LGA INSIGHTS
April 2019

Financing Family Ventures: Challenges and Opportunities

How can family enterprises keep diverse, dispersed next-generation members engaged and willing to participate? How best to nurture the entrepreneurial spirit of all members, including those outside the business? How can families harness the entrepreneurial capabilities of rising generations to grow collective wealth and know-how?

Families increasingly use entrepreneurship funds to finance and benefit from new ideas among members. Understand the opportunities and risks such vehicles represent and follow best practices to get the most out of them.

BY FERNANDA JARAMILLO

Financing Family Ventures: Challenges and Opportunities

How can family enterprises keep diverse, dispersed next-generation members engaged and willing to participate? How best to nurture the entrepreneurial spirit of all members, including those outside the business? How can families harness the entrepreneurial capabilities of rising generations to grow collective wealth and know-how?

Families increasingly use entrepreneurship funds to finance and benefit from new ideas among members. Understand the opportunities and risks such vehicles represent and follow best practices to get the most out of them.

BY FERNANDA JARAMILLLO

IN LINE WITH THEIR "EVERYONE IN EVERYTHING" FOUNDING PRINCIPLE, the Mulliez family (originally from France) launched CREADEV, a fund that invests in the business ideas of family members. The family, which is among Europe's wealthiest and owns large companies including the food retailer Auchan, has benefited from many ventures funded in this way, including many food-focused firms linked by retail and distribution networks. Aspiring business-builders in the family must gain the approval of the family association to receive CREADEV funding; once approved, they are provided formal, ongoing financial and advisory support.[1]

In general, entrepreneurship funds are investment vehicles for financing early-stage ventures with high growth potential—but also high risk. Like the Mulliez family, many family businesses

[1] Yann Cornil, Robert Crawford, and Morten Bennedsen, "The Mulliez Family Venture," INSEAD Case INS962, 2015.

worldwide have created such funds using excess liquidity from their operating business or its shareholders, to finance the entrepreneurial initiatives of family members, especially those from rising generations. More broadly, research shows that family businesses are the largest funding source for new business worldwide (through both formal and informal investments), including those of members[2]. Depending on the fund's size and purpose, it can be managed as part of the operating business or have its own management and governance structure. This article discusses the opportunities and risks entrepreneurship funds represent for families and provides recommendations to help optimize these high-potential financing vehicles.

Why Family Entrepreneurship Funds

Almost every family business founder dreams of keeping family members united and involved in the enterprise through generations. That's why rising generations in many enterprises understand they will enjoy access to employment opportunities in the family business. Indeed, most business families focus largely on growing and protecting the core business, the "crown jewel." At the same time, businesses may reach a point where they can't absorb more participants, and not all members may be interested in such employment, due in part to increasing geographic dispersion over generations. But there will almost always be extended-family members with the entrepreneurial spirit of their ancestors "in their blood," including next-generation members who wish to launch their own ventures. These young entrepreneurs often find themselves in need of critical capital, other business resources, and know-how. A family entrepreneurship fund can provide all of the above.

[2] Robert Nason, "Shift Your Gears, Intrapreneurship," Video Clip, Business Families Foundation, https://businessfamilies.org /en/education/p-the-future-of-family-business/ (accessed October 30, 2018).

Both the family and the entrepreneur benefit from such funds. At the *family* level, this type of financing fosters the entrepreneurial spirit of younger generations by supporting them in development of their own initiatives. The support, in turn, can create more employment opportunities—in number and diversity—for family members, through the emergent companies. This can be especially important when there are few or zero opportunities for next-generation members to join the original enterprise, as was the case with a Central American business family that owns a large agricultural and industrial business in the region. There, a second-generation leader established an entrepreneurial fund for the third generation to pursue ventures that would provide outside employment opportunities and grow the family's wealth.

Moreover, when funded entrepreneurs generate new sources of growth and value creation beyond the core family business, everyone benefits. The Central American family mentioned above has grown the value of their entrepreneurship fund many times over, for example. Finally, the growing knowledge, capability, and network of the new business-builders benefits the broader enterprise when these younger-generation members begin to serve in advisory or governance roles.

For aspiring family-member *entrepreneurs*, the funding enables them to create businesses while aligning their personal dreams and aspirations better with the shared vision for the enterprise. Additionally, young business-builders enjoy large educational and experiential benefits in the process of incubating and launching a new venture—many of which can't be gained in the classroom. "It's like 10 times what they get from an MBA," the Central American leader noted above said.

Perhaps most importantly, family entrepreneurship funds will likely strengthen emotional links within and between generations, along with

collective motivation to further the family legacy, thus enhancing the chances of continuity.

Know the Risks

Nonetheless, such funds also carry meaningful risks, for both the family and business. For one, the *family* may place significant financial resources in jeopardy by funding ventures that ultimately fail. Therefore, families should carefully evaluate the feasibility of proposed ventures prior to funding them, and develop policies and measures for assessing the success of funded initiatives—and consider potential consequences for negative outcomes. The Mulliez family, for example, rewards success, but also requires business-builders to give back some portion of shares of the holding company in the event of failure, as was the case when one member's fast-food venture failed.

Moreover, the implementation of an entrepreneurship fund can result in the sense of "winners and losers"; for the individual, to have this be a public failure in the family is different than someone starting a business on their own and not having it work out. Also, it may cause conflict within the extended family: "Why was my project rejected but my cousin's funded?" a family member might ask. Further, the failure of such an investment (likely, due to the early-stage nature of the ventures) not only diminishes value for the enterprise but may heighten tension among family members, especially if some viewed the initiative as risky from the start. Finally, the success or failure of individual ventures can lead to significant inequalities in personal wealth between entrepreneurs and other family members, again potentially causing tension and disharmony in the short and long term.

On the *business* front, the entrepreneurship fund may inadvertently result in conflicts of interest, such as when a successful venture becomes an ongoing supplier of the operating business, creating a financial dependency on that commercial relationship. For example, a next-generation member of a retail grocery enterprise may develop their own specialty food venture that sells mostly through the family business channel. In other cases, a funded venture rooted in the same industry as the family business may become a current or future competitor, causing tension and potentially eroding the original business's financial returns.

Adopt Best Practices

To maximize the opportunities represented by a family entrepreneurship fund while mitigating associated risks, consider these recommendations.

Define the purpose: It is paramount to define the fund's purpose clearly from the outset, to align all related rules, policies, and practices with the interests of the family, owners, and business. For example, if the fund's goal is to grow the family's equity, then it may be advisable for the fund to own a larger stake of new ventures, such that success may impact all shareholders and not just the entrepreneur. On the other hand, if the fund's main purpose is to support family entrepreneurs, then it should be associated with clear ownership exit mechanisms, to free up financial resources for future investments. Establishing a clear fund purpose will also provide guidelines for key decisions regarding the source of funds, the participation of the business or the family in governance, policies for using corporate funds to finance these ventures, and others.

Formulate investment policies: The fund must have clear investment rules that provide transparency for all stakeholders. The investment policy should include, among other terms, rules regarding maximum investment or participation of the fund in any venture, valuation/exit mechanisms, how the fund will be governed, and guidelines for how a funded firm can (or can't) become a supplier of the family business, along with how that commercial relationship would be managed. The risks associated with potential failure of a start up argue for setting a pretty

high bar in regards to the criteria for lending or investing the family money. Critically, the family must also adhere to these rules and policies consistently.

Promote thoughtful governance: It is highly recommended that families institute a dedicated governance body for an entrepreneurship fund, such as an Investment Committee, preferably with external independent members experienced with early-stage investments. This body would be responsible for analyzing and performing due diligence on each initiative and for making recommendations for approval/rejection, thus minimizing risks of failure. A rigorous, impartial project evaluation process including comprehensive, professional feedback will likely become a valuable continuous learning mechanism for entrepreneurs.

Provide business resources: Smart enterprises provide aspiring entrepreneurs with business tools and other resources to assist them with preparation of the business case, plan, and pitch, along with ongoing support for funded ventures. This might include instruction in entrepreneurial finance and access to mentors (such as C-level business leaders or independent board members) and other key contacts, to increase the quality of business proposals and skills, for future success. For example, the Mulliez family offers an apprenticeship program with a customized in-house curriculum for aspiring entrepreneurs—in place of financing degrees from top business schools. The curriculum includes studies in finance and law, with a healthy dose of hands-on experience in the family's companies, as informed by the family's values and culture.

Use strategic funding: To protect entrepreneurship fund assets, some families support entrepreneurial ventures through loans instead of through direct investments. Make such decisions carefully, with separate analyses, because while it's true that loan-based support protects the family from the risk of investment losses, it also shifts the risk to the younger entrepreneur and limits the upside of shared value creation.

Set realistic expectations: Last, but of great importance, is promotion of the understanding family-wide that a high percentage of funded ventures will fail, as is the case for any early-stage business. Indeed, a typical entrepreneurship fund's success generally reflects a positive balance between successful and failed investments. The family must be prepared to handle such failures without reproaching or ostracizing the entrepreneur, while still imposing any agreed-upon consequences, as a means of engendering learning and improvement rather than imposing a punishment.

In summary, a family entrepreneurship fund is a clear, practical way to formalize the commitment of the family to financing the business ideas of the next generation. While there are of course risks to such funds, as outlined here, the potential benefits are many and large, including the enhancement of family wealth, capability, and relationships. Consider the perspective and best practices here to get the most out of an entrepreneurship fund in your family enterprise.▪

Fernanda Jaramillo is a partner at Lansberg & Gersick, a research and consulting firm in New Haven, Connecticut, that serves family businesses, family offices and family foundations. She is an advisor to business families in Latin America and a frequent guest lecturer at conferences. She holds a BS degree in Industrial Engineering, an MBA degree from the Haas School of Business, University of California at Berkeley and a Master's Degree in Family Advisory from Universidad Javeriana in Cali, Colombia.