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feature

THE CHALLENGES OF RESTRUCTURING FAMILY-OWNED BUSINESSES

Restructuring distressed family businesses often requires addressing chronic under-investment and make-do attitudes in an emotion-charged environment where owners have everything to lose.

Small-to-medium sized enterprises (SMEs) are the foundation of the Australian economy and family-owned businesses – which comprise the majority of SMEs – make up 70 percent of all Australian businesses.

Peak representative body Family Business Australia (FBA) says the sector is valued $4.3 trillion; that average sales revenue is between $5 million and $10 million; and that on average family-owned enterprises have between 24 and 49 employees.

Not only that, family-owned SMEs employ 46 percent of Australian workers. They are in many respects the dominant thread in the nation's economic fabric, and they've been noticed.

In May this year, as part of their Federal Budget promotions, the Prime Minister and the Treasurer urged SMEs to 'have a go'. Small business minister Bruce Bilson embellished the message with a raft of fresh incentives, including a 1.5 percent tax cut for businesses with annual turnover of less than $2 million and a $20,000 tax write-off. But politicians working to restore their political fortunes weren't the only ones eyeing the sector.

Around the same time, the Australian Tax Office (ATO) commenced a campaign of more active debt recovery activity, illustrated by a sudden and substantial rise in the number of corporate wind up applications filed in the courts on behalf of the Deputy Commissioner of Taxation (DCoT).

From a long term average of 92 wind-up applications per month, numbers soared. In May – the same month Minister Bilson was spruiking the government's SME-friendly credentials – the ATO asked the courts to wind up 556 companies.

When queried the ATO revealed that it is owed at least $20 billion in recoverable debt and that SMEs account for more than $12 billion, or 62.4 percent of the arrears.

Despite some backlash, the next month the ATO initiated 450 wind-up applications. In July, almost 400. Wind up numbers are up and staying up it seems. But the ATO's intensified recovery campaign isn't all gore and misery.

Paul Gidley, principal of NSW-based insolvency firm Shaw Gidley recently said that along with an upsurge in wind-up applications, he had noticed an increasing number of dismissals. This he argued indicated that when confronted with the threat of liquidation, many company directors were engaging with the ATO and entering into repayment arrangements. The ATO confirmed that about half of the companies in receipt of a wind up notice will proceed to liquidation.

Given the ATO's intensified focus on outstanding SME debt and the reluctance of banks and other lenders to invest in their own workout teams, insolvency practitioners (IPs) can expect to encounter more distressed family-owned entities, and such engagements pose unique challenges.

TWO KEY CHALLENGES

Robin Buckham, chief executive officer of FBA, said there are two key challenges for any external adviser or restructuring specialist brought in to assist a family-owned business in distress.

‘The issues that emerge when an independent specialist begins looking at what has brought a company undone are succession or transition, and governance,’ Buckham said.

‘Family-owned businesses tend to be weak in the area of governance,’ she said.

‘If you think about it, it is along the lines of Mum and Dad starting one flower shop 30 years ago and now they have 10 florists but are running it the same way as when they had the one.’ Buckham also said family-owned companies often lacked a proper board and a clear, well thought out constitution.

‘This can be a real challenge for IPs who come in and find that the business is not well organised,’ she said.

‘The business may not have clearly set out the relationship between the family or families, or the relationship of the family or families to the business.

‘The more robust and sensible the governance, the easier the job for an IP,’ Buckham said. ‘But it doesn’t always happen. Founders like to stick around, which irritates a lot of next generation heirs and heiresses.

‘One family patriarch drives to work every day and his children – who now run the business – have placed tape on the ground running from his car space to his office door and instructed him that he is not allowed to detour from the tape. It’s their way of keeping him away from those parts of the business that are their responsibility,’ she said.

‘There are all sorts of arrangements. The English family behind the Clark shoe brand has something like 85 people on the family council and their rule is that no family member works in the business. They have professional staff and the family just sit on the council.

‘Other family councils have a rule that sees every family member offered an opportunity to work in the business. With others, no family member can be employed in the business until they’re 30 years of age, or before they’ve obtained a degree from a university.’

Then there’s the inadvertent succession issues created when a key family member dies intestate. This scenario presents multiple challenges for IPs called in to assess restructuring options. And that’s a problem likely to grow in the near term, with a submission to the recent Productivity Commission inquiry warning of an impending tsunami of business owner retirements.

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BABY BOOMER EXITS

According to Geoff Green of GRG Momentum a staggering 80 percent of businesses worldwide are owned by baby boomers but only a minority are focussed on restructuring their businesses so as to exit profitably.

‘Many business owners who planned to exit their business before the global financial crisis put off their exit plans due to a lack of buyers and reduced business values,’ he said.

Issues such as stamp duty on business transfers had to be addressed to encourage the younger generation to take over from their parents, Green said, adding he also supported the Productivity Commission’s recommendation that capital gains tax rules for small businesses be simplified.

‘For business owners, the complexity of the concessions effectively constitutes another barrier to efficiently planning for and completing business exit and succession.’

The mass move of the Baby Boomer generation into old age also increases the chances of more owners dying on the job, which will require IPs to expand their range of communication skills when called in to deal with a business that’s suddenly lost its driving force.

As well as the possibility of having no company officer authorised to operate the company bank accounts or write cheques, the IP may have to deal with highly emotional beneficiaries unable to assist with issues related to the viability the business, the effect of the IPs’ appointment on critical supplier contracts, the business’s cash flow and what if any goodwill may exist.

Of course, restructuring is not always so dire an undertaking. Veteran liquidator Max Prentice of BPS Recovery recalled being asked to review the operations of Snow Confectionary more than two decades ago.

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'We initially got it back on the rails by the simple expedient of appropriating the company chequebook,' said Prentice, who at the time was with PPB, the firm he co-founded with Steve Parbery and Vince Barilla.

'We didn't put it through any formal scheme. We just took over the chequebook so the directors and shareholders – two sons and their father – couldn't write any cheques.

'They were bound to a factorer as well. We got them away from the factorer and became the cash controller. That certainly worked because three of or four years later they were producing about $4 million a year in profit.' In terms of restructuring, it doesn't get more straightforward than that.

DARRELL LEA

Sometimes though, a family has to surrender more than the chequebook. To save confectioner Darrell Lea, its family owners had to sell the business.

One of Australia's best known brands, Darrell Lea was founded by Harry Lea in 1927. But by the time voluntary administrators Daniel Walley and Mark Robinson from PPB Advisory were appointed in in 2012, it was bloated and lacked strategic direction, being a manufacturer, distributor, exporter and retailer, and doing none of it well, a fact the company's owners had overlooked for too long. Daniel Walley and PPB Advisory partner Sunil Purba take up the story.

'Businesses owned by families can be slow to seek advice and get involved with external advisers,' Walley said. 'It's mainly a fear of the cost but if the price of giving in to that fear is losing your business then it's a big price to pay.'

Once installed as voluntary administrators (VAs) the PPB pair found a business suffering from chronic underinvestment.

Darrell Lea had no computerised point-of-sale system, no way of analysing profitability store-by-store in real time – the company's 70 retail outlets faxed their day's sales to headquarters at the conclusion of each day's trading – and a crippling retail lease commitment of almost $10 million per annum.

Further, the family owners outsourced management to a professional team but had not supported management, which in turn had failed to address the company's declining performance.

'Often with family-owned businesses that get into trouble, there is a family or families that are still shareholders, they're still the owners of the business but they are no longer actively involved in it,' Walley said.

'In the case of Darrell Lea there were family members on the board but there were no real family members involved in the day to day management and I question how closely they were looking at it on a monthly basis.

'As a result, they weren't close enough to the issues facing the business until it was too late.'

That didn't mean however, that the Lea family was unconcerned with the company's fate or were willing to hand it over to PPB without a second thought.

'When you're dealing with owners, they still have that emotional attachment to the business, even though they are not actively managing it,' Walley said.

'Their names are above the door, their lives and a lot of their life's work that they really value is attached to the brand name so the conversation you have with owners in those situations is very different from the conversation you'd have with a typical corporate team in a corporate structure.

'There were two big issues the Lea family focussed on in their dealings with us and they picked us apart time and time again.

‘The general theme with family businesses is that there is a lot more emotion involved. It impacts their decision making, it impacts the way we approach it, it’s a lot more emotionally charged than a standard business with a board that’s not as connected as a family business would be.’

Sunil Purba

'One was how we were going to deal with the employees, what our approach would be and they asked us to tell them of other experiences we'd had where we'd dealt with employees in a very empathetic manner. They were very interested in employee welfare and outcome.

'That just demonstrates the attachment family owners often have with their businesses. It can be a help or a hindrance.'

Walley said the Lea family was also intensely interested in what experience the VAs had in selling businesses as going concerns in such a way as to ensure the brand-name endures.

'It's linked to them personally and emotionally. You're not necessarily dealing with hard-headed corporate people.' Purba said.

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Understanding the dynamics of family-owned enterprises is one of the reasons PPB now utilises a specialised proprietary tool it calls Governance and Management Assessment (GMAS) which it developed in conjunction with the University of Melbourne based on research to identify the main causes of under-performance in business.

'The make-do attitude is very common in family-owned enterprises,' Purba said.

'Sometimes businesses don't want to ask the question and we try and explain that banks would often rather see investment in restructuring and innovation than investment in growth if it's not the right time for growth,' he said.

SPRING GULLY FOODS

As the experience of PPB and Darrel Lea showed, brand can be an IP's best asset. South Australian-based Spring Gully Foods sells its own brands through the major supermarket chains and manufactures food products under contract for brands like Dick Smith. But after sales slumped 60 per cent in the first few months of 2013 it was forced to appoint VAs.

Once in charge VA Austin Taylor of Meertens found that the company's margins had been ground down by onerous rebate arrangements with its major customers – Coles, Woolworths Metcash and ALDI.

But the Webb and MacMillan families behind Spring Gully are highly respected and the Spring Gully brand is ubiquitous in South Australia. The local media got behind the company. Social media magnified the effect and there was a groundswell of public support.

'There was a large social media campaign,' Taylor recalled. 'It came at a time when Holden announced the closure of its South Australian operations and it struck a chord

'Spring Gully at the time was factoring with Westpac but Westpac had a policy of not factoring Administrators,' Taylor said. However Westpac was willing to support the company by not enforcing its security.

As the news of the company's travails broke the South Australian Government contacted ALDI's Australian boss. Within days, two of ALDI's top executives were meeting with the VA and the Spring Gully board. An $800,000 order for Spring Gully's five top selling brands was placed.

Soon afterwards, the VA received a telephone call from South Australian Senator Nick Xenophon. Over the next three days, Senator Xenophon, Spring Gully's Kevin Webb and Taylor met with senior executives of Coles, Woolworths and Metcash. Spring Gully's trading terms were renegotiated so as to ease pressure on its margins.

'The wellspring of support from suppliers, customers and even competitors gave Spring Gully a huge surge in debtors which could then be factored to provide cash to keep the company going,' Taylor, who had sourced alternative invoice financing from Cash Resources Australia said. That support turned the tide.

A deed of company arrangement (DoCA) was put to creditors and accepted on 1 July 2013. It is expected to return 102 cents in the dollar for creditors by March 2017.

Clearly, if businesses with iconic brand names are led by families with a sound reputation, IPs can buy the time necessary to effect positive and enduring restructures.

Both the Darrell Lea and Spring Gully cases highlight the need for the oft-talked about safe harbour provisions to be enacted in the corporate insolvency regime so as to encourage owners to seek advice earlier, when there is more value to preserve.

But ultimately, engineering a genuine restructure still boils down to the quality of the offering.

'You need to have a business where the fundamentals are okay and if you can fix them you are alright,' Taylor said. 'There's no point trying to turn around a business that repairs typewriters.'