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BUSINESS VALUATION & FINANCIAL ADVISORY SERVICES

How to Communicate Financial Results to Family Shareholders

MERCER CAPITAL

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INTRODUCTION

Everyone agrees that communication promotes positive shareholder engagement, but what does it look like to communicate financial results effectively? In this whitepaper, we offer practical suggestions for presenting key financial data in ways that family shareholders find useful.

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Suppose that your exposure to the French language consists of two years of high school classes twenty-five years ago. Imagine how frustrating it would be if suddenly the only news outlet available to you was *Le Monde*. With no small effort on your part, there's a good chance you would be able to discern the broad outlines of the day's events, but the odds of misunderstanding a key part of the story would be high, and any subtleties or nuance in the writing would be totally lost on you.

That is likely how many of your family shareholders feel when it comes to comprehending the financial results of your family business. Perhaps they took an accounting course at some point in their lives. Or simply by virtue of having grown up around the family business, they have developed a vague sense of the differences between revenue and equity, or assets and expenses. As a result, when they read a financial report, they are generally able to discern the broad outlines of performance for the year or quarter, but the odds of misunderstanding a key part of the story are high, and any subtleties or nuance beyond the most rudimentary data are likely to pass them by.

The Balance Sheet

The balance sheet is a snapshot of what the family business owns, and what it owes, at a single point in time. The most important balance sheet concepts to communicate to family shareholders are scale, composition, and efficiency.

Scale

Is $1 million a lot of money? The answer to that question depends, of course, on your perspective. For a family-owned restaurant, it may be everything; but for Ford Motor Company, it is a rounding error. To have any meaning, balance sheet totals need context. As a raw data point, the fact that your business has net fixed assets of $205 million is meaningless to your family shareholders. To really communicate scale, you need a reference point, whether a prior date in your family business's history, a contemporary peer, or some other benchmark. Figure 1 is an example of contextualizing balance sheet scale.

Figure 1: Communicating Balance Sheet Scale

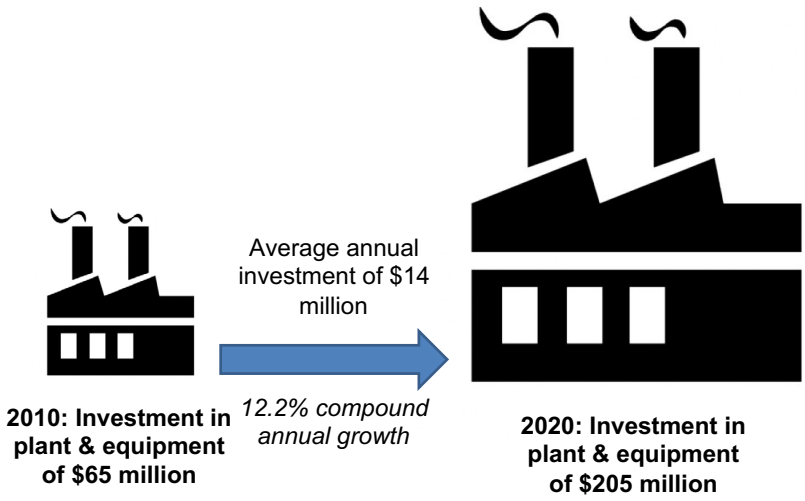


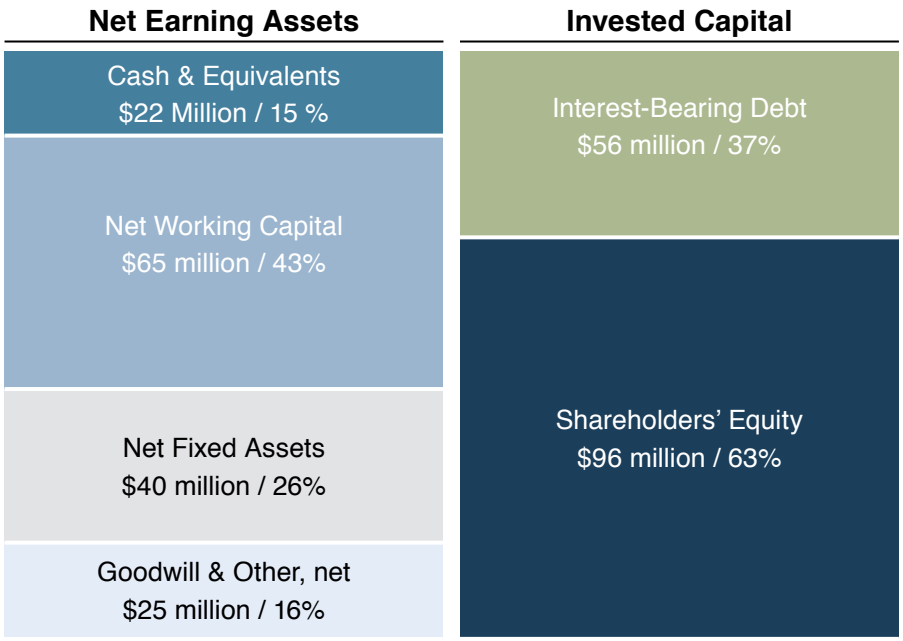
Figure 1 helps communicate scale more effectively in several ways:

- The icons help reinforce that financial statement balances aren't just numbers, but correspond to actual stuff in the real world. The family business doesn't exist to generate financial reports, but to produce real goods or provide real services.
- Comparing the balance today with that from a decade ago helps to give a sense for what $205 million really means. The meaning of a $205 million fixed asset balance today would be completely different if the balance in 2010 had been $300 million instead of $65 million.
- The average annual investment figure helps family shareholders to appreciate the cumulative nature of capital investment, and the fact that the need for capital spending is ongoing even though actual expenditures may occur only sporadically.
- The growth rate provides a benchmark for evaluating other parts of the company's story, such as revenue growth or the growth rate in other asset categories.

Composition

It is also important for family shareholders to understand the relative proportions of the balance sheet. With regard to the left side of the balance sheet, how are the total assets of the business allocated among the primary asset categories? The most important takeaway from the right side of the balance sheet, which consists of liabilities and equity, is the relative mix of funding sources used to finance the business.

Figure 2: Communicating Balance Sheet Composition

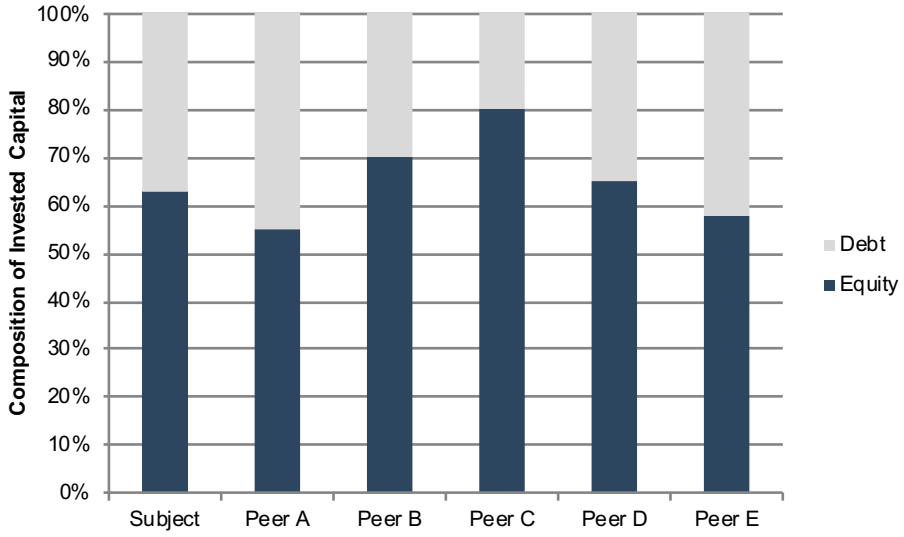


It is hard to beat a pie chart or area model for demonstrating the composition of a whole. Figure 2 illustrates one way to use area models to communicate the composition of the balance sheet. The balance sheet presentation in Figure 2 is effective for a several reasons.

- First, we have grouped individual line items together in order to reduce the "clutter" found on too many balance sheets. Detail that is appropriate for managers or even directors to consider just distracts from the overall message when the goal is communicating with shareholders.
- Second, we rearranged things a bit, netting non-debt liabilities against the left side of the balance sheet. This isolates the total invested capital entrusted to management, and helps prepare shareholders for an emphasis on return on invested capital as a primary performance measure.
- Finally, presenting the various balance sheet categories at scale conveys the relative composition of the balance sheet more intuitively than a series of numbers does.

Occasionally, it will be important to demonstrate the composition of your balance sheet relative to some benchmark, whether a peer group or historical measures for your family business. When comparing composition to differently-sized peers, it is helpful to express the components as a percentage of the whole rather than in dollar amounts, as illustrated in Figure 3.

Figure 3: Communicating Relative Balance Sheet Composition



Efficiency

The final balance sheet concept to communicate to family shareholders is efficiency. Managers and directors are stewards of family capital, and balance sheet efficiency measures demonstrate how effective their stewardship has been.

Efficiency measures include turnover and return statistics. Turnover measures compare a balance sheet item to a corresponding activity measure such as units sold, revenue, or cost of sales. Return statistics have a measure of income as the numerator and a balance sheet measure such as assets, invested capital, or equity as the denominator.

The cash conversion cycle measures the working capital efficiency of a business. In other words, how much family capital is tied up in inventory and receivables? Since the return on working capital is often relatively low, managers generally try to reduce their balance sheet allocation to working capital. Figure 4 provides an example of how to communicate the cash conversion cycle to family shareholders.

Figure 4: Communicating Balance Sheet Efficiency

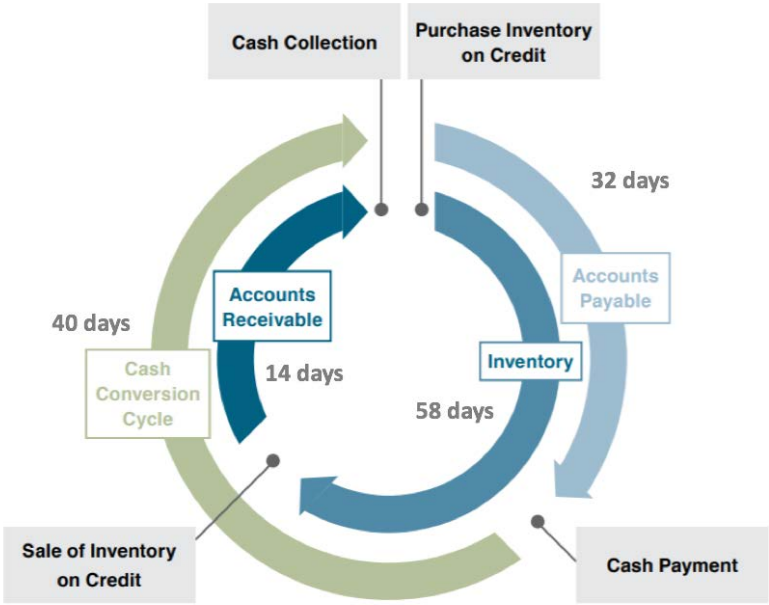


Figure 4 summarizes each component of the calculation, while also providing an intuitive basis for the calculation. By tracing the elements of the family business's operating cycle, it conveys how the business operates to family shareholders in a fresh perspective.

Conclusion

In this section, we have provided examples of how to communicate the key balance sheet concepts of scale, composition, and efficiency to your family shareholders. The figures in the post are simply illustrations; the challenge is identifying the best way to communicate these balance sheet concepts to the shareholders of your family business.

The Income Statement

If the balance sheet is a still photo, the income statement is a movie that tells the story of your family business over time. When presenting income statement data to your family shareholders, the goal should be to make the story as transparent and easy to follow as possible. The primary threads of the story for your family business as revealed in the income statement are growth, margin, and return on investment.

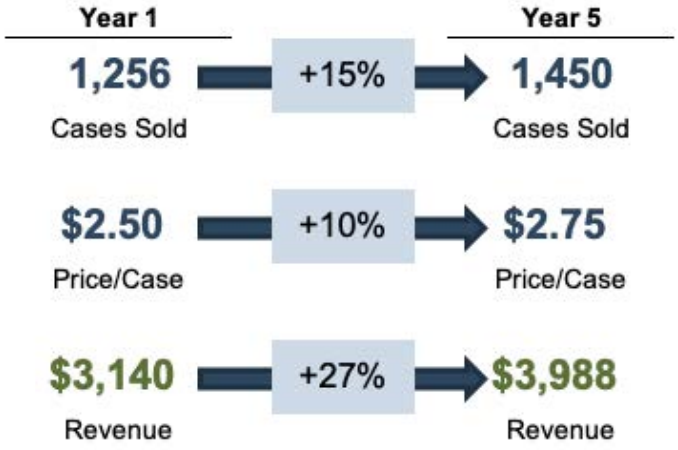
Growth

Growth is essential to family business success. As a result, family business managers should emphasize the trend in revenue over time when communicating results to family shareholders.

However, revenue growth alone does not tell the full story for most family businesses. After all, the business earns revenue by producing a good or providing a service, and revenue is the product of the volume of goods produced or services rendered and the effective price received per unit of activity. For some businesses, a volume metric is obvious (i.e., cases sold); for others, a bit more creativity may be required. Regardless of the specific volume measure, however, the underlying story is the same: revenue growth is a function of changes in the quantity of goods or services sold, and changes in the effective price received for such goods or services.

Figure 5 illustrates how breaking revenue into activity and pricing measures can add texture to revenue growth discussions. Figure 5 highlights for family shareholders that the growth attributable to selling more cases of product has been augmented by price increases to drive even faster revenue growth. The same type of presentation can then be used to discuss plans for the future. Telling shareholders that you expect revenue growth is pretty abstract; telling them that you anticipate selling 7% more cases at a 3% higher price is much more concrete and understandable.

Figure 5: Price & Volume Analysis



Margin

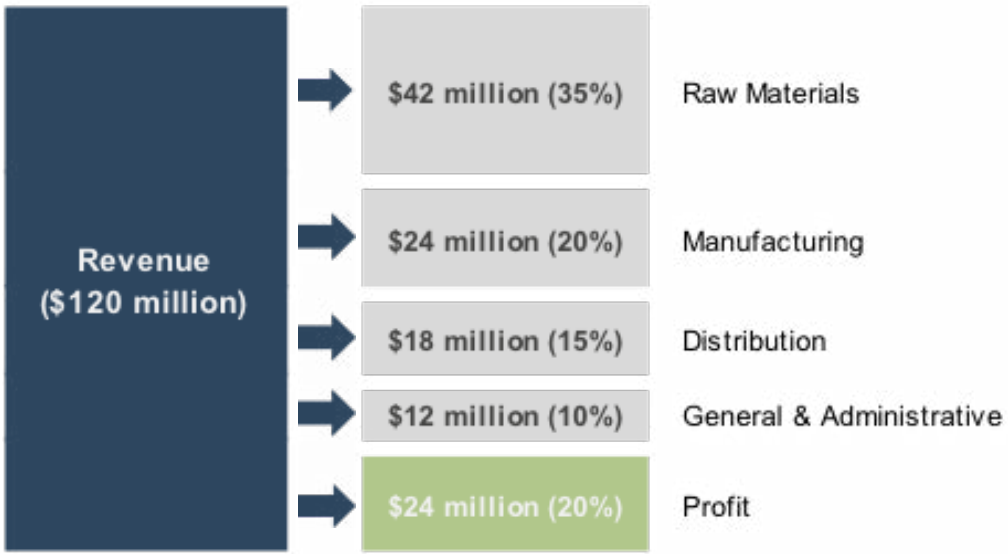
Revenue is the source of everything good in business. But your family shareholders benefit only to the degree that revenue outruns expenses. Profit margin measures the efficiency with which you convert revenue into profits. In other words, how many dollars of profit does your family business wring out of $100 of revenue?

As with revenue, the challenge for communicating margins to family shareholders is to move from the abstract (our EBITDA margin was 20% last year) to the concrete (we spend these proportions of our revenue on these expenses).

Figure 6 illustrates one way to depict the family business's profit margin in a more concrete and understandable manner.

One virtue of the presentation in Figure 6 is that it aligns the concept of profit margin with the functional areas of the business. In other words, it clarifies how much of the company's revenue goes to funding the various necessary functions of the business. This helps to remove much of the mystery about how the family business actually makes money. It also helps link profitability to business strategy by providing perspective on potential investments. For example, if we spend 2% more to acquire higher quality raw materials, we will be able to save 4% on manufacturing costs.

Figure 6: Illustrations of Profit Margin



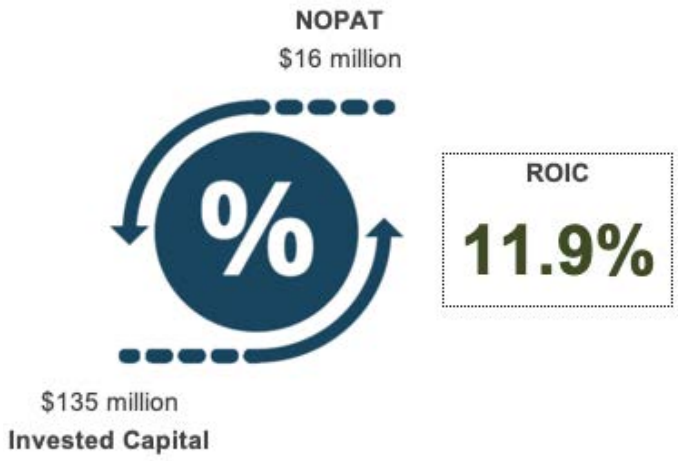
The presentation in Figure 6 relates to a single period. By establishing that base, you can then easily benchmark those results against available peer data or the family business's own performance over time. Tracing where the company's revenue goes is a great way for your family shareholders to better understand your current profit margin, along with the opportunities and challenges facing the business.

Return on Investment

One surefire way to double the interest you earn on your savings account is to double the amount on deposit. While that strategy works, it's not really what investors want to hear. Investors are much more interested in how to earn more per dollar invested. Yet, when companies report results to their shareholders, they often focus exclusively on the amount of income (profits increased 30%!) while ignoring the question of how much was invested. Return on invested capital (ROIC) is our preferred measure of financial performance for family businesses because it takes into account both earnings and the capital invested to generate those earnings.

In its simplest form, ROIC is the ratio of NOPAT (net operating profit after tax) to invested capital (the sum of equity and debt capital invested in the business). So if the 30% increase in profits referenced above was achieved only after increasing the capital invested in the business by 40%, that's really not such a good thing. Figure 7 helps to emphasize that ROIC depends on both the income generated by the business and the amount of capital invested.

Figure 7: Illustration of ROIC



ROIC is an especially effective tool for capital allocation decisions within multi-segment family businesses. As shown in Figure 8, family shareholders can benefit from a clear presentation of how much capital is allocated to each segment of the family business, how returns compare among business segments, and how returns compare to a specified hurdle rate. Figure 8 helps family shareholders see both the relative capital allocation to each segment and how the returns for those segments relate to the target return of 12%. This sort of presentation can help prepare family shareholders for important discussions about investment priorities going forward.

Figure 8: Example of ROIC Comparison Among Segments

Conclusion

The income statement is the story of your family business, and it is important to tell that story well for the benefit of your family shareholders. When telling the story of the family business, stick to the basics and focus on an easy-to-grasp narrative arc that emphasizes growth, margin, and return on investment. Your family shareholders will thank you.

The Statement of Cash Flows

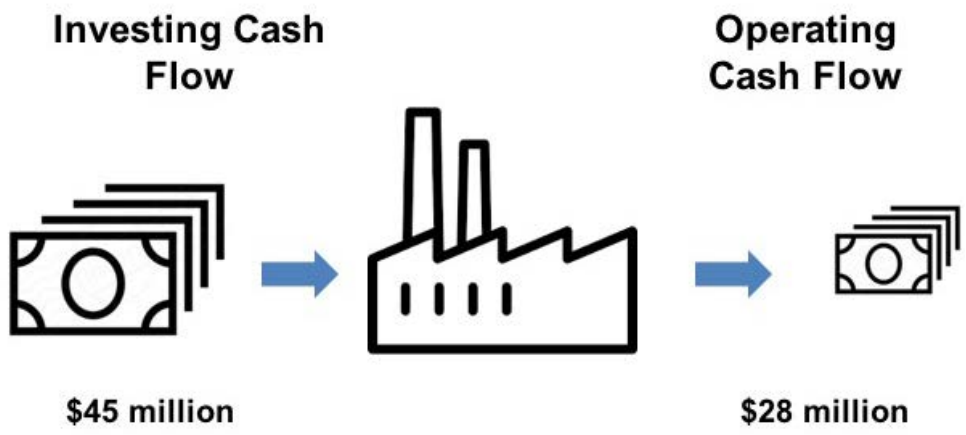
While every family business has a unique story, those unique stories will inevitably fit into one of a handful of basic plot structures. If your family shareholders don't know the underlying plot, they will have a harder time understanding what the details of the story mean. You can help your family shareholders discern the basic plot of your family business by answering two questions. First, what time is it? Second, how are we managing financial risk?

What Time Is It?

For farmers, the changing of the seasons dictates whether it is time to plant or time to harvest. Family businesses are not tied to the cycle of seasons. But at any given time, a family business is either planting or harvesting, and the statement of cash flows tells us what time it is.

The statement of cash flows allocates the cash flows of your family business into three categories: operating, investing, and financing. Comparing the operating and investing cash flows reveals what time it is for your family business. The operating cash flows are those generated by the existing operations of the business. The investing cash flows represent the amounts reinvested in the business (generally either through capital expenditures or business acquisitions). Figure 9 illustrates how the investing and operating cash flows interact to reveal the "time" for your family business.

Figure 9: What Time is it for Your Family Business



If the investing cash flows (the money being put into the business) exceed the operating cash flows (the money coming out of the business), it is planting time for your family business, as is the case in Figure 9. For family businesses in harvest mode, the opposite is true, and operating cash flows are greater than investing cash flow.

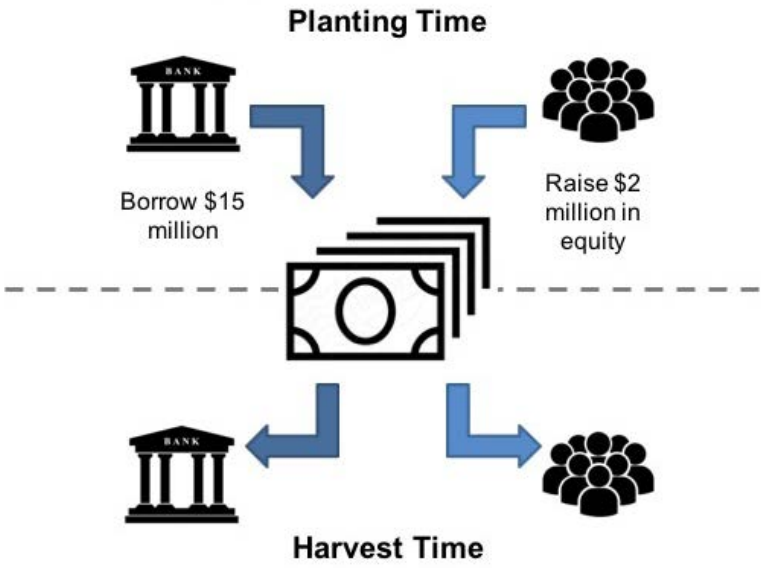
Since investing cash flows are often lumpy, we find it best to look at the statement of cash flows on a multi-year basis. Examining cash flows on a rolling three or five year basis helps to eliminate the "noise" that may creep into the results for a single year in which a major capital expenditure of acquisition is completed.

Your family shareholders should know what time it is for your family business, and why. It is not unusual for companies to oscillate between planting and harvesting over time, so a format like that in Figure 9 can be used with either historical or prospective cash flows, depending on what message you need to convey to your family shareholders.

How are We Managing Financial Risk?

Family businesses manage financial risk through capital structure, or deciding how much money to borrow. Companies that are in planting mode need additional capital, and that capital can come from the bank or from shareholders. In contrast, family businesses that are harvesting have "excess" capital to return to capital providers. Figure 10 illustrates how family businesses manage financial risk through capital structure.

Figure 10: How are We Managing Financial Risk



Our planting company from Figure 9 needs $17 million of outside capital (the excess of investing over operating cash flows). That capital can come from lenders or in the form of new equity from shareholders. Relying primarily on debt increases the financial risk of the company, all else equal. It also potentially increases future returns to family shareholders.

If it is harvest time, the family business will have "excess" capital that can be used either to repay debt or distribute to shareholders through dividends or redemptions. Repaying outstanding indebtedness is the more cautious approach for harvesters, while making distributions to shareholders is the more aggressive path.

Bringing It All Together: What Is the Plot for Your Family Business?

Figure 11: The Four Basic Plots for Family Business

	What time is it?		How are we managing financial risk?			
	Planting	Harvesting	Borrowing	Repaying Debt	Raising Equity	Repurchasing/ Distribution
Aggressive Planting	✓		✓			✓
Cautious Planting	✓			✓	✓	
Aggressive Harvesting		✓	✓			✓
Cautious Harvesting		✓		✓	✓	

Together, the two questions answered by the cash flow statement (What time is it? How are we managing financial risk?) reveal the basic underlying plot for your family business. Figure 11 outlines the four basic plots.

The navy check marks in Figure 11 indicate the dominant story threads for each plot, while the grey check marks identify secondary themes that may or may not be present in a particular story.

Plot #1 :: Aggressive Planting. When family businesses finance their capital needs during planting season with debt, they are following the aggressive planting script. This is the most nail-biting plot of them all, with the uncertainty of future returns from current investment compounded by increasing financial leverage. If the borrowing is accompanied by shareholder distributions, the risk profile is even more elevated.

Plot #2 :: Cautious Planting. Occasionally family businesses in planting mode will opt to finance their capital needs with new equity rather than debt. Family businesses often eschew seeking outside (non-family) equity capital, so this plot is less common. However, with the number of investment funds seeking minority stakes in family businesses increasing and the growing use of joint ventures and other "synthetic" equity raises, this plot may become more prevalent.

Plot #3 :: Aggressive Harvesting. Harvesters have "excess" capital to dispose of. Aggressive harvesters prefer to leave existing debt outstanding and distribute to shareholders in the form of dividends or share repurchases. The most aggressive harvesters actually continue to borrow more money to fund even more substantial shareholder distributions.

Plot #4 :: Cautious Harvesting. More risk averse harvesters view the "excess" capital at their disposal as an opportunity to repay outstanding debt. In other words, rather than provide an immediate return to family shareholders, the companies use the proceeds from harvest to reduce the risk profile of the family business and/or prepare the balance sheet for the next planting cycle.

The narrative details for your family business will be as unique as your family. Yet, the underlying story for your family business ultimately fits into one of these four basic plots. What is yours?

Conclusion

Effective communication unlocks the power of positive shareholder engagement. When it comes to the financial performance of your family business, effective communication is more than simply providing audited financial statements when requested by family shareholders. Doing so is like handing them a newspaper written in their second (or third) language. They may get something out of it, but it will largely be a matter of chance. Financial statements include and abundance of financial data.

The first step in effective communication is identifying the key themes that really matter to family shareholders. Figure 12 recaps the key themes we have identified from each financial statement.

Figure 12: Key Financial Statement Themes

Balance Sheet	Income Statement	Statement of Cash Flows
Scale	Growth	What time is it?
Composition	Margin / Profitability	How are we managing financial risk?
Efficiency	Return on Investment	

Focusing on these key themes will help you prune away unnecessary numbers and details, allowing you to communicate in a way that can actually promote positive engagement among your family shareholders. And that is an investment with a high return.

About Mercer Capital

MERCER CAPITAL
BUSINESS VALUATION & FINANCIAL ADVISORY SERVICES

Mercer Capital provides valuation, financial education, and other strategic financial consulting services to family businesses.

We help family ownership groups, directors, and management teams align their perspectives on the financial realities, needs, and opportunities of the business.

We have had the privilege of working with successful family and closely held businesses for the past 35 years. Given our experience, we are convinced that an effective board of directors and an engaged shareholder base are essential for the long-term health and success of a family business. Yet, equipping family business directors and cultivating an engaged shareholder base are often difficult. We can help.

Services Provided

- Customized Board Advisory Services
- Management Consulting
- Independent Valuation Opinions
- Transaction Advisory Services
- Confidential Shareholder Surveys
- Benchmarking / Business Intelligence
- Shareholder Engagement
- Shareholder Communication Support

The group also publishes weekly content about corporate finance & planning insights for multi-generational family businesses in the blog, *Family Business Director*.

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