RELATIVELY SPEAKING

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December 1999
THE NEWSLETTER FOR FAMILIES IN BUSINESS
Sponsored by: Belew Averitt LLP and Horwath International • Bank One • Brown Brothers Harriman & Co.

TOP TEN FINANCIAL CHECK POINTS FOR FAMILY-OWNED BUSINESSES:

What Are Banks Really Looking For?

For some people borrowing from a bank is a mystery – but it shouldn't be. Although each bank may have lending criteria they weigh differently, the fundamentals of forming a positive and lasting banking relationship with a family-owned business are surprisingly similar. Most banks will measure a family business against the following "10 Point Check List."

1. MANAGEMENT SUCCESSION PLAN: One of the first issues for a banker when presented with a request from a family-owned business is succession planning. Be prepared to answer the following questions:

- Do you have a management succession plan? If you do not, you will likely be asked to carry key-man life insurance and pledge the insurance to the bank.
- Does the plan require your successors to buy the company? The bank will need evidence that your heirs will have the financial capacity to make the purchase.
- Do you plan to withdraw any portion of the company's capital base when you leave?
- Are your heirs prepared to take over?

2. FINANCIAL APTITUDE: The family management team must be financially astute. This does not mean that each member must be trained as an accountant or hold a degree in finance. But, it is expected that the owners understand and play an active role in the company's financial reporting and internal financial systems.

Owners should design internal checks and balance systems to ensure the safety and reliability of their financial reports. They should review the financial reports regularly and address any inconsistencies quickly.

3. CASH FLOW: Revenues do not repay loans, cash does. It is precisely because of this that banks look at earnings leverage (cash flow to debt service requirements) rather than traditional leverage (debt to worth).

A company may have a very low leverage (typically thought of as debt to worth of less than 1:1), but still may not satisfy debt obligations because earnings are not resulting in a positive cash flow.

4. MANAGING MARGINS: Margins are the difference between what you pay for your inventory, or personnel in the case of a service providing business, and what you receive (not to be confused with charge) for your goods or services.

There are two factors at play here – pricing and costing. Although often used interchangeably, they are not the same.

Pricing relates to the amount you charge. This can be the most dangerous tightrope act you perform each day. You must set your prices to remain competitive, but still cover costs with a positive margin

Costing relates to how much it costs you to acquire, produce and deliver your product. Many companies focus solely on the cost of their raw materials or other inventory purchases. This is a piece of the puzzle but you need also consider storage, manufacturing, shipping, financing costs, obsolescence, and administration. We see many companies that think they are making money, but when they peel back the layers and see what their product really costs, they find that they aren't. That brings you back to pricing. Can you adjust your price to cover your costs and remain competitive?

5. PERSONAL FINANCIAL MANAGEMENT: The way an owner manages their personal finances is indicative of how they will manage their business. A debt adverse person is not comfortable if their company is highly leveraged. The reverse is also typically true. A person with excessive personal debt and a credit report which reveals chronic past due payments is often the bank customer with repetitive overdrafts and past due business loan payments.

A bank will look to your personal financial management as evidence of your responsible use of debt.

6. GROWTH PLANS: Most businesses plan to grow over time. A business either grows or runs the risk of being eliminated by competition. In some cases owners have reached the maximum achievable profit. They found that adding revenues either didn't add to the bottom line or actually reduced it due to additional costly resources (e.g. additional personnel, larger facility, and expensive equipment).

The company that does plan to grow must quickly address the issue of financing. Banks will only be interested in financing your growth if it translates into profits

7. SOPHISTICATION AND ACCOUNTABILITY: Nearly all bank relationships require timely financial reporting. A bank will want to see that the sophistication and reliability of the financial statements reflect the size and complexity of the company. As your company grows, so will this requirement – from company prepared statements, to compilations, to CPA reviews, to annual audits. Part of your job is to know when it is time to bring in additional staff or professional partners (e.g. attorneys, CPAs, tax specialists, trust administrators.

The second part of this is accountability. Being forthright with your bank and suppliers should never be taken for granted. A bank will expect you

(See **TOP TEN** on back page)

WHO IS MINDING THE FUTURE?

Most of us awake each morning with a ritual – whether its turning on the radio or television or reading the morning paper. We tend to focus on yesterday's news. But, what will our ritual be for looking at the future? What will the future bring to our doorstep, and what will we do when it arrives?

With the speed of business now on "Hyper", who in your business is minding the future? As we approach the next century, pause and consider what you can do to mind the future of your family and your family's business.

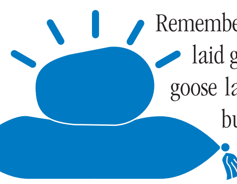
ELEMENT ONE – PLANT PEOPLE

A Chinese proverb says: *If you are planning for a year; plant grain. If you are planning for a decade; plant trees. If you are planning for a century; plant people.* As a shareholder or manager are you planting by helping the next generation decide their destiny? Are you providing the training children need to decide if they should join the family business? Are you coaching and pushing the next generation to excel?

Jim Roseman, an Anderson consultant, commented, *a business is like a tree, what we see above the ground (its trunk, limbs and leaves) are a reflection of its roots*. This is also true of a family business. As your business approaches the next century, consider the following steps to enhance your family business' root system.

- **Determine if your root system can support another limb.**
  Can the financial performance of the business support more family? Family businesses have to draw the line on family employment. The best rule is to only allow in those family members that can add value to the business.
- **Develop a ritual for nurturing growth.**
  Establish criteria for employment and promotion. This may include testing (i.e. Myers-Briggs, Birkman, HumanSide, etc.), interviews by independent professionals and periodic "no-holds barred" objective and professional performance evaluations. Remember you are nurturing – the farmer never gets angry at the seeds.
- **Articulate the role and responsibilities of the management team.**
  In many family-owned and managed businesses, the lines sometimes become blurred between family and business issues. Do your best to keep ownership issues away from the day to day operations.
- **Prepare the new leaders for the future.**
  Just because the son or daughter is the oldest child does not qualify them ascend to the top leadership role. Secure outside counsel to evaluate the potential family leaders of the future.
- **Be ready to step aside – slowly – and allow growth.**
  Apples may not fall far from the tree, but the roots can go anywhere. As the new family members begin their own root system, allow them to discover their own path, even if it feels like they are professionally "living on the edge." Practice letting go on the simpler issues and then when the day comes to take your hands off the tiller, it will not shock the system.
- **Remember to cross-pollinate.**
  Non-family managers may not be a part of the central root system but they are an important part of the continuity and success of almost every family business. Make an investment in their future and they will help you steer the family business into the future.

ELEMENT TWO – PROTECT THE GOLDEN EGG

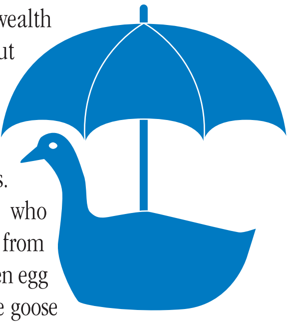


Remember the story of the goose that laid golden eggs? In the story the goose laid a golden egg every day, but this was not enough for the farmer who owned the goose. As you will remember, he killed the goose with the anticipation that he would find all of the golden eggs at once instead of having to wait each day for the golden egg. The "goose and the golden egg" issues in family businesses are:

- **Establish a sound financial reporting system.**
  Measuring the performance of your business in financial and productivity terms is mandatory. Go beyond the income statement and balance sheet and examine the daily and weekly measurements.
- **Plan your work, and work your plan.**
  An old saying, but still profound advice. With technology and the information age, planning has become more critical. Two of Jack Welch's golden rules for business success are, *Change before you have to* and *If you don't have a competitive advantage, don't compete*. In the ReGENERATION Partners' Family Business Survey CEO/owners revealed that only 20% of family businesses have a written strategic plan.

  Effective planning comes from not only looking at the performance and trends of your business, but also includes an examination outside your business and considers such factors as the industry, the economy, and maybe even the social and political landscape.
- **Formalize competitive intelligence.**
  With the advent and power of the Internet many businesses are now required to spin on a dime to stay competitive. If you don't know how to effectively build and use competitive intelligence, starting places would include seminars, universities and outside consultants.

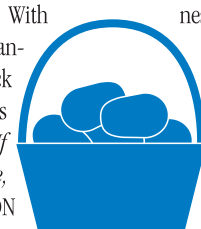
ELEMENT THREE – PROTECT THE GOOSE



Families work many decades to build successful businesses that provide wealth and employment. Without careful planning the succession of ownership and wealth may create burdens such as taxes and conflicts. Many families fight over who controls and gets money from the goose that lays the golden egg while others want to kill the goose to get all the golden eggs today. Begin protecting the goose and minding the future by:

- **Look at the estate tax and management issues.**
  Do proactive planning for the ownership and management transfer. Remember, liquidity may become critical just to protect the wealth that has been created.
- **Think about the economic power of your business and wealth.**
  What is your estate capable to generating in the way of income for your retirement? Is their enough to support family members projected lifestyle? What about civic and philanthropic values? Pause and reflect on the power of the goose that lays these golden eggs.

ELEMENT FOUR – HARVEST



Harvesting a successful career from a family business is one of life's most challenging events. It is not easy, but the following advice from one that has been there may help:

- **If you are the senior generation,** set aside a weekend and take your spouse on a trip to a quiet and peaceful place to talk. Talk about your own needs, dreams and desires for the remaining years of your life. Focus on those things that will add meaning to allow each of you to fully enjoy your life. Come to a mutual agreement about what you want the future to bring to you and your family.

HEAFNER TIRE GROUP, INC.: A STORY OF SPECTACULAR GROWTH

The opportunities and challenges facing private and closely-held public companies in the United States have never been greater. Many such companies see not only the opportunity but also the need to develop their business far more rapidly than they once envisioned.

In addition, private closely-held companies have enjoyed a period of sustained prosperity since the 1980s. A generally favorable economy, combined with declining interest rates, has enabled hundreds of thousands of private companies to build substantial equity value. Many of these companies now face the challenge of balancing their requirements for capital against a need or desire for liquidity from one or more shareholders.

James H. Heafner started a small tire business on May 5, 1935, with one upright mold recapper and two manual gas pumps operating out of Lincolnton, North Carolina. Sixty-four years and three generations later, the Heafner Group has grown to become a leading national tire and automotive service and equipment distributor pursuing an aggressive program of expansions and acquisitions that should bring the company's sales to a billion dollars this year.

HISTORY AND DEVELOPMENT

Heafner had enjoyed steady growth and a reputation for excellent service since its founding. The company opened its first branch location in Charlotte, North Carolina in 1954, and added nine locations in three states in the 1950s and 1960s. Heafner introduced its first private label brand, the Regul Tire brand, in 1972, and ten years later made its first major acquisition, Beech Tire Mart, bringing the company's total number of distribution centers to 25 in 12 states. The company sold its 10 millionth Regul Tire in 1986.

By the 1990s, Heafner was operating 29 distribution centers in 18 states and was a leading regional distributor of tires, wheels, and service equipment. However, it wasn't until 1997, when the Heafner and Gaither family determined that the company would have to grow through acquisition to achieve volume discounts and operating efficiencies necessary to survive in a highly competitive consolidating industry, that the real explosion began…

WINSTON ACQUISITION

In May 1997, Heafner entered the retail tire business with its purchase of Oliver & Winston, Inc. ("Winston"). Founded in 1962, Winston was the nation's fifth largest tire retailer with 175 retail locations in California and Arizona. In order to finance this acquisition, Heafner arranged, in combination with other debt and equity financing commitments, a mezzanine capital investment from the 1818 Mezzanine Fund, a partnership managed by Brown Brothers Harriman & Co.

In addition to achieving the shareholders' objectives of achieving volume discounts and operating efficiencies, the Winston acquisition provided Heafner a second high volume private label tire brand. Coincident with the closing of the purchase of Winston, the company also agreed to purchase certain of its own shares from several descendants of James H. Heafner who were not involved in the management of the company.

ITCO AND CPW ACQUISITIONS

Last year, the company took another important step in its growth toward the ultimate goal of becoming a leading national player in both the tires and related products distribution industry and the retail auto products and service industry.

On May 20, 1998, Heafner acquired ITCO Logistics Corporation and Competition Parts Warehouse ("CPW"). ITCO was founded in 1962 as Interstate Tire Company and was, at the time it was merged into Heafner, one of the largest wholesale distributors of tires, custom wheels, equipment, and tire dealer supplies in the Southeast. With 1997 sales of approximately $350 million, ITCO operated 30 full-service distribution centers in 8 states located from Baltimore to Miami.

CPW was started in 1971 as a performance automotive shop under the name Speed Merchants. By 1998, it had grown to a wholesale operation specializing in the after-market sales of tires, parts, wheels, and equipment, with six distribution centers in California and Arizona. CPW had fiscal 1997 sales in excess of $120 million and shipped more than 1.9 million passenger and light truck tires.

In order to finance the two acquisitions, the company issued $100 million of senior notes to the public. The two mergers increased Heafner's retail locations by approximately 30% and its wholesale locations by close to 100%. In addition, operating efficiencies were dramatically enhanced, purchase power with tire manufacturers also increased, and earnings significantly improved.

CALIFORNIA TIRE ACQUISITION

More recently, in January 1999, Heafner purchased California Tire Company from owner Michael Largent, a well known figure in the wholesale tire industry. With 1998 sales of $34 million, California Tire distributes passenger, light truck, commercial truck, farm, and off-road tires and tubes to more than 1,500 dealers in California, Oregon, and Nevada from three distribution centers in Northern California.

PRIVATE EQUITY FINANCING

Over the last two years, the shareholders of Heafner have experienced significant increase in company value through growth in operations, but had little or no diversification in portfolio for estate planning purposes. Shortly after the acquisition of California Tire, the Heafner and Gaither family instructed management to explore means of value realization available to them.

The shareholders evaluated several strategic options including a sale of the company and financing in both public and private markets. Discussions were held with numerous private equity sources, with the primary considerations being stability, access to capital, and management philosophy. On May 24, 1999, the shareholders sold all shares of the company, except those owned by management and the 1818 Mezzanine Fund, to Fund IV of Charlesbank Capital Partners for over $40 million.

This new partnership with Charlesbank Capital provided Heafner Tire Group with a new source of growth capital to advance further toward its goal of becoming the leading national distributor of tires and related products and services. With the elimination of family constraints, management was able to increase emphasis on both strategic and operational issues, and apply a longer-term approach toward the company and industry.

Heafner Tire Group

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BOOK ReVIEW

THE SUPERMAN COMPLEX: ACHIEVING THE BALANCE THAT LEADS TO TRUE SUCCESS
by Max Carey
Longstreet, 1999, $22

It seemed as though Max Carey spent his whole life dashing out of a phone booth attired in blue-and-red tights. A Top Gun fighter pilot who flew 110 Viet Nam combat missions, Carey set football records for Columbia University, founded the marketing consulting firm Corporate Resources Development, got written up in *Success* magazine and was named Atlanta Small Business Person of the Year. So what was this overachiever doing, at 34 in robust good health, crying his eyes out on the deck of his suburban home?

The problem wasn't a nearby node of kryptonite. Instead, says Carey, his attitude that he had to be super-successful at everything forced him into emotional overload. Carey called it "the Superman complex" in an autobiographical *Inc.* magazine article. He thought a few others might share it and was astounded when letters flooded in complaining of the same shallow family relationships, constant sensation of imbalance and profound lack of fulfillment.

By then, Carey had doffed his tights and returned to mortal form, in the process strengthening his family, increasing his happiness and making his over-achieving presence a lot easier on those around him. He explains how he did it in this touching and practical book that, he points out, is more relevant to family and small business owners and entrepreneurs everywhere – and those who work for and with them – than any other group. If you're never satisfied with anything less than "superheroism" – or you work for or are related to someone who is – Carey's tale provides some much-needed directions for heading back into that phone booth, putting on some street clothes and getting out of that goofy-looking cape.

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EDITORIAL

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It's almost impossible to glance at any publication, or even turn on the TV without seeing some reference to Y2K or Internet driven IPOs. These symbols are everywhere. Thank goodness we only have a few more weeks until Y2K is behind us. Interactive technology, however, has forever changed our lives and will be around for a long time. As more of us migrate our daily routines to the web, the old methods and rules of commerce are changing with equal zeal. What does this have to do with family business? We think, a lot!

During this past summer we examined over 60 family business case files. These clients ranged in revenue from $3 million to well over $5 billion and represented every geographic area of the US. Although every case had unique aspects, we discovered a few similarities. One of the threads that tied many of these clients together was money. Fully 85% of our clients either needed or wanted to recapitalize through a financial restructuring.

The expression "A rising tide raises all boats" has never been more poignant in the business world. Technology driven IPOs are largely responsible for raising the value of many family businesses, and many owners are now asking the question, "Is it time to sell?" One founder, who passed the business to his son and daughter six years ago and remained a 20% owner, was confronted with a term sheet that offered $8 million. He thought the offer was fair, but not generous. Then he discovered that the $8 million was not for the entire company, but for his 20% stake. He instructed the children to accept immediately.

To help address these issues we asked our resident experts to lend a hand. Jan Jemelka, with Bank One gives us our cover story, *10 Point Financial Check List*, and Lianne Lim and Rick Witmer, both of Brown Brothers Harriman, bring us the true story of how the Heafner Tire Group successfully expanded.

If you are like many family business entrepreneurs you probably work too much. Read the story of Max Carey and his Superman complex. It may just help you decide to seek that ever-elusive "balance" in your life. Although we didn't review it this time around, we highly recommend an invaluable series of booklets on family business collectively known as *Family Business Leadership*. You can order copies by calling 888.421.0110.

Also, you will notice a new name under the ReGENERATION Partners banner, Mr. Jerry McNabb. Although Jerry is new to REGENERATION Partners, he is not new to the field of consulting to family businesses. Jerry is a graduate of Baylor University, worked in his own family's business, was an entrepreneur with his own title and mortgage companies and for the past 15 years has been taking a "hands-on" approach to improving business performance and serving as a confidant to CEOs of family businesses throughout the US and Europe.

As always, we love hearing from you – whether it is via phone, fax, email or, next time you are in Dallas, stopping by our offices to say hello in person.

If you haven't completed your holiday shopping yet, what better gift could you give to a fellow family business peer than a gift subscription to *ReLATIVELY Speaking*? Call us today, and your gift subscriptions will include a special bonus.

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TOP TEN (Continued from page 1.)

to perform to the levels you present in your projections and to raise your hand if something goes awry. There is no need to be embarrassed or worried. Bankers and vendors are very aware that any business, from time to time, may experience problems.

If there is to be a change in your company, whether this is a management or earnings change, don't let your banker be the last to know. It is easier for bankers to accommodate these changes up front rather than deal with them after the fact. Think of your banker as your personal spokesman in a large corporation. They will be more effective as a spokesman if they have ample information. Your banker can easily lose their credibility if they don't know what's going on. Remember that their goal is to represent you.

8. SECONDARY REPAYMENT SOURCE: The primary source of repayment on most business loans is the earning stream of the company. Banks will, however, look for a secondary repayment source. These are typically assets like A/R, easily saleable inventory, equipment, real estate, or personal guarantees.

Be prepared to provide documentation to back up the value of your secondary repayment source. This may be in the form of A/R agings, inventory listings, or an appraisal of your equipment or real property. For inventory or A/R, you may need to provide monthly or quarterly updates so that the bank can verify that the value of the collateral does not decrease beyond some acceptable level.

In the case of personal guarantees, you will be asked to provide personal financial statements that detail your annual sources, uses of cash, as well as your personal assets and liabilities. A "strong" guarantor will have liquid assets sufficient to cover all personal debt requirements, with excess available to support business debt payments.

9. INVENTORY CONTROL: Inventory can be a company's most manageable cost, but is often the most mismanaged and costly asset. When a bank takes inventory as collateral, they look for assurance that the inventory number reported on your balance sheet reflects an accurate and reliable value. They will want to assure that the balance sheet does not contain obsolete inventory and is regularly adjusted for shrinkage.

Do you really know what you have in your warehouse? Some forms of inventory are prone to theft, obsolescence, or are perishable. You should have a physical inventory regimen and inventory reconciliation system appropriate to the type and number of inventory items you carry. Many companies perform weekly, or even daily, spot item checks, or cycle counts.

10. INDUSTRY RISK: Each industry has its own inherent risks. Bankers will want to see that you are on top of trends in your industry. They will also ask you how you hedge against risks for which you may have little control, like changes in state or federal regulations, or economic swings.

One of the most obvious and universal risks today is technology risk where new products and existing product improvements occur at a blinding rate of speed.

No matter what you manufacture or what service you provide, there is another business trying to do it better, faster, cheaper, or is on the brink of inventing something which could render your product obsolete. Because of this, banks feel more comfortable with companies that have at least some product diversity.

Technology changes apply not just to the product you sell, but to the way you advertise and sell it. The Web has opened up an entirely new channel of distribution for businesses to either contend with or embrace. No matter what your comfort level is in dealing with the Internet, it is a fact of business reality and it's here to stay.

Qualifying for credit in a family-owned business is not as simple as meeting a satisfactory current ratio. Bankers are interested in your family business financial story. Work with your banker by telling them where you plan to take the business and how you plan to get it there. Use your banker as the family's advocate when you find the need to take the next financial step.

Jan Jemelka is a vice president with Bank One, Texas. For an expanded copy of this article, please contact Nancy Pledger at 800.406.1112 or Jan at 214.290.2615 or by email jan_l_jemelka@mail.bankone.com

THE FUTURE (Continued from page 2)

- **Have a series of meetings with all of the members of the family** to open a dialogue about the future. Some of the meetings should include all of the children so they can see the process and learn how families communicate in positive ways about family issues and the future. Security comes from understanding what the future beholds.
- **If you have several family branches in the business,** first have a meeting of the head of each family to talk about the future. This can get complicated and you may want to involve a family business consultant or others to help. The objective is to reach a consensus on the business future.
- **Start acting on your plan today** – make it happen; don't procrastinate.
- **Measure the success of your plan.** Don't be too rigid, and be prepared to change it as new information on laws, taxes, needs of the family and the"Golden Goose" production changes.

Now that you are minding the future, kick back and enjoy each day of it as it arrives with the comfort that you will enjoy harvesting.

By Jerry McNabb, ReGENERATION Partners
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