UDC 334.722.24:658.14
Professional paper

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FAMILY BUSINESS: TRADITIONAL AND INNOVATIVE SOURCES OF FINANCING

Abstract

Family businesses represent a major part in economy, hence in order to acquire profit and accelerate growth, they need durable financing. Access to capital is not always an easy for such kind of businesses, hereafter financing can be very quiet difficult and challenging, particularly from the family businesses view, maintaining control over their company as a key success factor, which can make financing options even more limited. Optimal combination of traditional and innovative financial sources might trigger the family business to switch from traditional toward innovative sources of financing, heavily bearing in mind the influence of such financing toward limitation and reducing the control and ownership structure in family businesses. This paper aim to determine which are the most used sources of financing by family businesses, and if they prefer to use traditional or non-traditional way of financing. The results show that there are an increasing number of non-traditional sources of capital such as family offices and high net worth individuals which are increasingly favored source of family business finance.

Key words: Family business, financing sources, banking loans, 3F, high net worth individuals (HNWI).

JEL classification: L2, G23, G24

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Introduction

Family businesses stand as dominant form of enterprises around the world and represent an important role in modern economies. According to research in this area, 60% to 90% of businesses in the world are owned by the family or under the control of the family, and generate more than 70% of global GDP annually. The percentages may vary depending on the definition used by the researcher.[1] Their importance to the economy is indisputable because they contribute to creating new jobs and developing municipalities and countries in general.

Analyzing the activities and performances, we can clearly notice that family businesses have undergone quite dynamic changes in the last two decades imposing future challenges in several aspect such as family businesses rapidly move abroad, increase the level of professionalizing, demonstrate solid growth and undergoing fast strategic changes, extend philanthropic activities and finally open into new sources of financing.[2] Having in mind the family business financing, the most attractive forms of financing remain to be traditional bank debt and share ownership, nonetheless there are a growing number of non-traditional sources of capital. These new sources are willing to provide capital on favorable terms with investment criteria which are better aligned with family business's needs. For example, family offices and high net worth individuals (HNWIs) are increasingly becoming a preferred source of family business finance.

This paper elaborates the need for family business financing, grounding its focus on traditional and innovative ways of family business financing in order to identify the adequate finance having in mind peculiarities of each source.

1. THE MAIN FINANCING NEEDS OF FAMILY BUSINESSES

Funding is the fundamental and crucial source of every family business. Finding capital to finance their expansion plans is a real challenge because of their unique long-term perspective, as well as unwillingness to give up control

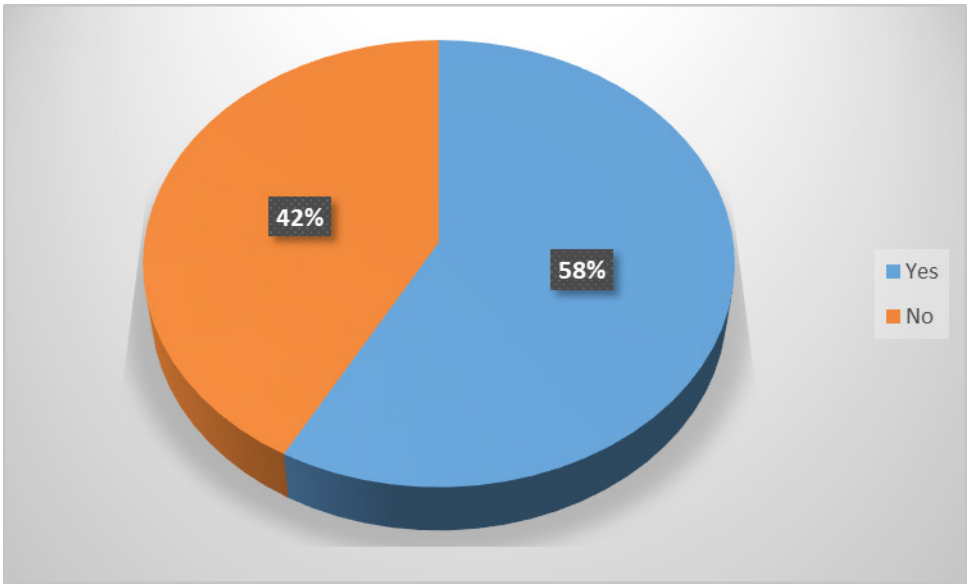
[1] Martinez, M. and Aldrich, H., Sociological theories applied to family businesses. In SAGE Handbook of Family Business. Edited by Melin L., Nordqvist M., and Sharma, P. Sage: London, UK, 2014, 83-99.

[2] KPMG International Cooperative ("KPMG International"), European family business trends 2015, pg. 1-15.

and the desire for discretion. Hence, family businesses seek different financial sources, starting with the traditional bank debt through to tapping family wealth, providing support from other businesses, and finding new innovative sources of funding.

According to the KPMG research the financial needs of family businesses depend on the period for which the funds are needed. On the short to medium term, family businesses need additional capital for expansion in existing markets through organic growth in 32%, funding day-to-day operations in 39%, new product or service development 17%, expansion in new geographical markets 2%, etc.[3] However over the longer term, family businesses aims are quite different and have more ambitious growth plans, hence the main purpose for external funds falls on acquisitions with 22%, expansion in new geographical markets follows with 18% accompanied with diversification in new sectors with 16% etc.[4] Family businesses would be more expansive if they could better utilize funding sources adequate to their needs.

Figure 1. Need for external financing for family business projects



Source: KPMG International Cooperative (”KPMG International”), Family matters, Financing Family Business growth through individual investors, 2014, p. 20.

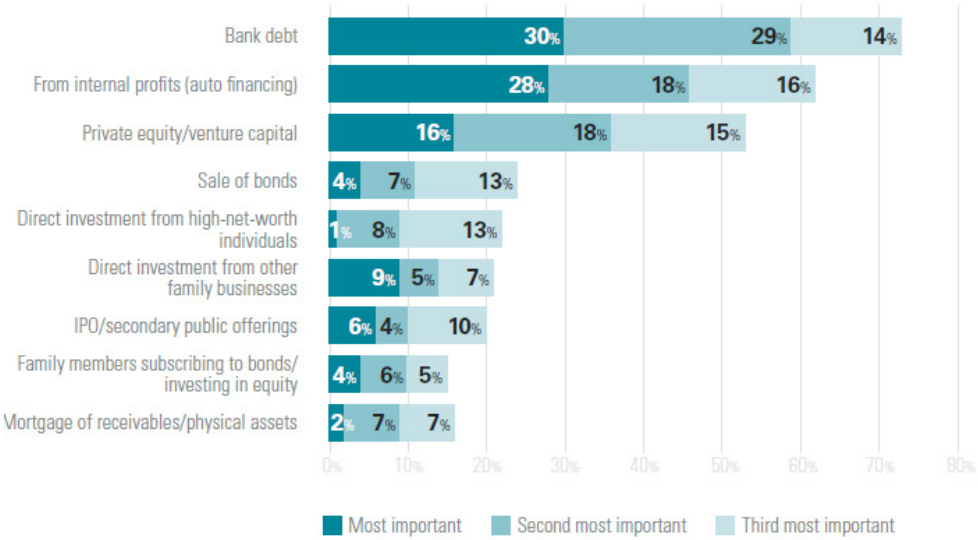
[3] KPMG International Cooperative (”KPMG International”), Family matters, Financing Family Business growth through individual investors, 2014, p.2

[4] ibid., p. 21

When it comes to financing family businesses for the most part, it is believed that they are mainly self-financed. This is confirmed by the data obtained from a survey conducted by KPMG, where 42% of respondents say that they are not currently looking for external finance (Figure 1) and many family members want to be financed through internal profits (28 %) whenever possible which is presented on Figure 2.

However, more than half of the family businesses (58%) indicate that they are looking for external sources of funding (Figure 1). The most commonly used external source of financing is bank debt with 30%, then direct investment from other family businesses with 9%, IPO/secondary public offerings with 6% etc. The most important financial reason for family businesses to go public is the need to raise higher funds to finance growth or to rebalance the debt– equity level.[5]

Figure 2. The family business sources for project financing



Source: KPMG International Cooperative ("KPMG International"), Family matters, Financing Family Business growth through individual investors, 2014, p. 22.

According to the family businesses, current economic climate has had an impact on their ability to finance their projects through bank loans. As re-

[5] Michiels Anneleen and Molly Vincent, Financing Decisions in Family Businesses: A Review and Suggestions for Developing the Field, Family Business Review 2017, Vol. 30(4), p. 376

sult of the crisis, banks have significantly reduced lending, fostering family businesses to provide detailed information needed bank loan applications. Banks are relatively reluctant to understand the unique characteristics of family businesses and fail to assess the sensitive characteristics of family firm. Consequently, family businesses are increasingly forced to seek new sources of external funding.

Europe's family businesses are becoming less conservative in their financing, since there is a definite trend toward external finance. Such stance is fostered by the low-interest environment which means borrowing from banks is cheaper than financing growth by own funds. Likewise, Europe's family businesses are considering private equity-type structures, by utilizing private equity firms which offer long-term financing options and are willing to take minority shares in companies.[6] Sufficient equity finance is crucial for strong and sustainable business growth as it impacts the company's access to debt. Therefore despite the unfavourable fiscal treatment of equity over debt in most Member States, equity financing is still on par with debt financing. A need in a level playing field for all forms of finance is confirmed by 30% of respondents who perceive that the equal treatment would significantly increase their investment capacities.[7]

2. FAMILY FUNDING: SOURCES OF CAPITAL

According to the annual survey on Access to finance (SAFE), the vast of the financial capital goes for addressing fixed investment needs, inventory and working capital, as well as developing and launching new products.[8] The biggest challenge however is obtaining the most effective combination of financial resources at the right time. Different types of financing dominate at certain stages of the business cycle. The decision is based upon the family type, the life – cycle stage, as well as personal finance health of the entrepreneur. Furthermore, the type of financing may depend on the industry, the availability of capital in the same and the entrepreneur's ability to pitch its idea with potential investors.

Although each business is distinctive, majority of family business follow the same route in the quest of capital for their business idea. **Primary per-**

[6] EY Family Business Yearbook 2017, p. 19

[7] EFB-KPMG European Family Business Barometer, Fourth edition, 2015, p. 8

[8] SAFE, 2014; SAFE, 2013; SAFE, 2011, Survey on the Access to Finance of Enterprises, Available at: http://ec.europa.eu/enterprise/policies/finance/data/index_en.htm, Accessed on 20 December, 2017.

sonal funds and **money from friends and family** represent the initial source of capital prior the establishment of the business. The **Business Angels** step in next, while the product is still in the prototype phase. **Venture capitalists** follow who are more interested in investing in the growth of already established family business. **Bank credits and loans** are not excluded, but at the early stage of establishment when family business has no history of payments or much collateral to provide as guarantee for credit applications, which makes it difficult for family businesses to gain access to debt financing.[9]

The following three sections provide better understanding of each source of capital previously mentioned, their pros and cons and availability for family businesses in particular.

2.1. Equity financing

The initial funds invested at the family businesses are always the personal savings of the family owner. This will gain trust with other relevant financing parties that the person believes in the business idea and it's potential to generate earnings.

The *3F money* coming from the founder, family and friends is the second most often used source of capital in the family businesses.[10] The investments from friends and family can also include outright gifts, forgone or delayed compensation or reduced or free rent. Priority when borrowing money from the inner circles of the family should be business-like manner, honesty and openness about the potential and risks the business bears.[11] Given the importance of networks, the owner of the family business should avoid possible damages to both personal and business relationships, especially in the very early stages of establishment. Other studies argue the connection between the household and business financing or investigate the financing coming from friends and family of the owner-manager.[12] The majority of studies specify that family firms do not significantly diverge from nonfamily firms in practicing traditional sources of financing, such as loans and 3F money.

[9] Barringer, R., B., Ireland, D., R. Entrepreneurship, Pearson, 4th edition. 2012. p. 355-360

[10] Fiti, T., Markovska, H., V., Bateman, M. (2007). "Entrepreneurship", Faculty of Economics, 2nd edition, p. 124

[11] Marriotti, S., Glackin, C., Entrepreneurship and Small business Management, Prentice Hall 1st edition, 2012, p.410

[12] Michiels Anneleen and Molly Vincent, Financing Decisions in Family Businesses: A Review and Suggestions for Developing the Field, Family Business Review 2017, Vol. 30(4), p. 375

The family owner can also use cost saving strategies to avoid external financing. ***Bootstrapping*** is an alternative source of capital for smart entrepreneurs implying cost saving strategies.[13]

Table 1. Bootstrapping as source of capital for start-ups

	Cost-saving strategies for start-ups
✓	Using second hand equipment
✓	Coordinating purchase with other business
✓	Lease equipment instead of buying
✓	Obtain payments in advance from customers
✓	Minimize personal expanses
✓	Avoid unnecessary expanses
✓	Purchase prudently, through discounts
✓	Share office space
✓	Hire interns

Source: Barringer and Ireland, Entrepreneurship,Pearson, 4th edition, 2012: p.350

Even though personal funds and financing through cost-cutting and saving money strategies is encouraged, these sources of capital are very limited and rarely satisfy the financial needs of family business especially in the startup when cash flows are unstable.

Business angels (BA) as a form of equity source of capital have gained importance and they are attracted by unique business ideas usually in a niche market. Investors retain percent of the profits and usually gain access to ownership rights which explains their appetite for innovative products with high growth potential. Nevertheless they have some advantages which make them extremely attractive among family owner:

- BAs are willing to provide smaller investments for startups, in contrast to the minimum $1 million that most venture capitalist require.
- BAs are geographically more dispersed, and often invest in local markets,
- BAs are very 'hands-on' investors.

BAs together with the financial capital bring expertise and networks from the business community especially in the given sector. Motivated by

[13] Barringer, R., B., Ireland, D., R. Entrepreneurship, Pearson, 4th edition. 2012. p. 350

potential high earnings of the company, they are willing to provide mentorship and assistance. Given the fact that lack of resources was major challenge family owner, they should really be informed about the options many business angel associations offer.

Venture capitalists is another form of equity financing more frequently used for financing the growth of already established family business. However, venture capitalists quite often fund so called "home run" companies which although highly risky have a huge expected return on investment (ROI). In practice, venture capitalists usually turn down many solid entrepreneurial proposals which do not fulfill their requirements for innovativeness and exponential growth.[14]

2.2. Debt financing

In general, authors researching the debt financing in the family business, remains inconclusive on the level of debt. Namely according to González, Guzmán, Pomp, and Trujillo (2013), Schmid (2013), and Burgstaller and Wagner (2015), a compromise needs to be made in family firms between withholding the control of debt financing over external equity, and risk aversion, which stimulates the company to have cautious approaches toward debt. [15]

When family businesses contemplate using external sources of financing, debt financing in better funding option for family firms. However, other studies find firm indication of a negative effect of family ownership on the use of debt financing in both private and public family firms.[16] The business cycle theory identified debt financing as source of capital used in the later stages of business growth. However according to latest data on access to finance, debt financing was the most common use of capital used among companies.[17]

The first disadvantage of ***debt financing*** is their interest-bearing instrument. In other words, a contract between the family owner and the lender obliges the family owner to repay the loan with a certain interest. For that

[14] Barringer, R., B., Ireland, D., R. Entrepreneurship, Pearson, 4th edition., 2012, p.356-360

[15] Michiels Anneleen and Molly Vincent, Financing Decisions in Family Businesses: A Review and Suggestions for Developing the Field, Family Business Review 2017, Vol. 30(4), p. 374

[16] Michiels Anneleen and Molly Vincent, Financing Decisions in Family Businesses: A Review and Suggestions for Developing the Field, Family Business Review 2017, Vol. 30(4), p. 373

[17] *Adapted data from SAFE, 2014, http://ec.europa.eu/enterprise/policies/finance/data/index_en.htm, Accessed on 1 December 2017.*

reason lenders prefer family owner with strong cash flows and low leverage, rather than innovative, high growth opportunities. The most common provider of loans and credits are commercial banks which primarily evaluate family owner creditworthiness depending on their history of payments and healthy balance sheets. In addition, tangible guaranty or collateral is required for credit approval.[18] Debt financing as source of capital provides family business with the needed financial resources mainly through bank loans which can provide both, short-term and long term financing for different purposes.[19]

Table 2. Types of bank loans

Asset base loans	Cash flow financing
Accounts receivable loans	Installment loans
Inventory loans	Straight commercial loans
Equipment loans	Long-term loans
Real estate loans	Character loans

Source: Adapted from Hisrich et al, Entrepreneurship, McGraw-Hill Irwin, 8ht edition, 2010: p.313- 314

Credit lines are mainly used for cash flow financing which is most frequently used by family owners. The arrangement ensures that a line of credit is available for usage upon the family owner's needs, for which the company pays a commitment fee and an interest on any outstanding funds borrowed by the bank.

A number of studies emphasis the alternative forms of debt financing. Di Giuli, Caselli, and Gatti (2011), Fitó, Moya, and Orgaz (2013), and Landry, Fortin, and Callimaci (2013) indicate the other financial instruments such as leasing or factoring.[20] ***Leasing*** enables family business to access facilities or

[18] Barringer, R., B., Ireland, D., R. Entrepreneurship, Pearson, 4th edition., 2012, p.363

[19] Hisrich, D., R., Peters, P., M., Sheperd, A., D., "Entrepreneurship", McGraw-Hill Irwin, 2010, p.313-314

[20] Di Giuli, A., Caselli, S., & Gatti, S., Are small family firms financially sophisticated? Journal of Banking & Finance, 35, 2011, p. 2931-2944; Fitó, M. À., Moya, S., & Orgaz, N., The debate on rented assets capitalization: The economic impact on family firms. Journal of Family Business Strategy, 4, 2013, p. 260-269 and Landry, S., Fortin, A., & Callimaci, A., Family firms and the lease decision. Journal of Family Business Strategy, 4, 2013, p. 176-187

equipment with little or no down-payment.[21] With the licensing agreement the owner of a piece of property allows an individual or business to use the property for a specific period of time in exchange for payments. Licensing is frequently used by family owners especially when growth strategies require additional space and technology. The result of the research indicate that family firms are less eager to use leasing and that the level of financial sophistication increases over generations.[22]

Another source for family owner is ***factoring*** as an option for satisfying an urgent need for money. The family owner sells its accounts receivable to a third party at a discounted price in exchange for cash.

Other authors such as Lappalainen and Niskanen (2013) and Psillaki and Eleftheriou (2015) focus on trade credit, a type of nonfinancial leverage, which is extensively used in many privately held family firms in practice as well.[23]

3. INNOVATIVE SOURCES OF FINANCING FAMILY BUSINESS

Although there is a common understanding the family businesses are entirely self-financing and dependent mostly on the own funds, friends and family, or relaying on the debt financing such as banking, some authors[24] postulate the a different story. The new type of family business financing mainly depend if the financing purpose is of short of long term nature. Seeking for long term financing opportunity, pushes the family businesses to pursue for long term financing other than generally assumed bank loans. Namely, research showed that many family businesses are interested in new type of financing, such as high-net-worth individuals (HNWIs), even if it means that those individuals will be present in the family business.

Positive experience with HNWIs can be confirmed by the research showing that 42% of respondents have previously raised financing from

[21] Barringer, R., B., Ireland, D., R., Entrepreneurship, Pearson, 4th edition, 2012

[22] Op. cit. Michiels Anneleen and Molly Vincent, Financing Decisions in Family Businesses: A Review and Suggestions for Developing the Field,…, p. 375

[23] Lappalainen, J., & Niskanen, M., Behavior and attitudes of small family firms towards different funding sources. Journal of Small Business & Entrepreneurship, 26, 2013, p. 579-599. and Psillaki, M., & Eleftheriou, K., Trade credit, bank credit, and flight to quality: Evidence from French SMEs. Journal of Small Business Management, 53, 2015, p. 219-1240.

[24] KPMG International Cooperative (”KPMG International”), Family matters: Financing family business growth through individual investors September 2014.

HNWIs and 92% of them explain the involvement into this new method of financing as positive.[25] Moreover the research indicate that the 1/3 would be ready to offer equity in the short to medium term, whereas 1/2 are willing to offer it for the long term. However choosing the adequate HNWIs means to have partner with a similar ambition for business risks and returns, and a strong appreciation of the family business. This type of investment may be challenging because of difficulties in finding a partner, lack of networking and experience-sharing in the family business community, and the desire of family businesses to keep these types of investment secret.[26]

We can summarize several reasons for using this innovative source of financing (Table 3).

Table 3. Reasons for choosing HNWIs

Bank requirements are too excessive and appreciate HNWIs' lower reporting requirements.
Personal relationships, useful expertise and experience, easier negotiations.
Individuals who can contribute a little, through their business ideas and experiences.
Patient investors that take a long-term view and are not focused on a rapid exit strategy.
Trusted partners who can treat information with discretion and have lower reporting requirements and are more flexibility than other sources of finance.
High-level experts, who will make judgements based on an overall view of the business rather than focusing on details.

Source: KPMG International Cooperative ("KPMG International"), European family business trends 2015, pg. 12 and KPMG International Cooperative ("KPMG International"), Family matters, Financing Family Business growth through individual investors, 2014

The 60% of HNWIs are focused toward reasonable risks and reasonable returns, and 95% has positive experience in comparison to their other investments. The main factor that would discourage HNWIs from family businesses financing is possible conflict among investee family members and lack of availability and limited information on the opportunities.[27]

[25] KPMG International Cooperative ("KPMG International"), European family business trends 2015, pg 12.
[26] Ibid., p. 13.
[27] KPMG International Cooperative ("KPMG International"), Family matters, Financing Family Business growth through individual investors, 2014, p. 6

Results from searching this new type of family member investment shows that 64% of the family business rate the experience as very positive, whereas only 8% rate it as generally negative. Moreover the same research identifies several reasons for choosing HNWIs rather than traditional sources of financing, such as longer investment time frames recognized in 19%, lower reporting requirements in 14%, easier negotiations in 13%, similar understanding of risk in 11%, etc. [28] Nevertheless, family businesses are not thinking about raising finances through a stock exchange listing as they would lose partial control and have to adhere to a new set of governance structures and in this circumstances HNWIs represent the financial model for shifting from one to another edge satisfying needs of family business of finding and control keeping.[29]

Conclusion

Family businesses mainly urge to be financed from internal sources (i.e. internal profits), but recently data show that family business are increasingly open to external funding sources. Commonly used external sources of funding are: bank debt, private trade sales, initial public offerings (IPOs) and private equity (PE).

The amount of capital collected through bank debt such traditional non-equity source, may not satisfy their numerous high-quality requirements. In fact, since the crisis, the availability of bank debt has dropped significantly. The additional funding options limit or reduce the control and independence of the family business owner. Hence it is important to identify investors on the market that are better appropriate for family businesses. Such investors, optionally underused in the transitional economies include the involvement of High-net-worth individuals (HNWIs), which are more willing to accept minority stakes without ambitions to provide total control or total sales in the future. Many of these investors have family business experience and can have a similar attitude with regard to the investment timeframe and risk stance.

The results from research demonstrate that significant percent of the family businesses (64%) rate the experience with this type of investors as very positive, whereas only small part rate it as generally negative. Several reasons are identified for choosing HNWIs such as longer investment time frames,

[28] KPMG International Cooperative (”KPMG International”), Family matters, Financing Family Business growth through individual investors, 2014, p. 18

[29] EY Family Business Yearbook 2017, p. 19

lower reporting requirements, easier negotiations, similar understanding of risk etc. Moreover, majority of family businesses demonstrate strong desire to retain majority ownership which creates the opportunity for high-net-worth individuals to play as financial source via partnering. HNWIs can provide a source of funding as well as insights that can benefit the business beyond funding, whereas in the same time they are willing to accept a minority stake in the business. Paper indicate that such solution covers the gap between constant need for finance and reluctance of family businesses to give up the ownership and control over family business and it can be consider as a future trend in family business financing.

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