealth after a liquidity event; however, certain wealth structures, like trusts, may best be established well in advance of a sale of a business. In some cases, the worst time to sell a business – for example during an economic downturn – may be the best time to structure ownership and wealth.
- After they have sold a company, many entrepreneurs take on too much risk in their investment portfolios by keeping substantial holdings in the stock of their former company. This may severely diminish wealth in times of market crisis. We show how important it is to secure the wealth needed to preserve the current lifestyle both in the years before a liquidity event and, more importantly, after the sale of a business.
- Liquidity events are often used to set up a charitable organization or philanthropic foundation. We provide an introduction to the process of setting up philanthropy and we present some portfolio models for philanthropies with different risk profiles and return targets.

Introduction

"Fortunes are made by concentrations of risk; fortunes are maintained by diversification, good governance structures, and a well-thought-out spending policy."[1]

So far, we have looked into the professional and personal aspects of the liquidity event. This chapter focuses on the financial aspects. From a wealth planning perspective, optimally managing a liquidity event requires several decisions with long-term effects. It may be difficult to imagine the years ahead for oneself and for family members, but an attempt to look into the future is important. A first step is to consider what wealth should achieve, today and tomorrow.

Unexpected liquidity event

Ideally, wealth planning is already underway when the business is started. But the months and years before the liquidity event may still offer good opportunities to work on a structured wealth plan. There may already be wealth planning structures in place when the liquidity event takes place. Then, the proceeds from the liquidity event can be directed into these structures if they are still appropriate.

While we emphasize the importance of planning for a liquidity event ahead of time we note that not all liquidity events are expected. Sometimes, a business needs to be sold because of an accident, death or deteriorating health. In these cases, planning may not have occurred in advance and the liquidity event has the characteristic of an emergency sale. For unexpected liquidity events, we suggest implementing a "transition plan," with different account structures. One account should hold a sizeable amount of the net worth and one should have sufficient funds for taxes related to the sale of the business. In addition, we suggest an account of only a fraction of the total assets for personal investments and expenses. In this way, one can manage ongoing expenses separately from the bulk of the assets, gaining time to adjust to the new situation, while the bulk of the assets remained parked in safe assets like money market funds or government bonds.[2] It rarely pays to rush into a wealth-structuring plan after an unexpected liquidity event, such as the sale of a business after the death of the founder. We recommend taking care of immediate financial, emotional and psychological needs first, and parking assets in safe investments that require little oversight or management.

[1] Croisier (2004).

[2] Ward et al. (2004).

Tax considerations

Whenever wealth is transferred, the tax authorities are likely ready to ask for the state's slice of the proceeds. As a consequence, tax considerations are an integral part of the wealth planning process. Liquidity events are likely to incur income (including capital gains) and, later, estate or inheritance tax liabilities. Depending on the country of residence, there may be other taxes to consider as well. When structuring wealth for the future, plans should consider that tax rules and rates will inevitably change. The wealth plan will therefore need a certain flexibility to adjust its structures as necessary. To simplify our discussion in this study, for the asset allocation examples we cite later in this chapter we assume a steady tax rate of 35% on generated income and no other tax liabilities.

Exploit periods of low valuation for ownership transfer

There are strategies to minimize the tax liabilities when transferring wealth. For one, favorable timing of wealth transfers can reduce the tax burden. During a liquidity event, the wealth will be valued differently before and after the sale. Assuming a successful sale of the business, the business is likely to have had a lower valuation prior to the sale. In the case of IPOs, studies have shown that valuations may be discounted by 30% three months prior to the sale.[3] If possible, transferring wealth to the next generation, or other beneficiaries, prior to the liquidity event may minimize the potential tax load. On the flip side, keeping valuations low for tax reasons may be a disadvantage when trying to get the best selling price for the firm.

Structuring wealth

Any structure chosen for the liquidity event will have long-term consequences for the business owner and his or her family. Suboptimal structures can be costly and can lead to unexpected risks or even the inability to access funds. There are several basic frameworks that can be used for efficient wealth structuring. As our focus on this chapter is financial planning, we only outline them. Depending on the individual circumstances, the investments may be managed through trusts, estates or foundations. Usually, wealth is structured using more than just one of these.

We advise wealth-owning families to seek professional tax and legal advice before engaging in any concrete wealth-structuring measures. That said, we can offer one generic structuring tip that might serve until a more appropriate model is developed for the particular situation: A simple way to structure wealth could be to set up a separate trust for every beneficiary of the current and next generation. For a large family, this might lead to many separate trusts and foundations, which would complicate oversight. In this case, it might be better to establish only a limited number of trusts and to share the beneficial ownership and oversight responsibilities of each trust in equal parts among its beneficiaries, for example, the children of the wealth owners.

Planning for liquidity events: The investment portfolio

A potential liquidity event also affects the asset allocation of an investment portfolio. Even before a potential sale of a business or any other liquidity event occurs, the investable assets need to reflect future cash flows and should be invested to maximize future wealth and preserve the lifestyles of beneficiaries, even in the event that the economic environment deteriorates and the expected cash flow from the sale of a business may decline. The goal of the asset allocation process should be to complement the other actions taken in order to preserve and exploit the opportunities available to an individual or a family.

Investing before a liquidity event

To demonstrate how asset allocation decisions can both maintain as well as destroy opportunities in the future, in this section we consider a business owner who is married, with three children. The business owner, age 55, has run a successful family business in the retail sector over the last 23 years. The business is domiciled in the US but also has operations in Asia that have led to a significant growth in sales and profitability over the last 10 years. Since none of his children (ages 24, 20 and 18) is willing or able to take over the business, and in view of his declining health, the business owner decided in 2008 to look for a potential buyer of his company. An M&A advisor had valued his company at USD 200 million, but because of the deteriorating economic environment in the United States and in Asia at the time, no strategic buyer could be found and an IPO also seemed unrealistic. Thus, the owner has decided to postpone the sale of the business by about five years, when he expects a strong economic recovery. He would then hope to sell his business for USD 250 to 300 million, but would expect to get at least its current value of USD 200 million.

At present, the family is in no rush to sell the business – except for the declining health of the owner – because it generates about USD 4 million in income annually (paid to the business owner in the form of semi-annual dividends), while the family's collective living expenses amount to USD 1.8 million per year (which also includes

[3] Brady (2006).

salaries for staff, education for their youngest two children, occasional big-ticket expenses and taxes). The family's liquid financial assets amount to USD 50 million. These assets are invested in stocks, bonds, real estate investment trusts (REITs) and money markets. The family also owns property that is not considered to be part of the investment portfolio and will not be sold.

Because the family wants to maintain their current lifestyle, they need to have sufficient assets after the sale of their business to generate enough income to cover their living expenses and protect against inflation. Furthermore, the business owner and his wife have decided to bequeath USD 50 million to each of their children, leaving another USD 50 million to charities. The entrepreneur thinks that he will need to have a total wealth (proceeds of business sale and existing financial assets) of USD 250 million in five years, adjusted for inflation, in order to achieve these goals.

Structuring a portfolio in preparation of a sale We often observe that investors have a well-designed strategic asset allocation in order to achieve their long-term financial goals – but as soon as equities or other risky assets decline in value during an economic contraction, they abandon their strategic asset allocation. Assets are sometimes shifted at the worst moment – after stock markets have declined. This problem can be avoided by structuring an existing strategic asset allocation in accordance with projected cash flows.

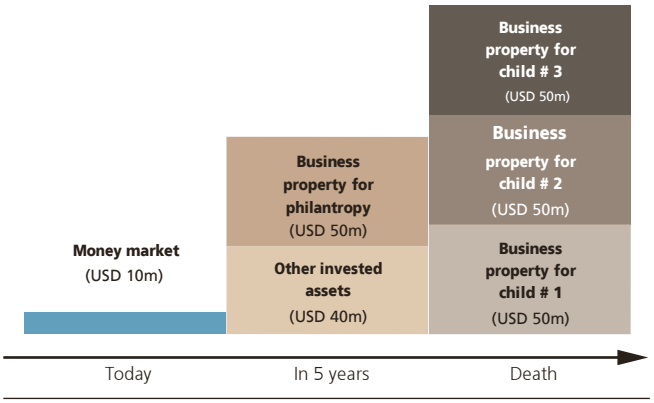
In our case study, one way to structure the portfolio would be to segregate an "iron reserve" to bridge any possible short-term liquidity needs that may arise before the sale of the business. For entrepreneurs, we typically recommend that this iron reserve should constitute about one to two years' worth of living expenses. These assets should be invested in money market funds and other highly liquid assets that offer 100% principal protection. In our example, we use the USD 10 million invested in money market funds for this iron reserve to provide the family peace of mind should the other existing assets temporarily decline. Additional existing funds can be dedicated to different medium- and long-term financial goals. In the case of our family, this might look like Fig. 3.1.

This structured approach to thinking about an existing portfolio also allows for the linking of existing assets to possible structures that would allow an efficient transfer of wealth. Business assets for heirs and philanthropic purposes could, for example, be transferred into trusts and foundations. This way, a clear beneficial owner is designated for every structure and the risk of the business property's possible declines in value is borne by the beneficial owner. Even though the transfer of a business asset's value might only be possible after the sale of the business, this would not preclude setting up the required structures before the sale, so that they could be quickly filled with the proceeds after the sale takes place.

Creating a floor under a financial portfolio
Very loss-averse investors can create a "floor" under the assets that are essential to achieve the most important financial goals. In our case, the business owner and his wife may want to protect at least USD 50 million of their current invested assets in order to at least maintain their current lifestyle after the sale of the business, along with having sufficient assets for possibly rising health care costs in the future. One way to do this would be to invest all assets in money market investments. We think this is inadvisable, however, because money market investments, while protected against loss of principal, typically have very low returns that may not even compensate for inflation. In fact, for long-term investors, the best risk-free asset is an inflation-linked government bond in their home currency. Thus, to make up for the negative effects that would be caused by inflation, fees, taxes etc., investments in riskier assets, like stocks, are needed to grow assets sufficiently over the long term. However, for a limited amount of time, say, until the business is sold, the use of derivatives or dynamic asset allocation strategies may provide a floor for the assets while allowing the investors to participate in rising equity markets.

The most common way of securing principal that also offers some potential for gain in rising markets is to buy zero-coupon government bonds with the desired maturity and call options on stock market indices. For example, a zero-coupon government bond in the US may pay 2% in interest per year, which means that, in order to receive USD 1,000 in five years, an investor

Fig. 3.1: Structuring the existing portfolio



Source: UBS WMR

would have to pay only USD 904 today. So our family could invest USD 45.2 million in such bonds in order to receive USD 50 million in five years. The remaining USD 4.8 million could be used to purchase call options on the S&P500, or other international stock indices, with a strike price equal to the current index reading, a so-called "at-the-money call option." These call options would increase in value if the stock markets rise in the future, and would become worthless if stock markets decline. The net effect of these transactions for the investor is that they will have at least USD 50 million in five years, but potentially more if stock markets rise.

CPPI: An old idea revisited

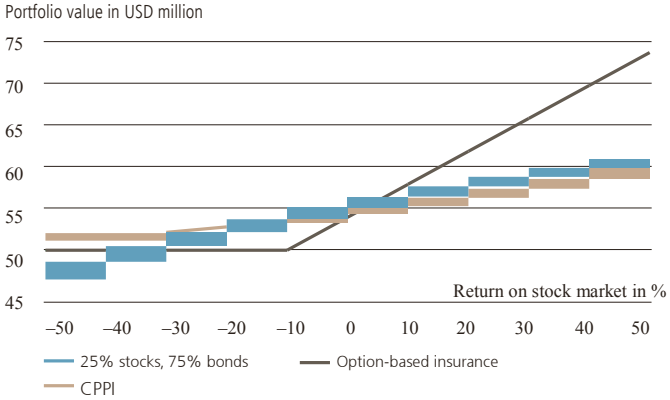
CPPI or constant proportion portfolio insurance is a dynamic asset allocation method that was launched more than 20 years ago.[4] The idea is that an investor sets a floor under which investments should not drop (in our example, 90%). The difference between the current portfolio value and the floor (the so-called "cushion") is multiplied by a leverage factor and invested in risky assets like stocks, while the remaining assets are used to purchase zero-coupon bonds. If stock markets decline, this cushion becomes smaller and the allocation to stocks declines and reaches zero if the cushion vanishes. In this case, in a declining stock market scenario, the cushion would remain fully invested in zero-coupon bonds and pay off the minimum amount at maturity. On the other hand, if stock markets increase, the expo- sure to stocks would increase and participation in future stock market increases would rise as well.

In Fig. 3.2, we show the value of a CPPI investment technique together with an option-based portfolio insurance technique and a defensive portfolio that comprises 25% stocks and 75% zero-coupon bonds. For declining stock markets, we see that both the option-based insurance and the CPPI techniques effectively protect the assets against a decline in value, while this is not the case for the defensive portfolio. On the other hand, if stock markets rise, the CPPI technique will always underperform the defensive portfolio; and if stock markets drop only moderately, the option-based insurance technique will underperform. Thus, there is no universal solution. A defensive portfolio, an option-based portfolio insurance technique CPPI each provide different advantages and disadvantages.

Especially during bull markets, CPPI techniques underperform. This is why they soon became unpopular with investors in the 1990s, when stock markets had their run-up to the internet bubble and investors following a CPPI technique were increasingly unwilling to pay for this insurance against market declines. However, we think in times of high volatility and increasing uncertainty about the future, when option-based insurance becomes too expensive, an investor about to sell a business might consider implementing a CPPI technique to insure the portfolio, at least temporarily. The investor can then focus on the sale of the business without having to worry too much about the investment portfolio. The peace-of-mind benefits provided by CPPI and option-based portfolio insurance may be their biggest attraction for business owners.

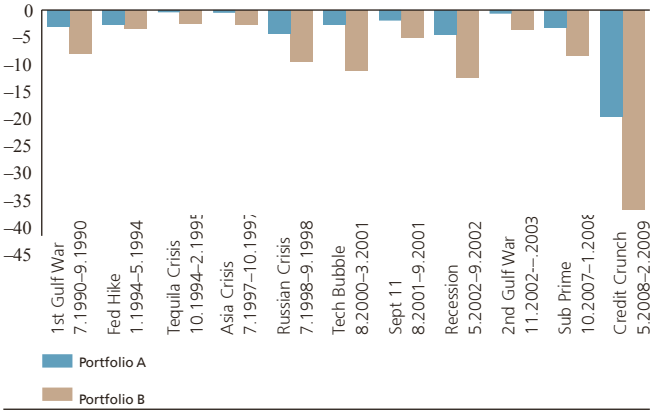
[4] A. Perold and W. Sharpe (1988) and F. Black and R. Jones (1987).

Fig. 3.2: Portfolio insurance vs. defensive portfolio



Source: UBS WMR

Fig. 3.3: Aggressive portfolios during market crises



Source: QIS, UBS WMR

Investing after a liquidity event

Once the business has been sold, the stocks or cash received in the sale need to be invested to meet long-term financial goals and provide sustainable cash flows. We examine several generic cases below that, in our experience, constitute the most common situations wealth-owners face after a liquidity event.

Case I: Conservative spending to maintain wealth in the long run

A conservative approach after the liquidity event would be to invest in a portfolio that does not erode the underlying asset base for the years to come without taking overly high risks. Depending on the amount at hand after the liquidity event, such a structure may constrain spending. Even a spending rate of only 2% of the total wealth per year will require the portfolio to have a performance target of roughly 6.5% when taking consumer price inflation (long-term average: 3% per year) and a 35% tax rate into account, ignoring growth in the family over subsequent generations. Increasing the spending target to 3% based on the same portfolio, keeping the 6.5% conservative return target, would erode the portfolio value by roughly 0.75% annually, assuming a 30-year investment horizon. In order to maintain the overall wealth using a higher spending rate would only be possible with a higher return target. Our calculations show that a portfolio with an 8% return target would account for the 3% annual spending. What this means in terms of risk is shown in Fig. 3.3, where we compare portfolio A, with a 6.5% target return, with portfolio B, which has an 8% return target. We clearly see that only a small increase in required returns may dramatically increase the risks of the portfolio, and may thus require steady nerves on the part of the wealth owners in times of crisis.

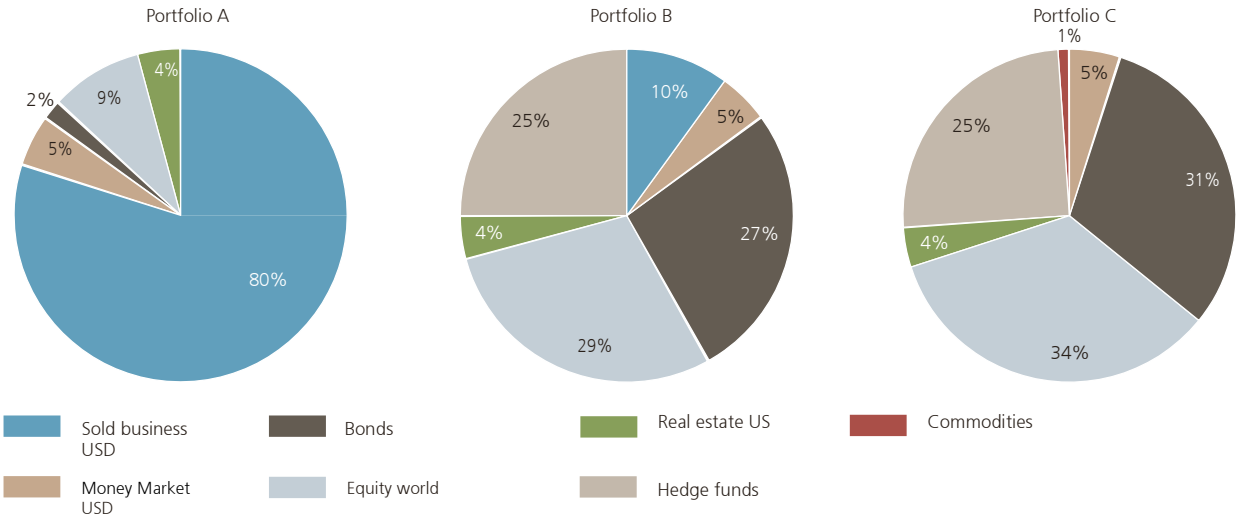
Case II: Remaining invested in the sold company

In many cases, the former owner may still hold shares in the company after its sale. These shares may be a large proportion of his or her total wealth. The dictum "Don't put all your eggs in one basket," or diversification theory, speaks for a reduction of these shares. But there may be reasons to retain these shares, such as personal attachment, a lock-up period, tax costs or legal constraints.

Even if one feels personally attached to and believes in the firm, financial markets are driven by the beliefs of others and the risk of the shares fluctuating is high. It may be helpful to ask whether one would invest the same amount of money in the stock today if one did not already own the stocks. If the honest answer to this question is no, it may be time to sell some or all of the concentrated stock position, if possible, even if this creates a significant tax liability. Often, the reduction in risk due to the diversification of assets far outweighs the immediate tax liability.

In times of crisis, single stocks often lose more than a well-diversified portfolio, so that the tax liability may eventually be surpassed by the excess losses in the portfolio during a crisis. The question is, whether one would like to pay 15% in taxes now or risk losing 50%

Fig. 3.4: Efficient portfolios with different exposure to the sold business



Source: QIS, UBS WMR

of the assets due to insufficient diversification during the next bear market. That does not mean that one has to sell the entire position. Any wealth plan should contain an amount that never is at risk, the "nest egg," to ensure the desired lifestyle as well as a cushion for unexpected events, as we have discussed above. What remains after the nest egg and iron reserve are set up can be kept in the concentrated stock position as a "satellite" investment. Even though it may not be the optimal financial structure, at least it would satisfy the investor's wish to remain attached to the firm, without putting his lifestyle at risk.

From a financial perspective, without doubt, the best solution would be to sell the entire stake, pay off taxes and re-invest the entire amount into a well-diversified portfolio. Portfolio A in Fig. 3.4 represents the portfolio of our investor from the beginning of this chapter prior to the liquidity event. He has a 4% stake in real estate, representing direct real estate ownership. Throughout our modeling, we maintained this real estate exposure as well as liquidity of 5%. We compare this portfolio, with an 80% allocation to his business, with portfolio B, where the business owner sells most of his stock but keeps a 10% allocation to his old business and portfolio C, where no exposure to the former business is kept.

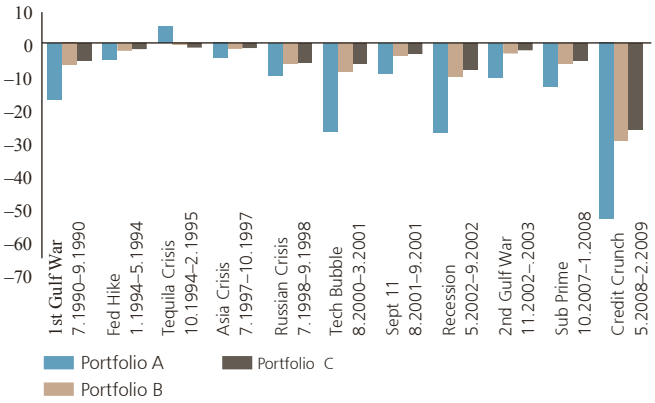
All three portfolios have been optimized to provide the best risk/return trade-off (the highest Sharpe ratio) for the entrepreneur given the desired exposure to his former business. Thus, these three portfolios try to achieve the highest possible return above money markets for every unit of risk taken in the investment portfolio.

As can be seen in Fig. 3.5, failing to diversify away from the business after a liquidity event can have devastating results for the overall portfolio performance in distressed markets. Much the same applies to concentrations in other assets, including real estate. For sentimental reasons, or because they believe they are still in control of the business they once owned, many former entrepreneurs mistakenly keep shares of their former business, or of the new firm that acquired their business. But many former entrepreneurs and their families have learned the hard way that once their stocks are traded in the public market or the firm is controlled by other managers, their share ownership is just an illusion of control.

These former owners have to understand that they can no longer influence the share price and that the market will set the price of these shares in the future. If the market decides to re-price the shares of the company during a bear market, they will lose large parts of their wealth. A prominent example of such developments can be seen in the Ford family in the US, which still owns a control- ling stake in the company that bears its name. However, due to poor strategic decisions both inside the family as well by third-party managers, the company was pushed to the verge of bankruptcy in 2009. The family failed to diversify their private wealth away from Ford stock, and the value of their stake in their company declined from USD 2.25 billion in 1999 to less than USD 140 million in 2009, according to the Detroit News. Today the shares are priced at USD 12.20, meaning the family's holdings are worth USD 900 million.

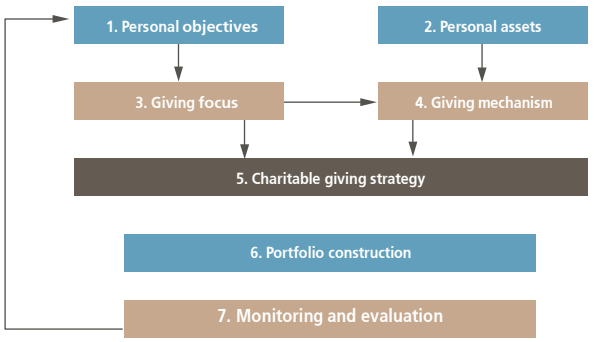
Compare this with the development of portfolio B during market crises, with just a 10% stake in the former business for sentimental reasons. As Fig. 3.6 shows, the losses when markets start to drop are much lower and can be reduced even further by selling the entire retained stake in the sold business.

Fig. 3.5: Portfolio behavior during crises



Source: QIS, UBS WMR

Fig. 3.6: A framework for effective giving



Source: Philantropy UK

There may be legal restrictions attached to the sale of a stock. When selling a firm, it is important to understand the legal consequences of different share classes. The right to sell immediately, without restrictions, would be ideal. This can be achieved through registered shares and avoiding affiliate status. If there are unavoidable restrictions on the sale of shares, we advise setting up a selling program based on professional legal and financial advice. Depending on the market share of the company, the liquidity of the stock and the potential market impact of a sale have to be considered to avoid moving the share price by a sale which could – in a worst case – lead to charges of illegal insider trading.

Case III: Remaining active and generating additional income

A liquidity event can come at any stage of a person's lifecycle. When a liquidity event occurs early on or in the middle of a career, it is likely that the seller of the business wants to obtain new employment, maybe remain in the old firm or might become a so-called "serial entrepreneur," someone who builds up another firm, possibly in another industry. The first two cases result in steady income from employment after the sale of the business, while the last option may require generating cash flows with the existing wealth before the next venture turns a profit.

It is important to take some money off the table and only invest a small portion of the existing wealth after the sale into a new venture. Warren Buffett once said, and we agree, that "investing what you need to get something you don't need is foolish." Successful entrepreneurs should secure their lifestyle by investing a sufficient portion of their wealth to generate enough cash flows for the remainder of their lives. Only what is not needed to preserve lifestyle should be made available to pursue new ventures or other life goals.

Once the new venture is successful, the personal income generated from it must be taken into account when structuring wealth. Potentially, the overall wealth structure and asset allocation have to be changed completely. This may also result from employment income. The income generated through a new business venture or employment takes some burden off the investment portfolio. The more income generated from external sources, the less has to be generated with the investment portfolio, and the more conservatively the portfolio can be invested. In other words, the more income derived from other sources, the higher the lifestyle can be if the investment portfolio remains unchanged.

Philanthropic activities

After the sale of a business, some entrepreneurs may want to give some of their wealth back to society or use it for charitable purposes. Our business-owning family from the beginning of this chapter also wanted to assign money for charitable purposes.

At the outset, we distinguish between charitable giving, which we see as a one-off event, and strategic philanthropy, which is a systematic approach to donating money or assets for charitable purposes. A strategic philanthropist usually wants to maintain a level of control of how his or her money is used. Strategic philanthropies are often run in a businesslike manner, an approach practiced by the Rockefeller Foundation since the early 20th century. Structures can be established for a predefined period of time, or as a legacy extending beyond the fund-giver's lifetime. As a result, the philanthropist often not only donates money but also time to the charitable cause. For a charitable gift, on the other hand, the use of a gift is usually controlled by the receiving charitable organization.

A philanthropic organization requires its own wealth plan, separate from the assets of the philanthropist.

Common to both donation structures is that they both tend to be tax-deductible in most developed countries. In the US, gifts can be deducted from income tax as long as they are given to a recognized tax-exempt recipient. The amount of the total tax deduction as a percentage of adjusted gross income (AGI) for donations to public charities is higher than for gifts to private foundations (50% vs. 30% for cash gifts, and 30% vs. 20% for gifts of appreciated property).[5] For US donors seeking to exploit the tax advantage of endowments, a direct gift may therefore be preferable. Local regulations of gifting vary from country to country, and governments play a large part in setting incentives through tax laws.

In the following, we focus on how to best structure a strategic philanthropy. A philanthropic organization requires its own wealth plan, separate from the assets of the philanthropist. Therefore, setting up such a structure can be understood as a liquidity event in its own right, requiring its own planning and a clear goal-setting process. As with the general wealth-planning process, there are several early decisions that determine the structureof the philanthropy, as outlined in Fig. 3.6 on p. 39.

[5] http://www.hurwitassociates.com

Fig. 3.6 shows the "decision tree" for effective giving. The objectives of the philanthropic activities are crucial and should be defined before deciding on a gifting structure. This focus will determine the philanthropy's structure, size and timing of expenses, all of which may vary. Besides the objectives, the amount of personal assets dedicated to the philanthropy will have an impact on the giving mechanisms the philanthropist chooses (regular payouts or only ad hoc lump sum payments), and so do tax considerations. A philanthropy that has a giving strategy of ad hoc donations requires more liquidity and a different investment portfolio than one where the expenses occur regularly according to a predefined and more predictable schedule. Thus, the strategic asset allocation of the investment portfolio of philanthropies may look somewhat different due to different giving strategies.

As with the liquidity event itself, the cash inflows of the philanthropic portfolio could take many different forms. These include a one-off donation at the beginning, or regular, predictable donations. From a planning perspective, the single donation without subsequent cash inflows is the simpler model. Especially if the philanthropy is to engage in fundraising, the amounts and timing of inflows for the philanthropic foundation become increasingly difficult to structure and need more intense monitoring, and the finances of the philanthropy need more frequent evaluation as well.

A further decision closely related to the objective of the philanthropy is its projected lifetime, as a finite lifetime requires a different set up than an infinite lifespan. The involvement of the donor and the donor's family in the management of the philanthropy may also significantly impact the lifespan of the philanthropy.

It is also important to calculate how much time the donor or the family may devote to running the philanthropy. There are "one-stop-shop type of service(s),"[6] where donors can run their philanthropy with the support of an existing "charitable umbrella"; while other philanthropists or their family members may be interested in running the philanthropic foundation themselves. Also the costs of running the charity will have to be planned and taken into account in the investment decisions.

Regardless of the strategy the philanthropist chooses, even with a limited amount of personal involvement, some monitoring and/or measurement of the impact of the giving is advised to make sure the money is well spent.

[6] Murray (2007).

How to choose the best philanthropic vehicle

As noted, there is a tax incentive to giving, which provides additional benefits to the inherent goal of giving back to society and doing good that lies at the heart of any charitable activity. While taxation may not be the main driver for setting up a philanthropic foundation, it is worthwhile to consider the tax implications of different philanthropic vehicles. Local tax requirements may require a different set of philanthropic vehicles. For our discussion in this report, we use structures from the US, where charitable giving has a long history. The three main philanthropic structures we look at are foundations, supporting organizations and donor-advised funds. The reason we choose them is not just that they are some of the most common US structures; rather, they provide solutions to decisions that need to be taken early on, such as the level of control and the projected lifetime of the philanthropy.

Foundations

UBS Wealth Planning defines a foundation as "a legal entity which is endowed with assets by the mandatory for the benefit of third parties, known as the beneficiaries, or for attainment of a specific purpose, such as charity."[7]

A private foundation provides the donor the most control and flexibility. A family foundation should reflect the family's values and can present a common goal for family members to work on for generations to come. The trade-off is in the time and money it takes to run a foundation. A rule of thumb calls for a minimum investment of USD 2 million to set up a foundation. A foundation with seed capital of USD 2 million will usually make grants in the range of USD 100,000 a year.

It is important to understand the limitations of a foundation. Such a structure will involve administrative costs and reporting requirements. Tax deductibility may be limited compared to other gifting structures, and typically there are minimum distribution requirements and even investment restrictions placed on the advantageous tax status.

[7] Source: UBS Wealth Planning.

The Bill & Melinda Gates Foundation

The Bill & Melinda Gates Foundation is one of the best-known and most professionally run family foundations of our time. It therefore serves as a good example of how to structure a family foundation.

The foundation employs roughly 980 people along with Melinda and Bill Gates, who act as co-chairs and trustees of the foundation. The Gates family is also represented by William H. Gates Sr. as a further co-chair. While the size of the Gates Foundation and its global reach may not be the aim of all foundations, it still offers many useful structuring ideas.

Core beliefs: The Gates family believes that "all lives have equal value." Our world does not reflect this core belief, however. In an age when science and technology can solve many difficult problems, Bill and Melinda Gates are not willing to accept that these disciplines are not focused in the service of those who have the most urgent needs. A key strength of their foundation is that it was established in order to correct this mismatch, a clear goal that is in line with the values of the Gates family.

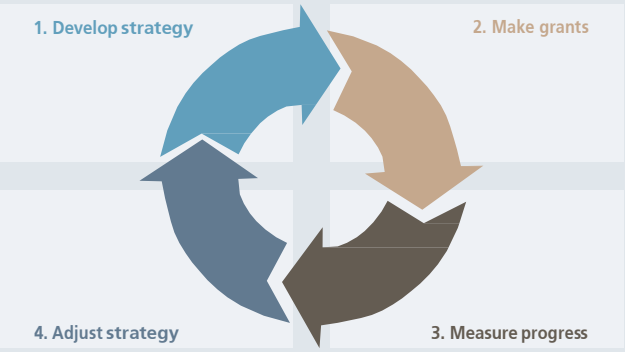
Mission: Philanthropists are well advised to set a specific purpose for their money. The clearer the mission, the higher the impact is likely to be. The Bill & Melinda Gates Foundation, which has had notable successes in improving healthcare in developing countries, among other activities, is an excellent example of a foundation with a clear mission.

To reach their target of enabling equal opportunity for all, the foundation is organized into three programs: Global Development, Global Health and United States. Each of these areas has a very specific focus. They also have a list of topics they would not get involved in, such as health problems in developed countries, political campaigns, direct support for individuals, projects with exclusively religious purposes as well as any "building or capital campaign outside the Pacific Northwest." Having such a clear definition of projects that are outside their remit allows them to turn away grant-seekers who do not comply with their mission.

Lifetime: One of Bill and Melinda Gates' aspirations is that within the 21st century, "the great human promise that all lives have equal value" should come true. Hence the foundation will have to spend all its money by the turn of the next century, or within 50 years after the two founders have passed away. A clear lifetime allows for a different approach to giving. A predefined lifetime should allow for higher grants. Especially when targeting goals as big as those of the Bill & Melinda Gates Foundation, higher grants may be needed. This is not to say that small grants will have no impact. It all depends on the purpose of the foundation and how it defines its lifetime.

Professional giving: The Gates Foundation takes a very businesslike approach to giving, employing a four-step process that is outlined in Fig. 3.10. While they claim not to follow this process rigorously, it imposes a structure to their giving. The model asks them to set goals for a donation, then make grants and follow through with the projects. One important aspect of their model is that they do not get involved with any projects whose progress cannot be measured. Setting measurable goals can help foundations to take a more businesslike approach and therefore increase its likelihood of succeeding.

Fig. 3.10: Bill & Melinda Gates Foundation's approach to giving



Source: Bill & Melinda Gates Foundation

Partnership: With a gift worth USD 31 billion, Warren Buffet joined the Bill & Melinda Gates Foundation as a trustee in 2006. The sizable gift allowed the foundation to intensify its giving, but the partnership has advantages beyond its monetary value. Finding a strategic partner who shares the values of the foundation can provide a big boost to the foundation's effort and open many new doors.

As of September 2011, the Bill & Melinda Gates Foundation had committed to grants totaling USD 26.2 billion (September 2011). As at the end of September 2011, the foundation held USD 33.5 billion in assets.

For a foundation to be recognized in the US and thus benefit from special tax treatment, it has to distribute at least 5% of the market value of its net investment assets per year. This restriction should be taken into account when setting up the optimal strategic asset allocation. In our strategic asset allocation examples, below, we therefore use the 5% minimum requirement as a fixed assumption. The most common type of family foundations in the US are "private endowed foundations" that make grants to other organizations. The more labor- and time-intensive foundations are "private operating foundations," which operate charities. Perhaps the best known foundation operating with this structure today is the Bill & Melinda Gates Foundation, a prime example of how a foundation can be structured (see box on pp. 42/43).

Supporting organizations

A "supporting organization" is a structure similar to a foundation. However this structure affords less freedom to the family, and family members may not make up more than 50% of the board. The major difference to a foundation is that a supporting organization is closely linked to one or more specific charities, while it remains freestanding and tax exempt. In fact the tax exemption and tax deduction of endowments to such a structure may be more favorable than for a foundation and, in addition, supporting organizations have no minimum distribution requirements.

Donor-advised funds

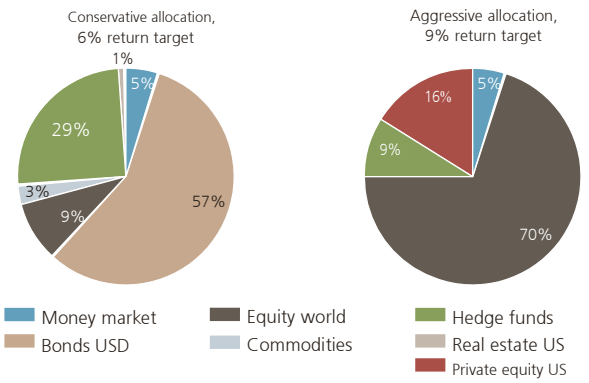
Donor-advised funds are even more removed from the full control a foundation would offer. The donor is allowed to steer where the funds are to be deployed, but is not involved in day-to-day management. The funds are managed by a public institution as a component of a public charity. Many big public charities, such as the Red Cross or United Way in the US, run such donor-advised funds.

Finding the correct asset allocation for the philanthropy

For a philanthropy with a possibly infinite lifetime, the strategic asset allocation may include a rather high share of fairly illiquid nontraditional asset classes, such as hedge funds and private equity, which offer an attractive risk/return trade-off in the long-run. Because liquidity is less of an issue for private foundations than for private wealth holders, as long as the minimum distribution requirements are met, many professionally managed foundations have used the additional return and diversification benefits of illiquid and nontraditional asset classes to meet their long-term goals.

In 2008 and 2009, this so-called "Yale model," named after the Yale Endowment, came in for harsh criticism. This was because university endowments like those of Harvard and Yale suffered losses from illiquid investments and were forced to sell assets at low valuations to provide liquidity for ongoing activities. We think, however, that this asset allocation approach is generally still valid because:

Fig. 3.7: Asset allocation of philanthropy model portfolios



Source: QIS, UBS WMR

- This was the first time in 20 years that the Yale Endowment had faced losses on its investment portfolio.
- The losses the Yale Endowment had were similar to the extent of losses of more traditional portfolios.
- The Yale Endowment considers a disciplined spending rule part of its overall asset allocation process. This allowed it to restrict spending in the good times and build reserves for a decline in assets.

To make sure that the costs of the philanthropy are met even in times of tight liquidity, we suggest that costs be considered in the return target. The asset allocation should then be devised to meet this return target. For the minimum 5% yearly payout requirement of US foundations, for example, we would set a liquidity buffer to meet this payout requirement. After all, a US foundation takes the risk of losing its status if this requirement is not met.

The asset allocation should still be structured to meet the 5% payout level without having to exploit the buffer except in case of emergency. Adding the costs of running the foundation, a conservative return target should aim for about 6% to 6.5% per year. This target does not account for inflation, however, so it is likely to be too low. Thus, such a return target will not be able to keep the portfolio at the initial investment level after accounting for inflation, or to grow the assets for future generations.

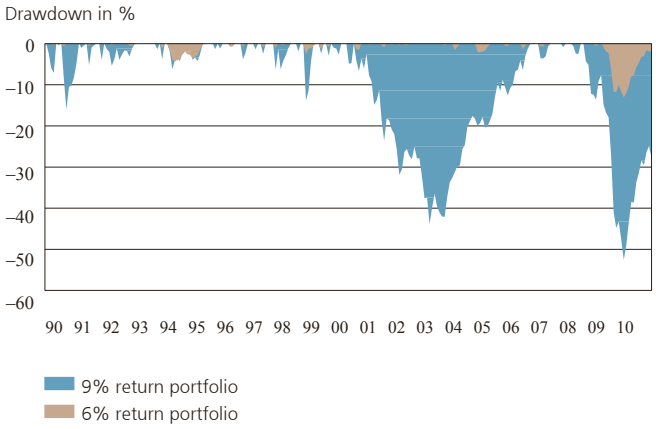
To sustain the real wealth of the philanthropy, higher return levels have to be targeted that take into account costs, inflation and the necessary payouts each year. But a higher return target also entails higher portfolio risks, higher risks of losses and thus a higher probability of missing the target return over shorter timeframes. Many foundations and endowments experienced this in 2008 and 2009, when their investment returns lagged the target returns by a wide margin. However, such higher-risk portfolios are necessary to meet these aggressive return targets in the long run.

Including inflation in the return goal is likely going to increase the return target of the foundation from 9% to 9.5%. To show the increasing risk of a portfolio with a slightly higher return target, we depicted the drawdown of our 6% portfolio in comparison with a 9% return target in Fig. 3.7. and 3.8.

As can be seen in Fig. 3.7, the asset allocation for a 6% return target differs significantly from that of the 9% return target. The high degree of equities in the 9% return target portfolio explains its higher losses during bear markets and financial crises that we see in the drawdown chart in Fig. 3.8. Focusing on the behavior of the two portfolios during equity market crises emphasizes the higher risk of the higher return allocation (Fig. 3.9).

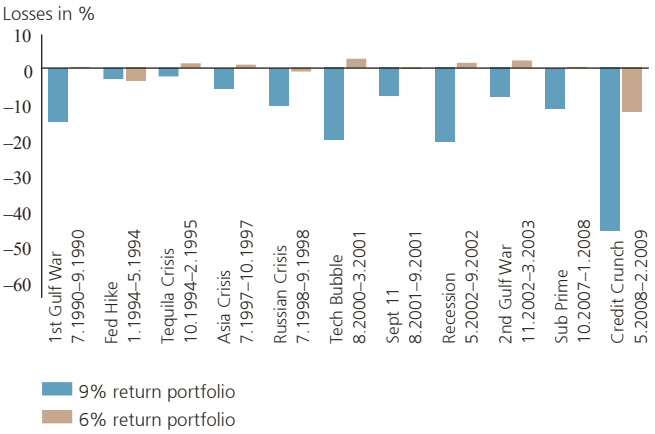
In order to avoid erosion of its assets after inflation, the Yale Endowment targets returns even higher than 9%. Its structure has no liquidity buffer at all and it keeps only a minimal cash position of 1% of its portfolio assets, relying on a stream of inflows throughout the year to cover costs. In our target return portfolios above, we assume that there is no "income" to the philanthropy over time. Income from continuous donations would allow a private foundation to reduce the amount of cash held in its portfolio if these income streams are reliable and predictable.

Fig. 3.8: Drawdown comparison



Source: QIS, UBS WMR

Fig. 3.9: Stress-testing the philanthropy portfolios



Source: QIS, UBS WMR

For philanthropies with continuous income, we recommend using the target return portfolios shown above as a starting point and perhaps reallocating unneeded cash to stocks and bonds in equal amounts. This will slightly increase the volatility of the portfolios while maintaining a high degree of liquidity. It allows creating a small asset buffer over time, which may be used to cover for excess cash outflows in some years.

Our two asset allocation examples, with the 6% and 9% return targets, clearly show why the decisions we highlight at the beginning of this section are so important. Only by understanding the nature of the cash in- and outflows and the lifetime of a philanthropy can an asset allocation be devised to meet these goals. A good strategic asset allocation is always derived from the financial objectives of the philanthropic institution and in most cases aims to preserve assets over time rather than grow them.

From entrepreneur to *wealth manager*

Highlights of Chapter 4
The sale of a business, and most other expected liquidity events requires well-considered effort and attention after the liquidity event has passed to ensure that its proceeds are optimally handled, both financially and in terms of how newfound wealth affects individuals and the family.

- We outline the most important steps of this transition phase. We intend this chapter as a general reference tool for the reader at any stage of a liquidity event. It is all too easy to lose sight of many important aspects of a liquidity event due to the distractions of daily life or the complexity of the event itself. Each individual liquidity event will be unique, but we seek to provide the underlying commonalities against which an owner may judge his situation. For example, we have outlined the process of planning for a liquidity event in terms of years. In some cases, and in terms of strategic exit planning for new businesses, these stages may take years to accomplish. In other cases, the event may initiate and conclude in a matter of months. We do not think of these time- frames as fixed and rigid, but rather as a succession of stages of different lengths.
- In the hectic days and months before the sale of a business, owners may risk losing focus on their main goals. Afterwards, control may be lost because of a lack of oversight or a lack of appreciation for the differences between managing a business versus managing financial assets. This chapter strives to mitigate these risks by outlining the major factors to be aware of and should encourage the reader to focus on the issues that we have discussed in more detail in the previous chapters.

Introduction

Once the decision to sell has been made, the preparation for a liquidity event may take several years, although ideally this will have been considered already when the business was founded. During the run-up to the signing of the final sale contracts, not only will business decisions be made, but also, as we outline in Chapter 2, personal issues will be given some thought. In addition, decisions about managing and preserving assets must be taken. Mastering all of these complex issues simultaneously, while trying to sell a business, is daunting even for the best prepared. Taking each aspect in turn and working with a variety of experts on each one can help owners avoid the primary pitfalls. Those may include a loss of oversight, a feeling of being overwhelmed, or in some cases even paralysis, where some owners have found themselves unable to sign the final contracts and transfer ownership.

At the same time, the years after a liquidity event pose their own challenges for former business owners. New goals, new careers and new opportunities emerge. One's self-image may change as may the behavior and perception of family members, friends and members of the broader community. Newfound wealth needs to be invested and managed, while many new wealth stewards find themselves pursued by many investment advisors, asset managers and even friends offering a range of investment options.

Choice can itself be paralyzing, and it is important for affluent individuals to consider how they will handle these professional relationships and differentiate between various offers.

In this chapter, we present an overview of the time before and after the liquidity event. We discuss the essential steps that need to be taken to smooth the transition from seller to "liquidity manager" as far as possible. While we focus on a generic transition in our discussions here, we are aware that every situation is different. We stress that what works for one person may not work for another. However, by focusing on this schematic process, shown in Fig. 4.1, we want to encourage the reader to reflect on these topics and read about them in the first three chapters of this report, where more detail and specific recommendations can be found.

More than two years before the event

Professional dimension:

- Monitor industry trends and business cycle to identify good timing for sale.
- Build team of trusted advisors and strategic partners for sale.
- Fine-tune business model, refine investment case.

Personal dimension:

- Consider and prioritize needs, goals and wishes.
- Understand roles of family members and their goals.

Financial dimension:

- Structure wealth and possibly transfer ownership to beneficiaries.
- Invest assets to protect them against losses before the liquidity event.

Ideally, a liquidity event is planned long before it actually happens. As we pointed out in Chapter 1, potential exit strategies may already be considered when a busness is started and as it develops. More typically, how- ever, business owners begin to think about potential succession or exit strategies for their firm much closer to the event. During this preparation phase the focus in the professional dimension should be on monitoring the business cycle and forecasts about future developments of the overall economy as well as the industry the firm operates in. Forecasting these developments over the coming years is difficult, but it is necessary for the timing of potential exit scenarios in order to sell the business at the best possible terms.

At the same time, business owners should focus on gathering a team of trusted advisors, or finding a trusted advisor who can bring different specialists to the table as needed. Selling a business today often cannot be managed by one person only. Typically, the following specialists need to interact with the business owner and his family at different stages of the planning and execution process:

- Accountants for bookkeeping and tax services.
- Tax attorneys and estate attorneys to optimize tax liabilities on sales proceeds and estates.
- Insurance agents to review personal and professional insurance packages.
- Investment bankers to find potential buyers and execute the actual sale or merger of the company.
- Investment advisors to help manage financial assets.

In addition, psychologists, operational advisors and other specialists may be part of the transition team. Wealth coaches and family governance specialists may also be called upon to help an owner and family with the personal transition processes of a liquidity event either before or after the event.

An important part of the preparation of a possible future sale of the company is to fine tune the business model and improve the investment case for a possible future investor. There may be a need to separate personal assets from a business to be sold. The company may also need to improve certain business

Fig. 4.1: Planning for liquidity events: an overview

	Professional	Personal	Financial
2Y to 5Y before	✓ Monitor industry trends and business cycle to identify good timing for sale. ✓ Build team of trusted advisors for sale. ✓ Fine-tune business model.	✓ Prioritize needs, goals and wishes. ✓ Understand roles of family members and goals.	✓ Structure wealth and possibly transfer ownership to beneficiaries. ✓ Invest assets to protect them against losses before the liquidity event.
1Y to 5Y before	✓ Prepare employees and managers for transition phase. ✓ Bring M&A advisory team on board and start looking for potential buyers.	✓ Prepare family members for transition phase and consider a more formal family governance. ✓ Think about your roles after the sale.	✓ Reduce management and oversight responsibilities for financial assets.
Up to 1Y before	✓ Focus all your energy on getting the best deal.	✓ Use personal activities to remove stress and relax as much as possible.	✓ Do not be distracted by your investments. If need be, park them in safe assets.
Up to 1Y after	✓ Do not interfere with new management if you still occupy a position within the firm.	✓ Go on a long vacation or take lots of time off with family and friends.	✓ Separate accounts for taxes, consumption and investments. ✓ Educate yourself about wealth management.
1Y to 2Y after	✓ Reassess work/career aspirations.	✓ Settle into your new role and pursue lifetime goals.	✓ Develop a strategic asset allocation that fits your financial goals. ✓ Invest your money along your personal financial plan.

Source: UBS WMR

capabilities to generate interest from a certain category of buyers. Management may need to be strengthened with external specialists in certain functional areas. Once the advisor team is in place, they will be able to provide recommendations on the optimal preparatory steps to increase the attractiveness of the company from the perspective of prospective buyers.

On the personal side, it becomes important to reflect on one's own identity and personal goals, as well as the personal goals of other family members. For many people, a business is not just a substantial asset upon which one merely hangs a price tag, but also a significant personal project which may have taken the greater part of a generation (or several) to build. The business is usually the primary legacy of the selling owner, and may be an important part of the legacy for future generations, even when the business will no longer be a part of the continuing family. As we have pointed out in our report *UBS key insights* "Wealth: Value and Values" (2008), a writ- ten family mission statement may help to define roles of different family members and trigger a communication process that reduces unpleasant surprises later on. It also helps distinguish between current goals of different family members and the values of the family that go beyond the most immediate wishes or superficial needs.

As discussed in Chapter 3, the years before a liquidity event can be used to structure existing wealth in the form of trusts and foundations that allow the transfer of wealth to other owners, for example children, in a tax-efficient way. Also, liquid assets can and should be invested so that they are protected against losses until the liquidity event has concluded. The sale of a business is a stressful period when attention and work are focused on getting the deal done. It is very helpful for many business owners to know they do not have to worry about their investments during this period.

One or two years before the liquidity event

Professional dimension:

- Prepare employees and managers for transition phase.
- Bring M&A advisory team on board and start looking for potential buyers.

Personal dimension:

- Prepare family members for transition phase and consider a more formal family governance.
- Think about your roles before and after the sale and "practice" giving up control and moving on to other roles.

Financial dimension:

- Reduce management and oversight responsibilities for financial assets.

In the immediate years before the actual liquidity event, the focus shifts from the day-to-day personal routine of managing the business and one's personal life to the professional challenges that lie ahead. M&A advisors need to be brought on board to find potential buyers and possible ways to finance the sale. Also, some entrepreneurs find it useful to increase transparency towards employees and managers about their plans to sell the business. However, the need for discretion and potential conflicts that may arise when these plans are revealed to company management may speak against such increased transparency.

Many entrepreneurs find it difficult to give up control over their business. It is important to become aware of the challenges of the new identity one will assume after the liquidity event. No more status symbols like a corner office or a personal assistant, and no influence over the operations of the business. These challenges often frighten business owners and ideally, they "practice" what it will feel like to give up control and influence.

Up to a year before the liquidity event

Professional dimension:

- Focus all your energy on getting the best deal.

Personal dimension:

- Use personal activities to remove stress and relax as much as possible.

Financial dimension:

- Do not be distracted by your investments. If need be, park them in safe assets.

In the months preceding the actual sale of the business, the owner's energy needs to be focused on ensuring the best possible deal. This is going to be a very stressful and intense period, when the assembled team of advisors will become constant companions of the business owner. Sometimes business owners spend more time with their advisory team than with their wives or husbands. It should also be considered as "the point of no return," where the decision to sell the business has been taken and a change in course should only be considered in extreme cases.

Given the increased level of stress during these months, entrepreneurs should focus their personal life on activities that help them reduce stress and recharge their batteries. Financial matters should not distract business owners and their families during this time. Do not worry about your investments; by now they should be invested in ways that do not risk the loss of capital until the sale is done. If financial assets are still unstructured, park these assets in very safe investments like money market funds or cash. The time to worry about them is only after the sale.

The first year after the liquidity event

Professional dimension:

- Do not interfere with new management if you still occupy a position within the firm.

Personal dimension:

- Go on a long vacation or take lots of time off to be with family and friends.

Financial dimension:

- Separate accounts for taxes, consumption and investments.
- Educate yourself in wealth management.

Congratulations! You have just successfully sold your business and entered a new stage of your life. Now what? After this intense period, your focus should shift from your professional life to your personal life. The former business owner should take active steps to not interfere with the new management, particularly if he or she still holds a position in the firm. Financially, many mistakes are made by investing the proceeds of a sale too fast without proper consideration of the personal financial goals and without settling into one's new life. It may often be better to get accustomed to the new wealth over time. Put some money aside to pay for your consumption over the next year, and for the tax liabilities that have arisen due to the sale of the business and the income generated by it. The remaining financial assets can be parked in a separate account in safe assets until one is ready to invest them.

Business owners have now turned into wealth managers, and their main responsibility is to preserve their wealth for their family and to invest it in ways that can help them achieve their personal and financial goals. This is when wealth-owning families struggle to differentiate among the myriad possible investment vehicles, products and solutions. Individuals need to be able to differentiate between good advisors, who propose solutions that are advantageous for both the investors and the advisor, and solutions that do not add any value for the investor.

Trust is the key foundation of modern business relationships and lasting relationships are only possible if all sides profit from the relationship.[1] In order to differentiate among the different options and opportunities and to effectively improve investment performance, we think it is vital to acquire a good understanding of wealth management practices. Many banks as well as universities and other institutions offer good training programs that introduce wealth-holders to the primary theories and strategies of wealth management. In our view, wealth owners need a basic understanding of topics such as modern portfolio theory, behavioral finance, financial planning and risk management. On top of that, a good understanding of different investment vehicles – stocks, bonds, commodities, hedge funds, private equity, etc., including their risks – is also necessary.

One to two years after the liquidity event

Professional dimension:

- Reassess work/career aspirations and potentially begin search for new ventures.

Personal dimension:

- Settle into your new role and pursue lifetime goals.
- Reflect on activities and potentially look for ways to fulfill career aspirations in the personal space.

Financial dimension:

- Develop a strategic asset allocation that fits your financial goals.
- Reassess financial goals: Is your lifestyle satisfying and financially sustainable?
- Invest your money in line with your personal financial goals.

Once new stewards of wealth have settled into their new role, it is time to focus on the most important financial decisions that need to be taken. This does not necessarily take a year after the liquidity event; it can be as short as a few months or even weeks. Yet, at some point, the role transition will be at a more advanced stage and former business owners will be ready to pursue new opportunities in life. On the personal side, these could include philanthropic activities or a possible new career or a new business. Whatever the new role, the financial assets have to be structured to allow the wealth owners to achieve these goals. The focus on the financial side should be on the development of an individual financial plan that is designed to meet the wealth-owner's financial goals and needs. This should eventually result in a strategic asset allocation and perhaps an investment policy statement that serves as an anchor for investment decisions many years into the future.[2] Only when these fundamental parameters of the investment portfolio are set should the actual investments be made.

[1] See Miranda and Klement (2009) for more details about the role of trust in our modern business environment.

[2] For more details about the importance of investment policy statements and strategic asset allocation see Klement et al. (2008).

A final thought: The ultimate goal

We have outlined the process of planning for a liquidity event in terms of years. For some business owners, these stages may indeed take years to accomplish. For others, it may be a matter of months. We do not think of these timeframes as fixed and rigid, but rather as a succession of stages of different lengths. But no matter how long this transition process takes, and no matter how smooth or difficult it may be, the ultimate goal is simple: Enjoy your wealth, enjoy your life and maybe even enjoy your new career. Hopefully this report helps readers to achieve these goals more easily.

Glossary

Acquisition
Obtaining control, possession or ownership of a private portfolio company by an operating company or conglomerate.

Buy-in management buyout
As a combination of management buyout and buy in, existing management and new management take a mutual interest in the firm. It can be a good solution for a seller as the existing management ensures a smooth transaction, while the new management may add to the knowledge pool.

Buyout
Purchasing what is normally a majority stake in an established, mature company.

Earnout
Links the price received for the sale of the business to the financial goals of the firm for a stated amount of time, for instance, a percentage of profits for the next three years. The earnout scheme redistributes some of the risks of the purchase from the buyer back to the seller. It also enables the buyer to tie the seller to the success of the business for that period. Especially when the seller remains employed, it can serve as a strong incentive. In addition, if the firm is successful, the outcome may be more favorable for the seller than a price that is set only on past performance.

Employee buyout (EBO)
With an employee buyout, the employees acquire a majority stake of the firm. It is often a reaction to the announcement of a potential sale of a business. Such a setup often promises greater job stability when the business is sold. For sellers concerned about the job security of their employees, this type of buyout offers a solution.

Initial public offering (IPO)
The sale or distribution of the company's stock to the public for the first time. Often, IPOs are done by companies seeking capital to expand. As investors seek to buy the company, including its human capital and senior management, the IPO does not necessarily offer a direct exit strategy for the owner who is involved in day-to-day management. Also, share ownership is likely to be subject to lock-up agreements for a time after the IPO to ensure that the shares don't fluctuate too much in the first trading months.

Leveraged buyout (LBO)
An investment strategy that involves acquiring a product or business from either a public or private company using a significant amount of debt. Special to the LBO is that the company's assets are used as collateral for the debt financing the deal.

Management buy-in (MBI)
The takeover of a company by external management that may offer a skill set to take the firm to a new level. The management buy-in may involve due diligence by the seller and the buyers. It is likely that external management will take over from existing management, which could cause a conflict that is a disadvantage to the business.

Management buyout (MBO)
This is a takeover of a company by existing management. For a business owner concerned about the continuation of the business and the jobs of the existing workforce, a management buyout offers advantages. As long as existing management shares the owner's values, they are the best positioned to continue the firm in line with the wishes of the previous owner. As an incentive for MBOs, managers often keep their jobs after a sale. A management buyout can be advantageous for keeping employees in general. Another advantage is that because management knows the company well, the due diligence process throughout the sale will be easier to handle. However, that can also be a disadvantage for the seller seeking the maximum amount of profits from the sale. Management may have distinct information about the company that it can use to its advantage.

Recapitalization
Recapitalization can be done for a number of reasons, including providing an exit strategy for owners. In the context of family- owned businesses, it may allow some family members to buyout others who may not want to be involved in the business. Basically, the term recapitalization means that the firm's capital structure (assets versus liabilities) is changed.

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