Institute for
Family Business

## Financing a private sector recovery

## Submission by the Institute for Family Business (IFB)

### 1. About the IFB and the family business sector

The IFB is an independent, not-for-profit, politically neutral, membership association which supports the UK family-owned business sector through Representation, Education (IFB Forum) and Research. There are currently 192 IFB members companies, whom together account for more than £40 billion in turnover.

Our membership is made up exclusively of family owned businesses, which in terms of scale are principally mid-sized companies (turnover £25M - £500M) with a number of larger groups and are predominately privately owned unlisted companies.

The core values that define the family business sector can be summarised as **stewardship** (the long-term responsible management of entrusted resources) and **entrepreneurship** (fostering a breeding ground for innovation and change).

Studies have consistently demonstrated the importance of the family business sector - research on the UK family business sector, conducted for the IFB by Capital Economics, estimates that:

· Family firms account for **65% of private sector enterprises** in the UK economy - 3 million Businesses

· Family firms account for over 40% of private sector employment, providing jobs to 9.5 million people **one job in three throughout the UK**

· Family businesses account for **£73bn per annum in UK tax receipts**[1]

The evidence not only highlights the size and importance of family businesses to the UK economy, but also the contribution the sector makes to the diversity of UK plc.

### 2. Financing the family business sector

Typically family businesses are less leveraged, have lower levels of working capital and use less trade credit compared to similar non-family businesses.[2] The financial behaviour of the family business sector, in aggregate, arguably brings stability to the economy, at a time when some commercial activities have become unsustainable due to excessive borrowing.

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[1] "The UK Family Business Sector", (IFB survey, London, 2008)

[2] Nottingham University- (draft report pending publication (2011)

Family firms often emphasise the need to build a healthy balance sheet where shareholders sacrifice receiving dividends in the short-term in order to secure the health of the organisation over the long-term. In spite of the harsh market conditions experienced in the recession this type of conservative policy has helped sector firms to weather the storm and potentially improve their market position, as competitors with poor financial structures caused by excess debt have been suffering.

SME family businesses (who account for approximately 80% of the family business sector in terms of output) are most likely to use bank borrowing as their primary external source of finance. From the anecdotal evidence available to the IFB, banks often regard family firms as good prospects in terms of credit risk because of their relatively conservative approach to financing their organisations, often allied with a solid asset base. Private equity is also used, albeit not very frequently, as a source of funding. Larger family businesses can also access external capital through a stock market listing, however the majority of listed family firms cease to be family controlled over a relatively short timescale.[3]

### 2.1. Access to finance in the current economic climate - case studies

A snapshot poll of six IFB member businesses (see table below) conducted for this submission, including one involved in a new business activity, showed the following results. The size of the companies polled ranged from medium (4) to small (Firm B, Firm F).

| | **Firm A** | **Firm B** | **Firm C** | **Firm D** | **Firm E** | **Firm F** |
|---|---|---|---|---|---|---|
| **Sector** | Construction | Leisure (early stage) | Building maintenance | Retail | Property | Food wholesale |
| **Bank borrowing** | Nil | Yes | Nil | Nil | Yes | V. Low |
| **Credit rating** | Good | N/A | Good | Good | Good | Good |
| **Credit availability** | Good | OK | Good | Good | Good | Good |

As the table illustrates only two firms were currently leveraged, three had nil debt and one had very low borrowings. All five established businesses reported their credit ratings were high at present and commercial credit was available from their bankers should they require it. In the case of the early stage business (Firm B) bank financing had been renewed but under tighter terms and conditions. The cost of debt was not generally a factor, although interest rate spreads had been increased in two out of six cases.

More generally the IFB believes that bank finance is readily available to most creditworthy family businesses. This is particularly true with respect to mid- and large-sized family businesses. Collectively the mid- and large-sized family businesses in the UK account for 2.7 million jobs, or 28% of the total employment provided by the sector. Finance availability may however be more restricted in the case of small family firms.

[3] Prof J Franks, How Persistent is Family Ownership Across Countries?, May 2010

## 3. Response to questions raised in the Financing a private sector recovery report

### 3.1. Equity gap (Question 6)

In general family businesses are more risk averse when it comes to debt and unlikely to borrow excessive amounts for working capital. This results in there being fewer defaults[4] in private family businesses than in non-family private companies. But notwithstanding these facts financing may not be readily available in the case of smaller and possibly earlier stage family firms.

When family businesses look for capital for growth they may prefer not to go to private equity investment sources as these firms can be very short-term in their investment horizon, keen to control a majority of the company, or looking for an exit through listing the company that could lead to the loss of control for the current owners. Equally many smaller family firms lack the predictable cash flows to be of interest to private equity funds.

The proposed Growth Capital Fund could deliver capital in an area where bank financing, provided through the private sector alone, may not provide sufficient guaranteed funding to underpin the growth of the family business. Additional and cheaper funds (mezzanine funds) made available for longer term investment, in the £750k - £10m category, could therefore be useful.

**The IFB is keen to be consulted regarding the development of the Government's proposed Growth Capital Fund**

### 3.2. Encouraging investment in new business activity (Question 7/9).

Family businesses have a track record of investing into new business ventures, for instance through start-ups run by enterprising family members. These investments face high levels of risk similar to that of any investment in an early stage venture. Current rules discriminate against businesses that are looking to raise capital from relatives. The EIS has an inherent presumption that investment by family members is not at arm's length.

**The IFB recommends allowing family members relief on EIS investments through a "commerciality test"[5]**

### 3.3. Competition (Question 11)

Encouraging more players in the financial sector to enter the market, providing a wider range of products and services, would help promote greater competition. This should have positive effects for the family business sector as a whole giving the nation's 3 million family firms more choices to fulfil their financing needs.

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[4] Nottingham University (draft report pending publication (2011)

[5] This policy recommendation was raised in meetings in 2009 with the Treasury but rejected. In view of the importance of early stage business activity to driving the recovery in the private sector the IFB suggests that this issue is revisited.

**The IFB believes that competition in the finance sector should be encouraged to provide a broad and varied market in terms of sources of funding**

### 3.4. Information provision (Question 12):

Firms, and especially smaller ones, may lack information regarding the sources of finance that are available. Leaving the provision of information entirely to market forces is not sufficient.

**The IFB believes that there should be ongoing support for the Government's Business Link website, which is a good vehicle to provide access to impartial information for businesses and their advisers free of charge**.[6]

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[6] The IFB edits the family business advice pages on the Business Link website.