Focus on fundamentals

Barbara Hauser considers next generation ventures

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New opportunities exist for advisors to wealthy families—helping to ensure the success of entrepreneurial ventures by the next generation. What is the current situation?

All wealthy families struggle with the challenge of supporting the next generation. Support is required not only with the provision of funds, but also, perhaps more importantly, support for the ventures of the next generation is required, in terms of guidance and advice. Why is this so important?

The success of the next generation is essential to the success of continuing a multi-generational family of wealth. Odds are tough. The three-generation cycle of failure is a global proverb. Also, the simple increase in numbers of family members often depletes the wealth faster than it can be replaced.

Always, next generation family members have sought to find their own ventures. As part of using their talents and planning their own lives, they often have an interest in creating their own new businesses. In some cases, the next generation members also want to 'prove' themselves, by creating a successful venture of their own, outside the existing family business. Finally, in some cases the next generation member starts a 'business' more as a pass time and without serious planning, in which case the chance of 'success' rarely exists at all.

Now, with the financial crisis, many families are turning their focus to 'operating' businesses, and not financial products. Next generation members are being encouraged to participate, and 'success' matters.

Failure by the next generation is of course unfortunate in a monetary sense, but that failure can be even more unfortunate in a sense of embarrassment or lack of competency. In fact, the public reputation of the entire family can suffer.

For those who have not been required to produce profits, some basic guidance can make all the difference. This all leads to a new focus on fundamentals, in which advisors can play a vital role. Here are five 'tips' for success.

Clarify the purpose of the venture, in terms of profitability

At the very beginning the new entrepreneur must be clear about the overall goal. The basic question that should be clear from the outset is whether or not this is a venture that is intended to make a profit.

Note that this is not a standard question for most entrepreneurs. In the general case they all intend to make a profit. But this is a serious question for those who have the benefit of not needing to earn a profit. The entrepreneur should also take into account the expectations of the various sectors.

If the venture involves a retail business, for example, then it would be expected to make a profit in order to be judged a success in the industry. On the other hand, if the venture involves providing needed services for a deserving base of customers who cannot afford to pay, then the expectations would be more about the numbers served and their satisfaction than about any profit.

An example that could fit in either category (profit motive or nonprofit motive) could be creating a school to provide education for students with special needs. The entrepreneur could be planning to make a profit (enough to support the staff and cover other expenses). Or the entrepreneur could be motivated primarily by providing a needed service. If the entrepreneur is not clear, especially to the family, about the motive (profit or not) there can be serious consequences. For example, the family might view the venture as a 'failure' for not producing a profit.

Evaluate alternative sources of funding

The next question is: where will the funds be coming from? The advisor can help evaluate the pros and cons of each of the choices. For members of a wealthy family there are usually a number of options, as listed below.

Is a trust fund available?

In general, if a trust fund is available, the specific questions will be first, whether or not the terms of the trust agreement include distributions 'to start a business venture' (this is common language in the United States), or if the beneficiary is allowed to borrow from the trust funds. Next is usually whether the trustee will agree, as they are usually charged with exercising their discretion in a manner that is for the benefit of all of the beneficiaries.

If a trust fund is available to the entrepreneur beneficiary, one positive is that oversight will be undertaken by the trustee, in its fiduciary capacity. A possible negative is that if the funds are from a portion that includes other beneficiaries, there might be some resentment and 'second guessing.' Given the potential conflicts, it may be difficult to find a trustee that is willing to take this risk.

Is there a pool of inherited wealth?

In some cases, the next generation member

has access directly to an accumulated pool of wealth. Usually this wealth has been given to the next generation family member over a number of years, from family ancestors. In a legal sense, the entrepreneur does not need anyone's permission to use those funds. In a practical sense, though, especially if future gifts are expected, it might be wise to consult those who have provided the funds over the years. They can be asked for their opinion and for their support.

Are there parents and 'uncles' or 'aunts' who would provide funding?

Often, there is not a trust, and the family funds are still controlled by older family members. In that case, the entrepreneur can make a request for funds directly from the parent or other relative, but some extra sensitivity is advised. There are likely to be other next generation family members who are not asking for those funds: will they see the request as unfair to themselves? Will there be charges of 'favouritism?' Will there be transparent information about the use of the funds? This approach has a negative impact on the senior family member: can or should they choose among different requests?

Is there a commercial lender familiar to the family?

Prior to the financial crisis, it was often a good idea to suggest to the next generation entrepreneur that they work with an objective banker (albeit one who was familiar to the family) to obtain third-party financing of the venture. An outside lender would usually insist on a business plan and engage in some amount of monitoring. Now there are fewer such lenders and also the families are generally less interested in adding debt.

Ideally, is there an organised 'family venture fund' to which requests can be made?

Many leading families have been creating a 'family venture fund' to address this situation. Often it is the family council that creates the fund and the rules that pertain to it. Those rules include: who may make a request for funding; what the maximum available amount would be; what types of ventures could be approved for funding and what type of ongoing monitoring and reporting will take place.

For example, a family in the real estate business might create a family venture fund to support next generation efforts to create their own real estate ventures, which would complement the family's primary business. Another possibility might be that the next generation ventures would have to be in different business entirely. The qualifications and guidelines would be determined by the family council.

This is an ideal source of funding. It involves the entire family (via the family council). It keeps all the information private and within the family. It requires the entrepreneur to make a successful case for the venture and it has ongoing accountability. Also, as a family effort it pulls the whole family together through involvement in the new ventures.

Require a formal business plan

Whichever the source of funds (including an internal source, i.e. the entrepreneur already has a fund) one of the basics is to create a solid business plan. Again, it is essential to decide at the beginning whether or not the venture is intended to produce a profit. In either case, though, the amounts can and should be thought through in advance. Without a business plan it is not possible to measure whether or not the venture is a success. Advisors can be extremely helpful in reviewing drafts of business plans before they are shown to a funding source.

Assist with monitoring progress

One of the saddest outcomes is to see an enthusiastic next generation entrepreneur be seen as a business failure, by the public and by the family. This can happen even if the original business plan was sound, and even if some outside safeguards applied to the initial funding. Conditions change and business plans need to be readjusted. Ongoing monitoring and accountability of the venture is essential to its success. This is another area in which the outside advisor can be extremely helpful. If challenges can be addressed as they arise, and adapted to with flexibility, success can still be achievable.

Create celebrations for success

Finally, the family needs to find ways to celebrate the success of each of its members, and particularly those who have undertaken an entrepreneurial venture. Why is this so important? As with all media news, it is unfortunately the failures that get all the attention. Celebrating success has very positive repercussions in many ways. For example, the individual receives family praise and the family wealth is increased (assuming there was a profit motive). The family's public reputation is increased (with success of either a profit or nonprofit nature). Other family members are encouraged to embark on their own ventures and the family will continue to be rejuvenated by its next generation members. The negative three-generation cycle is set aside. These are families that will continue to thrive for indefinite generations; that is worth celebrating!