Transitioning from entrepreneur to investor

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This article analyses the transition facing entrepreneurs and their families when a major source of their wealth – usually a business – is sold. This forces a shift in focus for the leader, from being an entrepreneur to becoming an investor and wealth manager. We look at the pitfalls most commonly encountered in this transition and describe ways to manage the associated challenges. We find that avoidable difficulties often arise from a lack of adequate planning, particularly failing to take human factors adequately into account. Other problems stem from overly concentrated investments, excessive portfolio interventions and pro-cyclical investment behaviour, as well as from weak governance structures and communication practices within the family. We outline a few basic practices of great value: timely planning that considers the 'soft factors' we will discuss here; the division of investable wealth into various distinct 'buckets'; and clearly defined frameworks for decision-making and family governance which are vital to successfully managing the transition from entrepreneur to investor. This is also the moment that sparks the involvement of a family office, which needs to be mindful of these challenges.

Introduction

While many entrepreneurs hope to hand over the company they built to a member of the family's next generation, very often, for a variety of reasons, the company that has been the source of a family's wealth is sold to a third party. Reasons for selling can range from an offer that is simply too good to refuse to the lack of a suitable successor within the entrepreneur's family. In any case, a sale suddenly releases a large amount of liquid funds that have previously been tied up within the business.

This liquidity event is a non-trivial change that challenges an entrepreneur in a variety of ways, some of them time-critical. When the sale is completed and the funds are released, an entrepreneur is suddenly faced with a fundamental change of roles, from being an entrepreneur to becoming an investor. The new role of investor requires new capacities and new ways of thinking.

Among the vital questions arising from a liquidity surge is how to structure the framework for managing the wealth in the future. A liquidity event can impose demands on family members who were not involved in the family's former business. Thus, one early question is, how and to what extent should family members be involved? We discuss this issue and some other challenges triggered by a liquidity event and present some potential solutions for managing them.

1. Step-change from entrepreneur to investor

To understand the challenges this transition creates, we start by looking at the situation before and after the sale of the company. Typically, a high percentage of an entrepreneur's wealth is locked up in his or her company, which means that this wealth is in a single, undiversified asset. In return for this concentrated holding, the entrepreneur can exercise direct and substantial influence on the company. Depending on the sector and the allocation of the entrepreneur's wealth, this in all likelihood is a high-risk and high-return proposition, and it is usually a precondition for the generation of large fortunes in the first place.

Understandably, most successful entrepreneurs are focused firmly on their businesses. Their personal wealth often remains a purely abstract notion for many entrepreneurs. This all changes with the sale of the company, as substantial sums of money flow into the seller's accounts.

Before selling the business, its clients, employees and suppliers were the entrepreneur's key stakeholders, but now family members are the focus. The operational and governance risks and the many quantitative and qualitative risks of running a business are now largely replaced by financial risks. Supervision of employees and corporate governance are replaced by governance of the external service providers such as banks and advisers that help to structure and manage the wealth of the newly minted investor.

When the entrepreneur's wealth was concentrated in the business, this lopsided allocation of assets and risk was compensated either by the direct control of or strong influence over the company. However, for an investor, such a narrow risk concentration is in most cases – depending on individual goals – highly inadvisable. An early lesson for new investors: financial risks are different from business risks, not to mention that the ex-entrepreneur's former levels of influence no longer apply.

Assuming the role of investor requires redefined

goals. While running the business, the goals were largely shaped by the nature of the business itself and by a raft of objective constraints. Now, the investor is free to choose what to do with her or his money, apart from sums budgeted for family demands and tax requirements. Typically, the ex-entrepreneur's focus must now shift from the growth orientation of a business towards long-term capital preservation, particularly with considerations of the next generations in mind.

The following table summarises the main aspects of the transition from entrepreneur to investor, with general recommendations to make it a success.

We think defining the financial goals for newly acquired, liquid wealth is a vital first step. Many issues need to be considered. There may, for example, be conflicting goals between the entrepreneur who was the boss of the business and other stakeholders who had more passive roles, if any, in the business. Indeed, the investor might have conflicting goals. Besides preserving capital, the ex-entrepreneur/new investor may be attracted by the thrill of engaging in concentrated investments and exerting an influence on the invested company's management.

Thus, a possibly even more important question than what to do with the money is what to do with the ex-entrepreneur's sudden surfeit of available time. Research by the Columbia Business School and Credit Suisse based on interviews with individuals involved in this kind of transition confirms that building their

Transitioning from entrepreneur to investor: changing circumstances and challenges

Enterpreneur		**Investor**		
			Don'ts	Dos
Focus	Running a business	Wisely allocating wealth	Narrowly concentrate assets (and risks)	Diversify holdings to spread financial risks
Control	Direct and considerable	Indirect or very limited	Pursue 'interventionist' investment strategies	Carefully define an investment approach and implement it systematically
Targets	Largely defined by constraints related to business objective	Lots of freedom regarding targets	Think that targets are 'obvious' or that business success is easy to replicate	Explicitly think about and set targets
Risks and goals	Numerous qualitative and quantitative risks and goals	Mostly quantitative return and risk objectives	Have unrealistic return expectations, nor overestimate your risk tolerance	Set reasonable long-term objectives
Stakeholders	Clients, employees, suppliers, regulators, competitors, other shareholders	Family members and other beneficiaries	Ignore stakeholders	Adequately involve all relevant stakeholders
Governance	The entrepreneur and possibly independent board members and management	Family governance, advisers, banks, wealth managers, lawyers	Indulge in constant ad-hoc intervention	Establish committees with clear responsibilities and governance
Conflict resolution	Hierarchical	Consensual	Decide unilaterally without involvement of concerned parties	Apply well-defined family governance and communications practices

Source: MFO.

company is typically the main thing successful entrepreneurs do with their time and that the business is the prime source of their social relationships as well (Roberts and Low, 2015).

2. Common challenges

The transition from entrepreneur to investor is clearly a profound one. The Columbia/Credit Suisse study also found that most entrepreneurs greatly underestimate the disruption triggered by the sale of their business. Among the challenges, the following issues need to be addressed when morphing from entrepreneur to investor:

- planning;
- asset concentration;
- frequent interventions and pro-cyclical behaviour; and
- governance and communications.

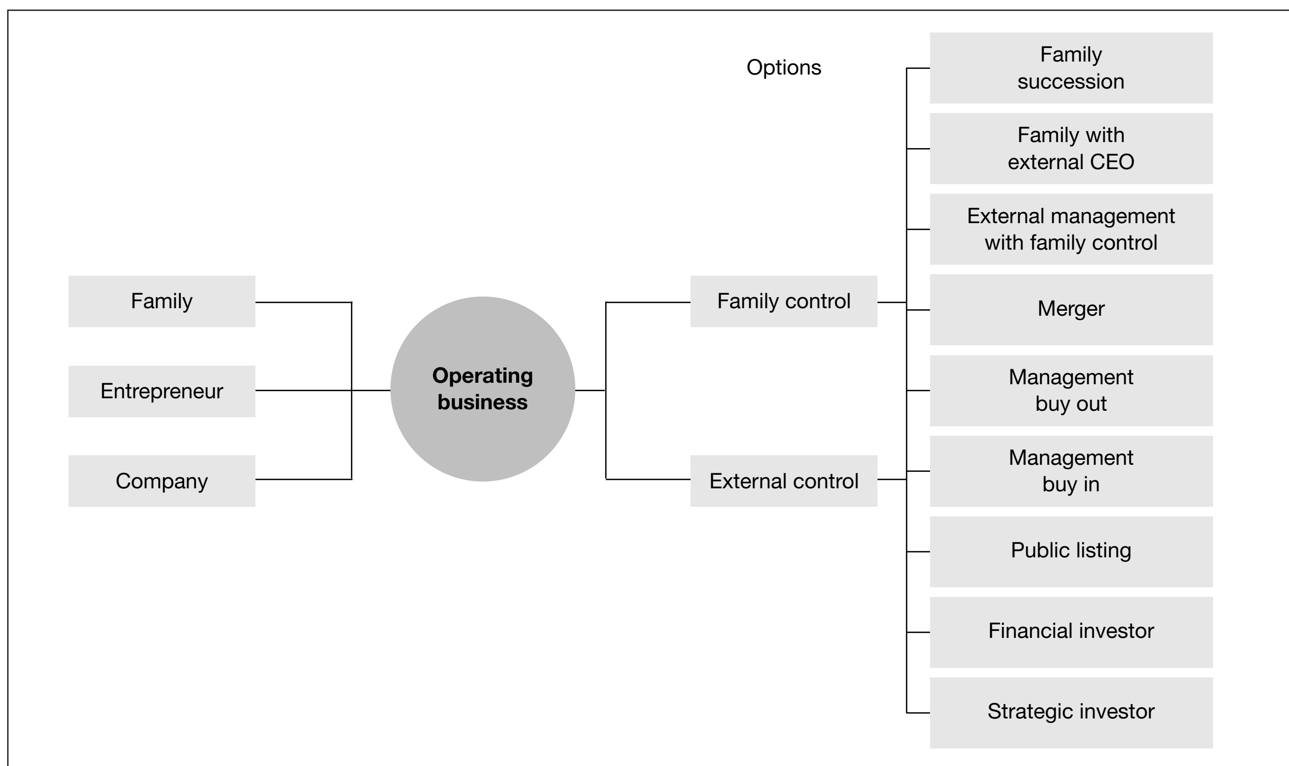
Before detailed planning can start, the entrepreneur first needs to consider the options available for his company and its stakeholders. Assuming that the company will not be liquidated, it can either be retained under the control of the family or it can be sold to a third party. The chart below shows most of the options a family faces in succession planning.

Some options entail different degrees of family involvement, such as recruiting new management from within the family, or a management team consisting of family members complemented by an external CEO, or external management that is overseen by a family-controlled board.

Most other succession solutions involve third parties to some extent, for example selling the company to the current non-family management (a management buy-out), or to a new management group (a management buy-in). Another approach to succession might be listing the company on a stock exchange – assuming that the family does not want to sell only a minority stake – or the outright sale of the company. If sold, the acquirers can be grouped into two different types. There are financial investors, typically private equity funds, that buy a company, improve its operations and optimise its balance sheet with the ultimate aim of selling the company profitably. Then there are strategic investors who acquire a company that complements their own activities. Because the latter are looking for synergies, we note, they may be willing to pay a premium price.

The options in which family control is maintained allow the entrepreneur to postpone the transition to an investor. If no internal solution is desired or possible, the business will be sold, a step that quickly transforms the entrepreneur into an investor. Options that involve a full or partial sale of the family business will lead to a liquidity event. In other words, the 'aggregate state' of wealth changes. Money once locked up in the business is liberated. That may sound unremarkable but this is a transition that requires sufficient *planning* in order to be successful.

What to do with the family business? Possible options:



Source: Neuhaus (2016), translated and adapted by MFO.

An entrepreneur who has not sufficiently planned before a sale could face a range of problems, not least a significantly higher tax bill.

Hard factors to consider before the transaction takes place include selecting the organisational structures to manage the proceeds, for example advisers, taxes (optimal corporate structure, tax rulings, estate planning, etc), account structures (opening of bank accounts, negotiation of fees and conditions, etc), defining the investment strategy, as well as the formal definition and division of responsibilities among family members, advisers and other service providers.

An entrepreneur who has not sufficiently planned before a sale could face a range of problems, not least a significantly higher tax bill. The responsibility of dealing with a sudden surge in liquid wealth and the challenges of potential conflicts among family members can weigh on relationships, with the unwanted side-effect of reducing the opportunities of the current asset owners and those of the next generations too.

These hard issues are usually straightforward enough to resolve but ignoring some *'soft' human factors* can also have adverse consequences. Soft factors include being prepared, personally, for the time when the entrepreneur is no longer associated with the company that was once at the centre of his or her working life. Here, the question of what to do with the entrepreneur's newly available time needs to be addressed. In addition, the transformation into an owner of substantial liquid wealth can change how the ex-entrepreneur is perceived by associates and by the general public, which may also raise security concerns, for example. Also, some family members might no longer be motivated to pursue their professional careers since the surge in their wealth after the sale of the company might surpass whatever they can realistically earn professionally.

Once the planning phase of the transition is concluded and the organisational set-up and responsibilities are clear, articulating an investment strategy for the newly available funds is advised. When defining these guidelines, a major challenge for an entrepreneur is to change her or his own mindset: while full concentration on the business might lead to success for an entrepreneur, it can be a recipe for disaster for an investor. It is only very rarely advisable to concentrate wealth in one single security or sector. Research and experience unarguably show that diversification is a more prudent path to preserving wealth (McCullough, 2010). From our own experience we know that a high allocation to a single stock, for example, might lead to significant gains in the short run, but this approach usually fails over the long term. One reason is the well-documented behavioural trait of investors who, having made such a big commitment, resist taking their gains on the way up, and then enter a state of denial when their stock declines, in the process exposing their portfolio to high concentration risk.

In this regard we would also point out the illusion that *frequent interventions in and micromanaging of an investment portfolio* leads to the same kinds of positive results that the former entrepreneur's constant adjustments of his or her business did. As Vincerò Capital Management (2012) put it: "Liquid assets do not respond to normal motivation and manipulation techniques". This behaviour might be the result of flawed risk perceptions: people tend to underestimate risks when they are in control – eg, when driving a car – and to overestimate risks when they delegate control – eg, flying in a plane (Gigerenzer, 2013). This can lead to *pro-cyclical behaviour* and high trading costs, which can contribute significantly to disappointing investment performance. This kind of 'activist' investor is, among others, explained by the well-known behavioural bias of excessive self-confidence, a trait not uncommon among successful entrepreneurs. Their motto: "If I can manage my business successfully, why shouldn't I be able to manage my financial wealth?" (McCullough, 2010).

While liquid assets may not respond favourably to intervention, other investments need it – private equity investments and other direct allocations in real assets are investment modalities that a former entrepreneur can relate to and even find a new passion for. A study by Ernst & Young finds that people with an entrepreneurial background prefer direct investments (Brock, 2013). Contrary to traditional financial investments like stocks and bonds, direct investments grant an investor a much higher level of information that is closer to the situation a former entrepreneur probably had in his company, such as having a detailed picture of the company's assets, understanding its cash flow patterns, and also having the capacity essentially to predict profits and losses (Crain, 2013). This contrasts with the uncertainty that is associated with market volatility and financial market cycles, not to mention

the personal influence factor at or near zero that an equity investor has on the management of the invested company.

Another major and often underestimated succession challenge is related to the adequate involvement of and *communication* with family members, based on their capabilities and interests. As long as an entrepreneur's wealth is illiquid, tied up in the company, the involvement of family members is probably limited. However, when the wealth becomes liquid and is converted into financial investments, the entitlements and expectations of family members are likely to come up, perhaps increasing their interest to participate in the decision-making processes and raising their information needs. The inadequate involvement of and communication with family members in succession planning bears the risk of potentially severe conflicts.

3. Ways to deal with the challenges

While there is no single set of rules that fits all situations, we think some approaches have proven useful to mitigate the challenges that come with a surge in liquid wealth, including succession planning.

The issue of *planning* cannot be addressed early enough. It starts by taking into account the degree of the entrepreneur's emotional attachment to his company – a soft factor. If he or she is tired of the company and eager to move on, it is probably advisable to plan for a complete sale to a financial or strategic investor without any lingering obligations for the entrepreneur. However, more often than not, entrepreneurs prefer to phase out their engagement over a period of time.

A long-term plan is the basis for good results in the area of taxes. This involves getting professional advice on how to structure business activities in the most efficient way, also incorporating succession concerns in the form of tax planning for the current and coming generations. In contrast, questions regarding a reasonable account structure (eg, which banks to use) can be addressed comparatively quickly. In that connection, the most important factor is to fully understand the account structures, fee models and the respective incentives of the providers since this will bear on the behaviour of the selected banks. We aim to avoid banks that grow their revenues through constant change, creating undue costs for the portfolio. We prefer banks that avoid conflicts of interest and we believe that the interests of the investor (the buy-side) should not be dominated by those of the providers (the sell-side).

An important part of the planning stage consists of defining investment objectives and strategies for the family. To avoid problems like pro-cyclical or interventionist investor behaviour that are often driven more by emotions than by facts, it is vital to articulate a long-term investment strategy and assure its disciplined implementation regardless of financial market noise. An investment policy statement serves as an anchor. It provides the framework by specifying the objectives, risk factors, and decision-making processes for the family in order to systematically manage investment uncertainty and even market panics (Crain, 2013).

Financial literacy is an extremely important human factor for successfully implementing long-term investment plans. The next generation should be involved in the investment process in order to prepare them for their future decision-making responsibilities. This requires them to learn about banks, financial markets, investment theories and the like. This kind of preparation helps a family manage what is a formidable step-change in available wealth. The goal is to avoid wealth becoming a burden rather than an opportunity. According to Godfrey (2015), the following goals should have priority:

- to help children to achieve a purposeful life;
- to give them good tools for self-protection; and
- to help them become active participants in the family's long-term plan.

Building up the financial knowledge of the next generation can be supported by including them in discussions when formulating the family governance system and involving them in family meetings where investments and other topics like philanthropy are discussed, and ultimately by gradually handing over responsibilities. Financial literacy can also be acquired via workshops and seminars on specific topics related to investments, philanthropy and family governance – possibly with the help of specialised advisers or its own new family office.

Another major and often underestimated succession challenge is related to the adequate involvement of and communication with family members, based on their capabilities and interests.

As we have noted, successful entrepreneurs often regard *concentration* as a positive attribute. They have seen that intense focus and dedication within a narrow domain can lead to business success. This approach, however, is unlikely to work in financial markets. But while recognising and honouring an entrepreneur's inherent preference for concentrated positions, one solution is to allocate a portion of the wealth to a separate bucket in which concentrated risk positions can be taken without exposing the entire portfolio to these risks. For example, this bucket could be used to fund private equity investments that include an active ownership role, such as a seat on the board of the invested company.

The clear distinction between purely financial assets and real assets, which are typically concentrated direct investments – whether in a single company or a real estate project – helps to maintain investment discipline and to avoid disproportionately large direct investments (Becerra, Rose and Carafi, 2015). Investments in real assets are usually closer in nature to entrepreneurship, since, in our experience, successful investments in single companies or real estate projects not only profit from the know-how and experience of an entrepreneur, but also from the willingness to dedicate enough time and energy to provide valuable guidance. In other words, providing money alone rarely works with these kinds of investments. Hence, allocating money and time to private equity could be a good way for a former entrepreneur to successfully leverage his or her capabilities while respecting a strict separation of liquid assets to avoid excessive risk concentration and interventionist-type manipulation of financial investments.

Frequent interventions and pro-cyclical behaviour can be avoided and investment discipline can be maintained if there is a systematic investment process with clear responsibilities that follows a defined investment strategy based on the specific goals of the entrepreneur and his or her family. Such a framework normally includes a long-term strategy with defined benchmarks.

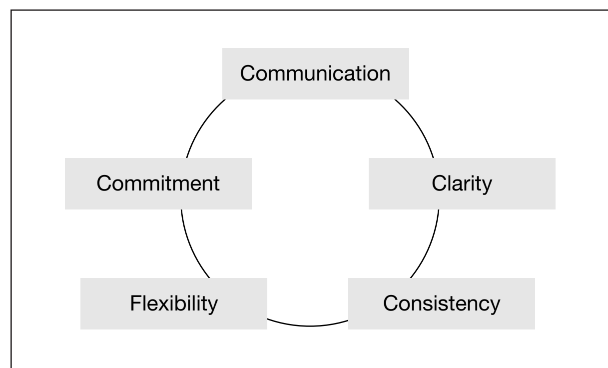
The basis of well-functioning family *governance* is a clear definition of the roles and responsibilities of the family members involved, their advisers and service providers and the respective decision-making powers of each body. Initially, an entrepreneur might prefer to take decisions within a rather small group, possibly only consisting of himself and one or two advisers. The advisers' knowledge might cover legal, tax and operational issues and is then typically complemented by additional advisers, including representatives of a family office.

Over time, different bodies, for example an investment committee or a philanthropy committee, can be introduced, which can also create opportunities to involve members of the family's next generation. Becerra, Rose and Carafi (2015) argue that effective governance mechanisms also foster family cohesion by ensuring transparency and thus preventing disputes and, when one arises, facilitating its resolution. It is important that the involved family members agree on the governance system and acknowledge its benefits in terms of long-term wealth preservation as well as those of the planned approach to managing the transition and succession. Ideally such a system grows the human and intellectual capital of the family and empowers the next generation, with the outcome that the family recreates the characteristics of the founder's generation.

One way to tackle the challenge of communication is to designate a neutral body like a family office to host family meetings and prepare and distribute updates on any changes in the tax or regulatory environment, as specified by the responsible bodies of the family, as well as providing an independent assessment of investment results according to pre-defined criteria. A functioning communication process is the prerequisite for an open exchange about the needs and objectives of stakeholders, which can change from one generation to the next. It also assures the capacity to deal with diverging interests among different family members.

However, overall successful family governance involves more than *communication*. It also includes the elements depicted in the chart below. *Clarity* means that intentions and expectations are well understood. *Consistency* is achieved as decisions are then implemented. *Flexibility* refers to the readiness to adjust family governance structures over time, as circumstances or needs change. Finally, there should be the *commitment* of everyone involved to fairness and working towards common goals.

Elements of family governance



Source: Blondel (2015), MFO[1].

Summary and conclusions

The metamorphosis from entrepreneur to investor is a challenging one. The transformation can be successful if an entrepreneur is open to adapt to a fundamentally

new situation. This openness is the prerequisite to successfully avoid the pitfalls we have discussed in this article. Planning requires early preparation and ample consideration of the human factors. The inherent tendency of concentration that many entrepreneurs have in abundance can be exploited wisely in an allocation strategy that separates total wealth into a long-term-oriented financial portfolio and a direct investment portfolio for more concentrated investments. The negative effects of frequent portfolio interventions and pro-cyclical behaviour are best avoided by sticking to a systematic investment process with clear responsibilities according to a defined investment strategy. Good governance requires the clear definition of the roles and responsibilities of the family members and involved third parties. Communication can be greatly improved by using an independent family office as a neutral agent.

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