UNDERSTANDING THE BARRIERS TO AND OPPORTUNITIES FOR ACCESS TO PRIVATE EQUITY AMONG SMALL-TO-MEDIUM-SIZED FAMILY-OWNED ENTERPRISE (SMFE) OWNERS IN AUSTRALIA: AN EXPLORATORY STUDY

Pi-Shen Seet: University Of Adelaide, Adelaide, Australia
Christopher Graves: University Of Adelaide, Adelaide, Australia
Magdalena Hadji: University Of Adelaide, Adelaide, Australia
Andrew Schnackenberg: University Of Adelaide, Adelaide, Australia
Petter Gustafson: University Of Adelaide, Adelaide, Australia

Contact: Pi-Shen Seet, University of Adelaide, Adelaide Graduate School of Business, 3rd Floor, 233 North Terrace, SA 5005 Adelaide, Australia, (T) +61 8 83036460, (F) +61 8 8223 4782, Email: pishen.seet@adelaide.edu.au

ABSTRACT

This paper presents the findings of exploratory research into the challenges that Small-to-Medium-sized Family-owned Enterprises (SMFEs) face when engaging with the private equity (PE) sector. There is an upcoming crisis in the succession of Australian SMFEs where it is estimated that two-thirds of the owners may be unable to handover their businesses to the next generation. The scale of these problems suggests that not all SMFE owners can look forward to traditional exit options such as trade sales. The recent rapid growth of the Australian PE sector has resulted in new exit options through ownership restructuring deals with PE firms such as Management Buy-Outs (MBOs). But most SMFE owners are unprepared to or ill-equipped to engage with such organisations. This study, conducted through interviews of SMFE owners, PE firms and family business professional advisors in South Australia, indicates that there are three large gaps between SMFE owners vis-à-vis the PE community: (1) a finance gap; (2) a knowledge gap; and (3) an empathy gap. The results of this study also suggest that these gaps interact with each other to exacerbate the overall gap, and that some professional advisors were found to contribute to (rather than bridge) these gaps. This paper concludes with a revised conceptual framework model for the better understanding of the barriers to and opportunities for SMFEs to gain access to PE.

Key Words: Small-to-Medium-sized Family-owned Enterprises (SMFEs); Private Equity (PE); Professional Advisors; Australia

INTRODUCTION/ RESEARCH BACKGROUND

Small-to-Medium-sized Family-owned Enterprises (SMFEs) contribute significantly to the Australian economy, constituting 83 percent of all private business enterprises (Glassop et al., 2005b), accounting for 40 percent of Australia’s private sector output and generating 50 percent of Australia’s employment growth (Smyrnios et al., 2003). However, there is an upcoming crisis in the succession of SMFEs where it is anticipated that two-thirds of owners will be unable to handover their businesses to the next generation (Waddell, 2005). Research by Glassop et al. (2005a) shows that 56 percent plan to retire in the next decade as part of the general trend of retiring baby-boomers. Recent media reports indicate an average of one family business will be sold or closed down daily in Australia in the next decade (Emmerson, 2006). With $1.6 trillion of an expected $3.6 trillion in value of SMFEs expected to come onto the market over the next decade (Smyrnios et al., 2003), not all will be able to utilise traditional exit options such as trade sales.

Following recent trends of PE involvement in family businesses in Europe and North America, which have a similar if not a more rapidly ageing population (Maherault, 2004; Poutziouris, 2001; Reier, 2006), the cash-rich Australian PE sector has also begun to explore similar opportunities (The
Advertiser, 2006). These are mainly through ownership restructuring deals with PE firms (e.g. via Management Buy-Outs (MBOs), Management Buy-Ins (MBIs), or Buy-In Management Buy-Outs (BIMBOs) (BVCA, 1999)). However, there has been little research into how SMFEs and/or their advisors engage with the PE sector (Romano et al., 2001) let alone in the Australian context and the limited research to date shows that most SMFE owners are unprepared to or ill-equipped to engage with such organisations (Poutziouris et al., 2000).

This paper presents the findings from an exploratory study into factors that influence SMFEs in utilising PE. Specifically, the study found evidence of finance gaps, knowledge gaps and empathy gaps between SMFE owners, their professional advisors and the PE community. The paper concludes with a revised conceptual framework model as well as avenues for further research. In addition to contributing to current family business research through a better understanding of this under-researched area, the findings of this study may assist in the smooth transition of SMFEs and therefore benefit the Australian economy as a whole.

**LITERATURE REVIEW**

Although there has been little research into how SMFE owners and their advisors engage with the PE sector (Romano et al., 2001), some studies indicate that there are possibly three gaps between SMFEs and PE: (1) a finance gap, (2) a knowledge gap, and (3) an empathy gap.

Poutziouris et al. (2000), in exploratory work, show that some family businesses are open to external capital for long-term investment to develop new technologies and markets. However, this may not be significant as the evidence indicates that when there is PE involvement, most of the deals are on restructuring ownership (e.g. MBOs) instead of facilitating entrepreneurs to grow new ventures (Joseph, 1999).

**Finance gap**

The ‘finance gap’ refers to when particular sources of financing (e.g. PE) are not available to SMFEs. The finance and family business literature suggests that SMFEs face a finance gap due to supply and demand reasons. In the supply side, a finance gap arises when there is a difference between the minimum investment criteria of PE providers and the corresponding size of prospective SMFE investments. As Mason et al. (1995) argue, there is a shortage of long-term investment finance for smaller firms on account of PE providers’ preference for making larger investments in established companies. On the demand side, family business research suggests that owners follow a pecking order when financing the business (Watson, 2006). The pecking order hypothesis (figure 1) states that SMFEs may experience a finance gap because of their aversion to equity financing relative to debt financing and retained earnings.

**Knowledge gap**

The ‘knowledge gap’ refers to any lack of understanding SMFE owners may have about the PE industry. This includes any lack of knowledge about the different transition vehicles used in succession financing, the investment criteria commonly applied by PE firms and the PE market in general.
Commenting on research in the UK context, Poutziouris (2001:289) remarks that a knowledge gap may exist as “family companies (may be) antithetic to venture capital options simply because they feel less knowledgeable and comfortable about deal structures” in particular and the PE industry in general. Harvey et al. (1995:164) agree noting that:

“The cost of capital from venture capital firms normally goes well beyond the financial parameters of the loan arrangement. They frequently expect ... a host of other requirements. Many of these requests would seem foreign in the privacy of the family business.”

Poutziouris et al. (1997), in their research, found that as a result of inadequate knowledge around different financing options, SMFE owners were hesitant to discuss finances with outsiders. Accordingly, this knowledge gap may create a barrier to effective communication between SMFEs and PE providers. Recent research suggests that SMFE owners have a general lack of knowledge of the financing options that can be provided by the PE sector (Seet et al., 2007). Despite this, Wu et al. (2007) argue that there has been a paucity of research into the deal structures used by SMFEs when using PE as well as relationships with and access to PE.

Australian industry research has found also that Australian SMFEs have little knowledge on how to present themselves as a financially attractive investment opportunity to PE providers (KPMG, 2006). Lindhe (2007) notes that the lack of knowledge on how to plan for exit is a key barrier to a successful trade sale or buyout, and this is supported by Emmerson (2006) who argues that PE buyouts in Australia are not common partly due to a lack of knowledge on the SMFE side.

**Empathy gap**

In some studies, a dislike for institutional finance, particularly external PE, has been identified (Gallo et al., 1996; Upton et al., 2000). This “empathy gap”, may be due asymmetries between family business sources of capital and their personal, business and familial objectives (Gasson, 1999). The ‘empathy gap’ relates to family business being antithetic to PE simply because they may not have had any experience with PE providers and feel less comfortable about PE deal structures (Poutziouris, 2001). A lack of knowledge of the PE process and their goals can lead to a lack of trust in the PE provider. Similarly, a lack of understanding of the dynamics of family business may cause the PE provider to lose confidence in the SMFE. The empathy gap thus refers to any disconnect in trust between the SMFE and PE fund.

Using complementary theoretical frameworks relating to trust and negotiation behaviour, Howorth et al. (2004) identify that family businesses undergoing MBOs or MBIs had large information asymmetries. The existence of such asymmetries supports the existence of the gaps under discussion. When good relationships and trust were found to exist between the vendor and the MBO or MBI team, Howorth et al. (2004) found that information asymmetries were mitigated. Thus, a buyout transaction may result in a more mutually beneficial outcome when knowledge and empathy between the two parties is increased. However, there is limited research on the cause and effect relationship of information asymmetries, such as issues of moral hazard and adverse selection, and the level of trust to-and-from family businesses and PE firms, specifically (Gomez-Mejia et al., 2001).

Most family business owners take a long-term perspective towards performance (Donckels et al., 1991). Preference for control, lifestyle objectives, and job security has been shown to be more important to owner-managers than rates of return (Boyer and Roth, 1978; Poutziouris, 2001). PE investors, on the other hand, are generally concerned with finding opportunities that will yield high returns on investments with manageable risk. The objectives considered by SMFE owners and PE providers can be seen to fundamentally conflict. Thus, PE is often not considered as a viable source of capital for the family firm.

Upton et al. (2000) found that out of six critical factors listed by PE firms in assessing the value of a transition financing opportunity, the entrepreneur’s willingness to let go and the firm having a ‘stable family’ were ranked fourth and fifth below the business having a qualified successor, potential for business growth and the business having a strategic plan. However, when investors were asked why they would not fund a particular deal, issues of “family conflict” and “unstable family members” were widely noted.

It is clear from these paradoxical findings that investors initially regard transition financing to be a relatively straight-forward investment. Conversely, when considering reasons why an investment may encounter hardship, investors are also aware of some of the negative outcomes of working with family businesses.
The role of professional advisors

One way to close these gaps between business owners and PE providers may be through the use of professional advisors, because when the SMFE grows, such advisors are often engaged to advise the owners on the increasing complexities of business transactions as part of the professionalisation process (Gersick, 1997; Gurd et al., 2006; Hofer et al., 1984). However, there is little research or evidence that the professional advisor may have experience in PE deals or appropriate knowledge of the sector and therefore the capability to help bridge any empathy or knowledge gaps that the business owners have.

For the purposes of this study, professional advisors can be considered any Certified Public Accountant (CPA), attorney, financial planner, business consultant or academic offering professional advice to client companies. EVCA (2005) found that in almost a third of the buyout processes investigated in Europe, the SMFE approached an independent advisor when initiating the deal. This finding denotes that professional advisors in many cases may act as a link between SMFE owners and PE providers.

CONCEPTUAL MODEL AND RESEARCH PROPOSITIONS

Based on the research literature, an initial conceptual model is shown in Figure 2 whereby the professional advisor acts as a bridge between SMFEs and PE across the finance, knowledge and empathy gaps.

From the review of the literature, this study then investigated the following research propositions.

P1: What is the nature of the finance gap between providers of PE and SMFE owners?

P2: What is the nature of the knowledge gaps between providers of PE and SMFE owners?

P3: What is the nature of the empathy gap between providers of PE and SMFE owners?

P4: What is the role and competencies of professional advisors in bridging these gaps?

RESEARCH METHODOLOGY

Because of the paucity of research into the challenges that SMFEs face when engaging with the PE sector, an exploratory qualitative approach was taken using in-depth interviews, focus groups and content analysis.

In-depth Interviews and Content Analysis

In-depth interviews were conducted with 15 SMFE owners, 6 PE providers, and 13 family business advisors in South Australia. Given the importance of gathering “rich” data (Steyaert et al., 1997), the data was collected primarily via a combination of in-depth guided and semi-structured interviews as there were few media and other research reports and the contexts were important and could not be discounted (Patton, 1990). As we did not have access to an official register or database of the population, a non-probability convenience sampling process based on snowballing was used as this offered a better solution to the problem of data collection amongst hidden groups (Van Meter, 1990). A content analysis of the interview data revealed themes associated with the engagement of PE by the SMFEs and the roles and competencies of the professional advisors.

Respondent Profile

A profile of respondents is shown in Table 1.
Table 1: Profile of Respondents

<table>
<thead>
<tr>
<th>Company</th>
<th>Size</th>
<th>Employees</th>
<th>Investment Sectors/ Industry</th>
<th>Generation</th>
</tr>
</thead>
<tbody>
<tr>
<td>PE1</td>
<td>$35M</td>
<td>3</td>
<td>Technology</td>
<td>-</td>
</tr>
<tr>
<td>PE2</td>
<td>$500M</td>
<td>15</td>
<td>Stable growth</td>
<td>-</td>
</tr>
<tr>
<td>PE3</td>
<td>$200M</td>
<td>10 – 20</td>
<td>Current SME + large clients</td>
<td>-</td>
</tr>
<tr>
<td>PE4</td>
<td>$34M</td>
<td>20</td>
<td>High growth</td>
<td>-</td>
</tr>
<tr>
<td>PE5</td>
<td>$200K - $2M</td>
<td>3</td>
<td>SME Fund Manager</td>
<td>-</td>
</tr>
<tr>
<td>PE6</td>
<td>$20M-$30M</td>
<td>3</td>
<td>Growth/turnaround fund</td>
<td>-</td>
</tr>
<tr>
<td>Advisor1/PE7</td>
<td>$10M-$50M</td>
<td>5 - 8</td>
<td>General fund manager</td>
<td>-</td>
</tr>
<tr>
<td>Advisor2</td>
<td>-</td>
<td>-</td>
<td>Consultant</td>
<td>-</td>
</tr>
<tr>
<td>Advisor3</td>
<td>-</td>
<td>-</td>
<td>Consultant</td>
<td>-</td>
</tr>
<tr>
<td>Advisor4</td>
<td>-</td>
<td>-</td>
<td>Financial Advisor</td>
<td>-</td>
</tr>
<tr>
<td>Advisor5</td>
<td>-</td>
<td>-</td>
<td>Consultant</td>
<td>-</td>
</tr>
<tr>
<td>Advisor6</td>
<td>-</td>
<td>5 to 15</td>
<td>Trade-sale consultant</td>
<td>-</td>
</tr>
<tr>
<td>Advisor7</td>
<td>-</td>
<td>5 to 15</td>
<td>Firm re-structuring</td>
<td>-</td>
</tr>
<tr>
<td>Advisor8</td>
<td>-</td>
<td>5 to 15</td>
<td>Transition Mgrs</td>
<td>-</td>
</tr>
<tr>
<td>Advisor9</td>
<td>-</td>
<td>-</td>
<td>CPA</td>
<td>-</td>
</tr>
<tr>
<td>Advisor10</td>
<td>-</td>
<td>5 to 10</td>
<td>Financial Advisor</td>
<td>-</td>
</tr>
<tr>
<td>Advisor11</td>
<td>Tier 1</td>
<td>15 to 20</td>
<td>Financial Advisor</td>
<td>-</td>
</tr>
<tr>
<td>Advisor12</td>
<td>-</td>
<td>-</td>
<td>Government advisor</td>
<td>-</td>
</tr>
<tr>
<td>Advisor13</td>
<td>-</td>
<td>200+</td>
<td>Family Business owner &amp; advisor</td>
<td>3rd Gen</td>
</tr>
<tr>
<td>SMFE1</td>
<td>10% p.a. growth</td>
<td>12</td>
<td>Project Management consulting</td>
<td>1st Gen</td>
</tr>
<tr>
<td>SMFE2</td>
<td>“large”</td>
<td>200+</td>
<td>Wool</td>
<td>3rd Gen</td>
</tr>
<tr>
<td>SMFE3</td>
<td>“low”</td>
<td>5</td>
<td>Manufacturing</td>
<td>2nd Gen</td>
</tr>
<tr>
<td>SMFE4</td>
<td>$1M-$5M turnover</td>
<td>~15</td>
<td>Publishing</td>
<td>1st Gen</td>
</tr>
<tr>
<td>SMFE5, SMFE6, SMFE7, SMFE8, SMFE9</td>
<td>$1M-$20M turnover</td>
<td>3 - 70</td>
<td>Two wineries, Printing, Drilling, Automotive air/condition</td>
<td>2nd - 3rd Gen</td>
</tr>
<tr>
<td>SMFE10, SMFE11, SMFE12, SMFE13</td>
<td>$20M-$100M turnover</td>
<td>25 - 260</td>
<td>Manufacturing, Funerals, Hydraulic, Winery</td>
<td>2nd - 3rd Gen</td>
</tr>
<tr>
<td>SMFE14</td>
<td>$20M turnover</td>
<td>200</td>
<td>Confectionery</td>
<td>2nd Gen</td>
</tr>
<tr>
<td>SMFE15</td>
<td>$1Bn turnover</td>
<td>multiple businesses (total = 3000)</td>
<td>Manufacturing</td>
<td>3rd Gen</td>
</tr>
</tbody>
</table>

FINDINGS

Based on the analysis of the data collected in this study, the original model presented in Figure 2 was adapted to incorporate the fact that in certain circumstances professional advisors were found to exacerbate rather than bridge the gap between SMFEs and PE. A revised conceptual model is presented in figure 3 that more accurately maps out the effect of the finance, knowledge and empathy gaps between SMFEs, their personal advisors and PE providers and is further elaborated on below.
Finance gap

All three groups of respondents (PE providers, SMFE owners and PE providers) confirmed that SMFEs face a finance gap when it came to accessing PE. However, the extent of the finance gap appears to be dependent on the size of the PE fund. Contrary to Schaper (2006) who argued that SMFEs with AU$1 million in turnover will increasingly be sought out by PE firms, a growing trend in the minimum investment threshold was noticed. Accordingly, SMFEs are increasingly less likely to receive PE investment from larger providers. However, a number of niche PE providers were identified as having the opportunity to fill this void with three out of the seven PE providers interviewed being established after 2003. This contrasts interestingly with the United States which has seen a downward trend on the minimum PE investment thresholds (Choi, 2007). From the SMFEs’ perspective, most did not consider their size and growth potential to be adequate for PE minimum investment criteria. Five of the seven (or 71%) of PE providers interviewed concluded that smaller deals can be more expensive to execute as the family business at this level may not be professionalized. For example, one PE provider stated

“smaller deals can just be more expensive because they don’t have their books in order”

Table 2 gives an overview of the minimum investment criteria indicated by the PE funds interviewed.

<table>
<thead>
<tr>
<th>Firm</th>
<th>Fund size</th>
<th>Minimum Investment</th>
</tr>
</thead>
<tbody>
<tr>
<td>PE1</td>
<td>AU $35 million</td>
<td>AU $100K (Mostly Venture Capital)</td>
</tr>
<tr>
<td>PE2</td>
<td>AU $500 million</td>
<td>AU $ 5 million</td>
</tr>
<tr>
<td>PE3</td>
<td>AU $200 million</td>
<td>AU $ 2 million</td>
</tr>
<tr>
<td>PE4</td>
<td>AU $34 million</td>
<td>AU $ 1 million</td>
</tr>
<tr>
<td>PE5</td>
<td>Private fund</td>
<td>AU $ 250K</td>
</tr>
<tr>
<td>PE6</td>
<td>AU $25 million</td>
<td>AU $ 2 million</td>
</tr>
<tr>
<td>PE7</td>
<td>Private fund</td>
<td>Private fund</td>
</tr>
</tbody>
</table>

The findings also provide evidence that the increased transaction costs from dealing with family business fuels the finance gap. While PE providers noted that experienced advisors had the ability to lower due diligence costs and may add financial value for the SMFE on the final price paid by the PE firm, it was also found that less knowledgeable and experienced professional advisors could increase the cost of due diligence and potentially lower the final price paid for the business by the PE firm. One professional advisor noted that for their advice to be financially feasible,

“minimum enterprise value of the company, excluding debt, is AU $10 million. AU $5 million or less will be too small for the [Advisory Group] to help” and leave enough money in the deal.

“A] Business broker would provide a better service for smaller firms.”

Both PE providers and professional advisors commented that the pecking order hypothesis broke-down when SMFE owners were faced with a strong need for exit financing. However, the
feedback received from SMFEs was mixed. For most firms, the legacy of the business was seen to be at jeopardy if PE providers were to fund the exit.

Figure 4 summarizes the effects of the finance gap between the three different groups.

Knowledge gap

The respondents consistently noted that SMFEs lacked knowledge and awareness of PE, which is consistent with the findings reported by Poutziouris’s (2001). Larger firms and firms heavily associated with family business associations exhibited a greater awareness of PE as an option and also demonstrated that they possessed knowledge about specific PE providers operating in South Australia. While several interviewees indicated that there is a growing knowledge and appreciation of PE among SMFEs in South Australia, all the PE providers and professional advisors interviewed commented on the low level of knowledge on PE in general and specific PE processes in the SMFE community. This was confirmed in that none of the SMFE owners exhibited thorough knowledge of the PE industry in general, and on the transition vehicles usually used by PE. As one PE provider noted:

“There is still a great deal of naivety on how much work that is required as well as the length of the processes.”

In agreement, a professional advisor noted that “...PE is an unknown term” among SMFEs. The specifics of PE investment processes proved to be a highly specialized field of expertise. SMFE owners and advisors that had previously not been involved in deals involving PE funding were less knowledgeable on investment vehicles such as MBOs, MBIs and BIMBOs. This can hardly be attributed to the characteristics of family business owners in general, but is more likely due to the nature of the PE investment processes being a narrow subject matter.

In line with KPMG’s (2006) research, SMFEs were found to lack the expertise on how to make themselves a financially attractive investment opportunity to PE providers. Regarding limitations in SMFE succession planning, one PE provider stated “They often do not know what the company is worth.” While most SMFEs indicated that they had a formal succession plan, it was also apparent that the succession plan was to be used during succession crises and events, and not as a ‘live’ strategic planning document for the firm.

On the advisor side, the knowledge level seems to be related to size of the advisory firm as well as actual deal experience. The larger accountancy and law firms showed that they had expertise in the field, while smaller firms demonstrate lack of knowledge of the PE investment processes if they have not previously been involved in deals for their clients. One PE provider noted that:

“The expertise only resides in the big 4, and possibly in the second tier”
Some larger PE and advisor firms indicated that this may be a problem as SMFEs often deal with smaller accountancy firms. On the other hand, a number of firms indicated that the role of advisors would be to provide the PE firm with the necessary information (e.g. for due diligence), and the specifics of the knowledge on deal structures would be produced by the PE provider. The combination of specific skills in the PE sector space combined with an understanding and appreciation of specific dynamics in family businesses appeared to be a rare skill set in the professional advisor community.

Figure 5 illustrates how the knowledge gap is created between the three different groups.

Empathy gap

There was also evidence of a significant empathy gap. Regarding the inclusion of PE in the firm, one SMFE owner stated “someone else coming into the company would just complicate the system.” On the other hand, one PE provider identified that “family businesses are those that have not run as hard as they could.”

The differing goals of PE providers and SMFEs were found to be a barrier to SMFEs gaining access to PE. By employing standardized investment terms, PE providers were perceived by family businesses to be inflexible; thus decreasing SMFEs trust towards PE. Confirming the PE side of the empathy gap, PE providers identified the goals of family businesses as “less motivated” and “employ[ing] more patient capital.”

PE providers perceived professional advisors as functional, non-empathic pieces of the investment process. However, this was not corroborated across the SMFE professional advisor spectrum and was largely found only among larger advisory firms who were keen to emphasize objectivity and hence did not perceive themselves to have empathic issues towards or against SMFEs or PE providers. For example, an interviewee from one of the larger advisory groups in the study perceived SMFE owners as “coffee sippers in morning meetings” and as such were incompatible with “hard business people.” PE providers claimed to understand the possible causes of family business resistance to outside equity financing. However, SMFEs felt otherwise and the views of professional advisors were mixed. Further research is required to clarify the level of understanding PE providers have of the causes, rather than effects, of family business issues and conflict.

Another aspect mentioned by several respondents was the effect of age difference between SMFEs seeking retirement and the majority of professional advisors and PE fund managers. SMFEs perceived advisors from larger advisory firms as well as the majority of fund managers to be from the Generation X or Y, while SMFE owners were often much older. Such generational differences were found to contribute to an inherent empathy gap.

Figure 6 shows a representation of the empathy gap between the three different groups.
DISCUSSION

In summary, analysis of the data collected in this study provides support for the argument that finance, knowledge and empathy gaps all influence whether SMFEs utilize PE as a source of financing for growth or exit. The results also suggest that the overall gap is influenced by the characteristics of PE providers, SMFEs as well as their advisors. One particular characteristic that was found to influence the overall gap was the size of PE providers, SMFEs and advisory firms. An interaction effect was also found between the knowledge and empathy gaps, influencing the extent of the finance gap. These issues are explored in greater detail below.

Effect of Size

The findings indicate a relationship between size of the different groups of interest (PE providers, SMFEs and advisory firms) and the relative size of the finance, knowledge and empathy gaps.

Figure 7 indicates that all the identified gaps increase in size as the SMFE size decreases and PE fund size increases. The finance gap relationship is obvious from the findings presented above – larger funds increased their minimum investment limit and therefore did not consider the smaller SMFEs as viable investment targets. On the empathy and knowledge gaps, the findings indicated that there was a positive correlation between SMFE size and PE knowledge as well acceptance of PE, while there was a negative correlation between PE size and knowledge of, and ability to empathize with, specific family business issues, thus increasing the empathy and knowledge gaps.

Figure 7: Size effects on the gaps between SMFEs and PE

Similar relationships are seen when looking at SMFEs and professional advisors (Figure 8). The finance gap is increased by the increased transaction costs relative to the size of the investment when...
increasing the size of the professional advisors. The larger professional advisory firms noted that their fees would be too high for them to be involved in deals with the smaller SMFEs. There was also a positive correlation between the size of the SMFE and the level of trust they had towards the larger accounting and law firms.

**Figure 8: Size effects on the gaps between SMFEs and Professional Advisors (PA)**

![Diagram showing the gaps between SMFEs and Professional Advisors](image)

**Interactions**

Even though the gaps were seen in the initial conceptual model as distinct constructs, the study finds interactions and overlaps between the three gaps. For example, PE providers’ lack of knowledge and understanding of dynamic issues in family businesses due to integration of family and business dimensions, may lead to a lack of trust in, and understanding of, how SMFEs operate as well as the advantages that may flow from family involvement (e.g. lower agency-related costs). Conversely SMFEs that lacked knowledge on the investment vehicles used by PE providers as well as the potential benefits offered by PE decreased their trust in PE providers. SMFE owners were thus reluctant to communicate and disclose information to outsiders seeking to provide equity financing for their business. Without communication in an open and honest manner, building empathy on both sides will be difficult. A lack of trust in PE providers would logically lead to a lack of interest in getting information on how they operate through deal structures. This indicates a reverse interaction, where the lack of empathy fuels the knowledge gap (refer to Figure 9).

**Figure 9: Interaction between knowledge and empathy gaps**

<table>
<thead>
<tr>
<th>Knowledge Gap</th>
<th>Empathy Gap</th>
</tr>
</thead>
<tbody>
<tr>
<td>- SMFEs lack of knowledge on PE</td>
<td>SMFEs lack of trust in PE</td>
</tr>
<tr>
<td>- SMFEs lack of knowledge on specific PE transition vehicles</td>
<td>Lack of disclosure towards outsiders</td>
</tr>
</tbody>
</table>

Building on Figure 10, we propose a new framework model (Figure 10) to explain the proposed relationships and interactions. The framework proposes a close overlapping relationship between the knowledge and empathy gaps, as well as a one-way relationship between the knowledge and finance gaps as well as the empathy and finance gaps.
Two knowledge-based factors appeared to drive the degree to which SMFEs exhibit lack of trust towards PE. First, the SMFE owners’ level of knowledge regarding specific PE investment processes appeared to negatively correlate with the existence of an empathy gap. Second, the degree to which SMFE owners have heard of successful PE investments in other family businesses appeared to negatively correlate with the existence of an empathy gap.

Real and perceived lack of knowledge in the SMFE community can be argued to fuel the finance gap by increasing transaction costs. If knowledge levels about PE and financing in general are low, PE providers would need to spend more effort on educating and searching for relevant information in the due diligence process than in the situation where the target is more knowledgeable. Non-disclosure of information due to lack of trust (empathy gap), would also increase transaction costs, and thereby fuel the finance gap.

The pecking order theory may be closely linked with SMFE-PE trust issues. SMFEs will rarely consider PE if their financing needs are not substantial enough to eliminate retained earnings and debt funding as an option. In addition, SMFEs were found to be reluctant to approach PE providers for financing even when the family firm met the minimum investment requirements of most providers. This reluctance, or empathy gap based on a lack of knowledge of the PE process and PE’s intentions, in effect widens the finance gap.

It is also proposed that less knowledgeable professional advisors could increase the cost of due diligence and potentially lower the final price paid for the business by the PE firm. Such advisors were perceived to be less experienced and educated in the processes of PE investments and possibly knowingly (or unknowingly) anti-PE, thus minimizing the financing options open to SMFEs.

LIMITATIONS

The first limitation is that all interviewees were based in South Australia, hence there may be regional effects that may not be found in other parts of Australia, let alone in other parts of the world.

Secondly, given that this is an exploratory qualitative study together with the small sample of PE providers, advisors and SMFE owners interviewed suggests that in order to generalize some of the findings discussed above, a comprehensive empirical study with more respondents is needed.

SUMMARY AND CONCLUSION

Our study was entitled, ‘Understanding the Barriers to and Opportunities for Access to Private Equity among Small-to-Medium-sized Family-owned Enterprise (SMFE) owners in Australia: An Exploratory Study’. To that end, the main research findings are as follows:

1. There is strong evidence for finance, knowledge and empathy gaps between SMFE owners vis-à-vis the PE community.

2. There is also evidence to indicate that professional advisors instead of bridging some of these gaps, also contribute to the gaps between SMFE owners and PE providers. Given this, a revised conceptual framework model was developed.
3. The size of firm affects the size of gaps between SMFEs and PE providers. This means that the use of PE as an exit option for smaller SMFEs may not be relatively feasible.

4. There are strong dynamic interaction effects between the knowledge and empathy gaps that drive the gaps between SMFEs and PE providers through a negatively reinforcing effects. This in turn feeds into reinforcing the finance gaps.

To some extent, the findings in this exploratory study raises some other interesting questions for further research. These include:

1. How does the relatively large age difference between PE professionals and SMFE owners affect the potential engagement of PE among retiring ‘baby-boomer’ SMFE owners?
2. Why is the experience and knowledge of PE so limited among advisors to SMFEs and how can they effectively bridge the gaps between SMFEs and PE providers?
3. What role does trust play in the interactions between the 3 parties of PE providers, SMFE owners and professional advisers?
4. Within the SMFE categorisation of firms, besides employee size, what are the other major factors that play a role in the SMFE-PE engagement process (e.g. type of industry, regional effects, age of firm, growth prospects etc.)

In conclusion, the findings of this study may assist family business associations, the PE community and professional advisor bodies to better understand the barriers to and opportunities for access to PE among SMFE owners in Australia. In turn, this study may inform policy makers in formulating strategies to reduce the finance, knowledge and empathy gaps, and thereby promoting the smooth transition of SMFEs over the coming decade. Private equity is a relatively new solution and therefore engenders more fear, apathy and ignorance. However, it remains a viable solution provided some of the issues identified in this research are addressed.

REFERENCES

EVCA. 2005. Private Equity and Generational Change, EVCA Buyout Committee:


