Spring 2024

OWNER TO OWNER

BROWN BROTHERS HARRIMAN

SHIFT YOUR MINDSET:

INNOVATION IN FAMILY BUSINESS

OWNER TO OWNER

TABLE OF CONTENTS

01
A Letter from Jeff Meskin

02
The Business Environment Q1 2024

08
Shift Your Mindset: Innovation in Family Business

12
Are You Ready? What to Know About the Corporate Transparency Act

14
Pillars of Persistence: Strategies for Building Work Ethic and Determination

18
We the Family: The Benefits of Creating a Family Constitution

Contributors

Jeff Meskin
Michael Conti
Grant Smith
Neriah Ray-Saunders
Jack Goryl
Christine Hourihan
Ben Persofsky
Beth King
Ross Bruch
Karin Prangley
Anne Warren
Madeleine McGrath

Editors:
Jen Gilbert, Madeleine McGrath, and Katie Carolan

Designed by
BBH Creative Services

Jeff Meskin / Partner

Dear clients and friends,

Spring is a season of change, new beginnings, and transitions. As we enter warmer months and leave winter behind, strategies for navigating these transitions – both personal and business – are front of mind.

When you and your family change, so do the needs and dynamics of your business. In this issue's feature article, Director of the BBH Center for Family Business Ben Persofsky discusses how business owners can shift their mindset toward innovation in order to sustain entrepreneurship for generations. In another article, Senior Wealth Planners Karin Prangley and Anne Warren explore how creating a family constitution can help make these business and wealth transitions seamless, and Wealth Planner Ross Bruch lays out seven research-backed strategies to best prepare the rising generations for these new responsibilities.

President of the BBH Delaware Trust Company Beth King covers the essentials of the 2024 Corporate Transparency Act: what it is, who it affects, and how to take action. And as always, Michael Conti, Jeff Miller, Neriah Ray-Saunders, Jack Goryl, and Christine Hourihan provide an overview of the economy, the credit markets, and the private equity and mergers and acquisitions markets.

We hope you enjoy this issue. If you have any questions about the topics covered in this edition, my colleagues and I would welcome the conversation.

Sincerely,

Michael Conti, CFA / Investment Research Group
Jeff Miller / Corporate Advisory & Banking
Neriah Ray Saunders / Corporate Advisory & Banking
Jack Goryl / Corporate Advisory & Banking
Christine Hourihan / BBH Capital Partners

The Business Environment QI 2024

In each issue of *Owner to Owner*, we review aspects of the business environment on three fronts:

- Overall economy
- Credit markets
- Private equity (PE) and mergers and acquisitions (M&A) markets

The following article examines the state of the economy as the recession speculation that characterized much of 2023 continues into first quarter 2024. Thus far, the Fed's effort to curb inflation through monetary policy shows incremental progress, while domestic banks continue to tighten their lending standards and private equity fund managers battle headwinds as a result of ongoing market volatility and high inflation.

The Economy

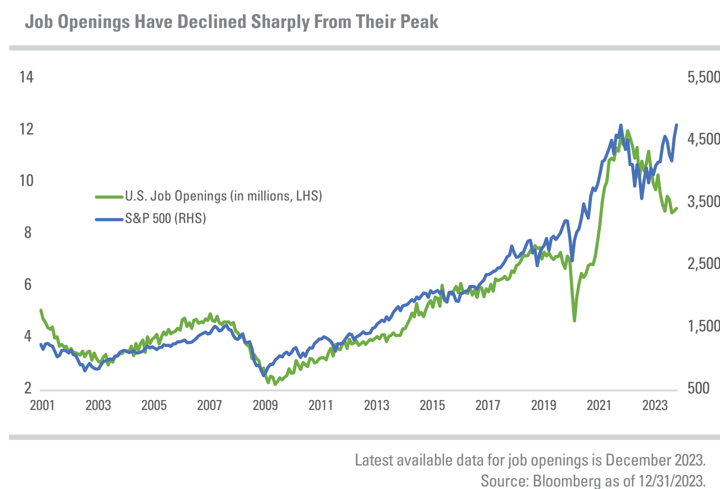
Entering 2023, investors worried that the Federal Reserve's interest rate hiking cycle might trigger a recession. Instead, inflation subsided and despite regional banking instability, the U.S. economy remained solid. According to the "advance" estimate by the Bureau of Economic Analysis, U.S. GDP expanded at a quarter-over-quarter annualized rate of 3.3% in fourth quarter 2023, above the 2.0% consensus estimate. The increase in real GDP reflected increases in consumer spending, federal government spending, exports, and nonresidential fixed investment. The personal consumption expenditure (PCE) component of GDP – which drives 70% of GDP over the long run – advanced 2.8% with increases in both services and goods.

Meanwhile, despite the U.S. unemployment rate remaining near its lowest levels since the 1950s, job openings continue to trend downward and are now 25% below the all-time high recorded in March

2022. While the stock market is forward-looking, job openings often reflect current economic conditions and signal a potential slowdown in growth expectations.

For 2024 and 2025, the Fed estimates real GDP growth of 1.5% and 1.8%, respectively, down from the 2.5% GDP growth rate in 2023 .

Job Openings Have Declined Sharply From Their Peak



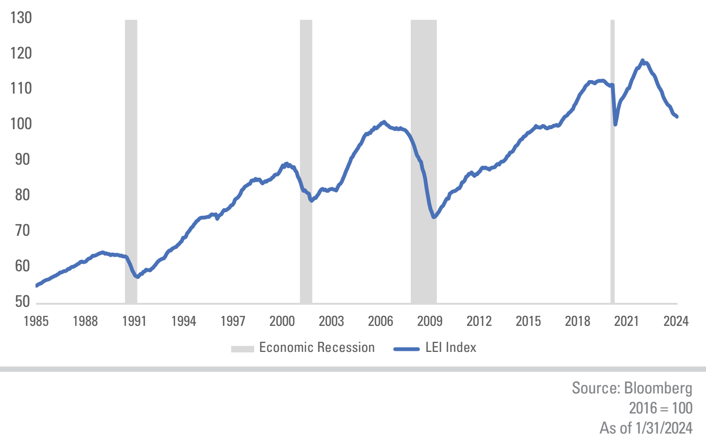
Latest available data for job openings is December 2023.
Source: Bloomberg as of 12/31/2023.

Turning to forward-looking indicators, we believe that The Conference Board's index of 10 leading economic indicators (LEI) provides the most balanced, forward-looking gauge of economic activity. While many economic indicators display more noise than signal, the LEI has proved to be a valuable forecasting tool over multiple economic cycles. In the prior three recessions (excluding the COVID-19-induced recession in 2020) that started in 1990, 2001, and 2007, the LEI began declining between 12 and 22 months prior to the start of the recession.

While the declining LEI continues to signal headwinds to economic activity, for the first time in the past two years, six out of its ten components were positive contributors over the past six-month period (ending in January 2024). As a result, the leading index currently does not signal a recession ahead, despite declining for 23 consecutive months since peaking in March 2022.

There is no guarantee the LEI will prove to be as good a forward-looking indicator this time around, but given its history and the broad base of data it includes, we still believe this index is worth consulting.

Conference Board - Leading Economic Indicators (LEI)



Source: Bloomberg
2016 = 100
As of 1/31/2024

In line with expectations and after maintaining the fed funds rate target range in December, the Federal Open Market Committee (FOMC) held rates steady and maintained its target range of 5.25% to 5.50% during its January 2024 meeting. As of January 31, the fed funds futures curve is pricing in that the fed funds rate ends 2024 at 3.9%. This implies a target range of 3.75% to 4.0%, which is more ambitious than the Fed's terminal rate guidance of 4.6% (implying a target range of 4.50% to 4.75%) estimated in its December 2023 Economic Projections release.

The difference in the number of potential rate cuts in 2024 between the Fed and investors may result in elevated volatility in the near-term and may impact equity prices, as real interest rates are likely to stay higher for longer than what is currently priced (equity multiples share an inverse relationship with real interest rates).

During the month of January, medium-to-long-term treasury yields across the yield curve advanced slightly despite encouraging U.S. core inflation, which continues to show signs of disinflation. The 10-year Treasury yield advanced to a monthly high of 4.17% (an increase of 30 basis points from the end of December) as investors processed stronger-than-anticipated economic data, such as the initial estimate of fourth quarter U.S. GDP growth of 3.3% (vs. the consensus estimate of 2%). However, the 10-year Treasury yield exited the month only three basis points higher from the end of December and down sharply from its monthly high after ADP jobs data showed the labor market is slowing down.

> “The market for middle market loans remains tighter, with spreads increasing marginally for all but the soundest credits.”

There is much underway as we progress through 2024 – balance sheet runoff, the timing of a Fed pivot, and a U.S. presidential election, to name just a few – and we will be watching inflation and global growth developments closely.

The Credit Market

For 2024, the Federal Reserve remains committed to achieving a stable long-run inflation rate of 2.0%. During its fourth quarter 2023 meetings, the FOMC voted to maintain an upper federal funds target of 5.50%; economic data will determine any additional policy adjustments.

According to a survey of December FOMC meeting attendees , a majority anticipate the Federal Funds rate to be between 4.25% and 5% by year-end 2024, with only a few expecting rates to remain above 5% or fall to between 3.75% and 4%. In 2023, the FOMC implemented four rate increases at the start of the year totaling 1.0%, but has left the rate unchanged since its July 2023 meeting. This was a slower pace compared to seven increases totaling 4.5% in 2022.

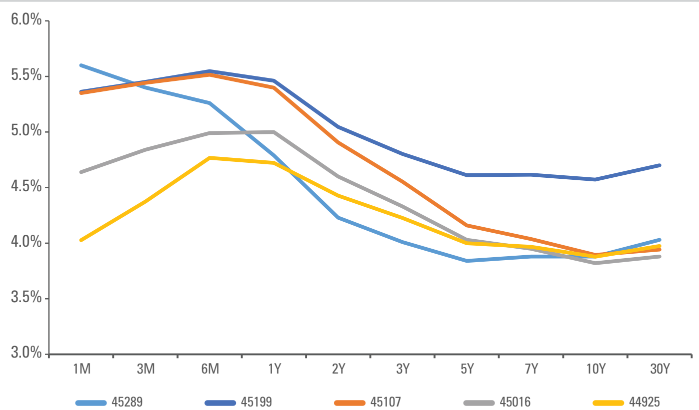
The Fed's effort to curb inflation through monetary policy shows incremental progress, with core inflation easing from a high of 6.6% in September 2022 to 3.9% by December 2023, though still above its 2% target. On a positive note, the Fed's second mandate of promoting maximum employment has not been impeded by its rate hikes, with U.S. employment rates remaining near record lows at 3.7% as of December 2023.

Through quantitative tightening, the Fed is gradually reducing its balance sheet, allowing around $100 billion worth of debt (mainly treasury and mortgage bonds) to mature monthly without reinvesting the cash. During 2023, the Fed reduced its balance sheet by just over $1 trillion, from a peak of $8.7 trillion on March 22nd to $7.7 trillion on December 27th.

According to Fed Chair Jerome Powell, in 2024 the Fed intends to "slow and then stop the decline in the size of the balance sheet when reserve balances are somewhat above the level judged to be consistent with ample reserves."

While there is uncertainly around the timing and size of this reduction, general consensus from primary dealers (firms with which the Fed trades directly) is that the Fed will begin slowing the reduction process towards the end of this year and finish in the middle of 2025, allowing the balance sheet to decline and remain between $6 and $7 trillion thereafter.

Yield Curves Over Time



Source: Bloomberg.
Data as of December 29, 2023.

The FOMC will continue to monitor the implication of its decisions and the economic outlook as it assesses its monetary policy moving forward; however, market expectations of future growth and inflation often have a more significant impact on longer term Treasury interest rates.

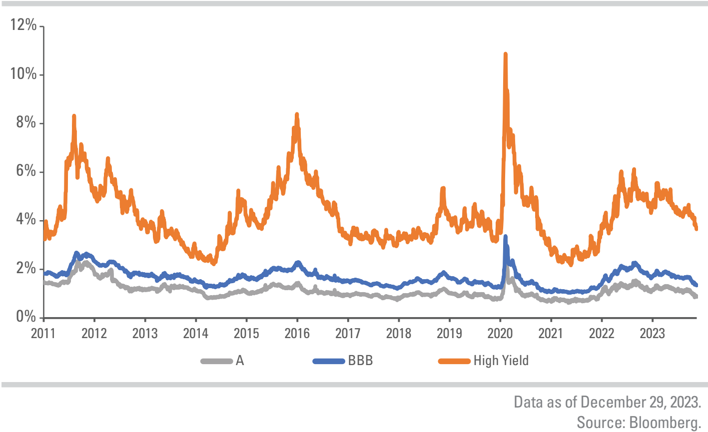
As inflation continued to ease through the end of 2023, an increased market demand for higher coupon Treasury notes and bonds decreased medium to long-term risk-free rates by 12/31/23. Medium to long-term rates increased for a time in 2023, most notably in Q3, as investors processed the slowing U.S. GDP and Consumer Price Index (CPI) growth data alongside meaningful exogenous events like the regional banking crisis and Hamas' attack of Israel.

The overall impact of elevated but slowing inflation is shown in the nearby chart, where the U.S. five- and seven-year Treasury yields

shifted downwards by approximately 0.75% during fourth quarter 2023, and by 0.12% over the entire fiscal year. This offset the impact of the Fed's balance sheet tightening, although short-dated Treasury bills continued to be influenced by the increased federal funds rate.

Corporate spreads reflect how the market assesses risk and credit quality by measuring the additional return demanded for investing in riskier borrowers. Throughout 2023, spreads for corporate bonds across various rating classes narrowed: As of 12/29/23, spreads for high-yield, BBB, and A bonds were 3.7%, 1.3%, and 0.9%, respectively. All were below their respective 20-year historical averages of 4.8%, 1.9%, and 1.3%. The nearby chart indicates that the bond market is cautiously optimistic about the economic prospects of corporate borrowers.

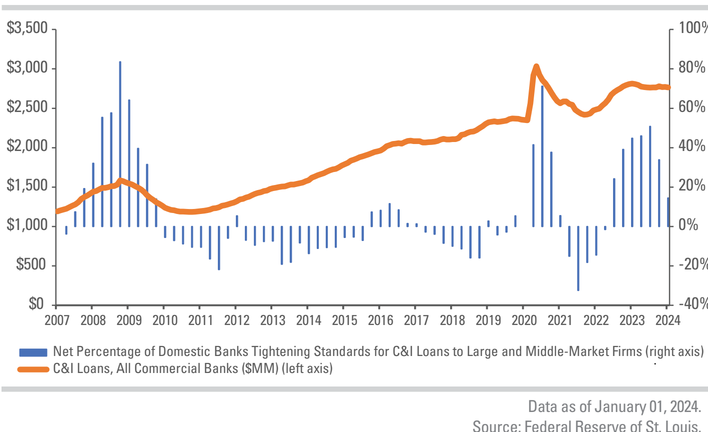
Corporate Spreads by Quality



Data as of December 29, 2023.
Source: Bloomberg.

Fourth quarter 2023 marked the seventh consecutive quarter of domestic banks tightening their standards, matched with continued easing of loan demand across all major segments. The nearby graph illustrates the trend of C&I loans outstanding to U.S. companies alongside the net percentage of U.S. banks adjusting their credit standards for loans to large and middle-market firms.

Amount of C&I Loans vs. Bank Standards



Data as of January 01, 2024.
Source: Federal Reserve of St. Louis.

The net percentage data is derived from the Fed's quarterly "Senior Loan Officer Opinion Survey on Bank Lending Practices" (SLOOS). In fourth quarter 2023, a net 15% of domestic banks tightened standards for commercial and industrial (C&I) loans to firms of all sizes, compared to 34% in the third quarter and 51% in second quarter 2023 – the latter of which may likely be the peak of increasing bank lending conservatism following the recent banking crisis. Although fewer banks tightened their credit standards in fourth quarter 2023, the majority of lenders are proceeding cautiously to reduce risk-taking. Overall, the share of banks reporting tightening lending standards remains at elevated levels.

A less borrower-friendly environment is typically associated with a recession, or the preamble to and aftermath of one, as demonstrated by the SLOOS completed in the first quarter of 2008. As the U.S. economy entered the Global Financial Crisis, a net of 32% of banks tightened standards for business loans to large firms, 30% to small firms (versus 19% in the most recent SLOOS), and 80% for commercial real estate (CRE) loans (versus 41% in the most recent SLOOS).

In the most recent SLOOS (January 2024), most banks noted increasing premiums charged on riskier loans and raising the cost of credit lines by widening the loan spreads above the costs of funds. Additionally, a significant portion tightened loan covenants and collateral requirements. Banks also reported that they expect demand for loans to strengthen but quality to weaken, across all categories. While the U.S. economy remains resilient, the forward-looking aspect of the latest survey suggests continued credit tightening.

Unsurprisingly, the cumulative effect of tougher standards over the past 18 months has resulted in a 1.3% decline in the amount of C&I loans through December 2023. BBH bankers have commented that the market for middle market loans remains tighter, with spreads increasing marginally for all but the soundest credits. Other trends from fourth quarter 2023 include:

- Regional banks focusing on the all-in return on their banking relationships, often requiring significant deposit accounts or ancillary business in order for them to join or remain in a relationship.
- Middle-market borrowers increasingly turning to the private debt markets as a viable path for funding, albeit at a higher cost than traditional bank loans, driven by a range of factors including tighter bank lending standards.

Nonetheless, certain banks, such as BBH, remain active in growing their corporate loan portfolios.

The Private Equity and Mergers and Acquisitions Markets

The fourth quarter of 2023 was more of the same for PE and M&A. Fund managers continued to battle headwinds as a result of ongoing

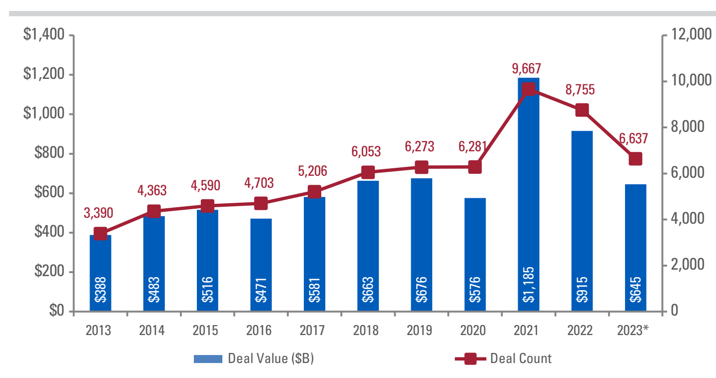
“The slowdown [in PE exits] has created a shift in focus toward value creation across existing portfolios.”

market volatility and high inflation. Dealmaking, exits, and fundraising all remained excessively competitive. Going forward, General Partners (GPs) will need to be highly adaptable, embrace technology and artificial intelligence (AI), and move quickly in this ever-evolving market environment.

Year-over-year (YoY) deal count declined by 7.3% to 8,115 in 2023 and marked the U.S. PE market's worst year in deal activity since 2016. Deal value declined by 29.5% to $645.3 billion, its lowest point since 2017 (excluding the COVID-19-pandemic-induced period in early 2020). Of all deal types, platform deals fared the worst (down 36.5% from 2022 and 51.8% from 2021) due to their dependence on leverage. Leverage ratios have decreased significantly since the beginning of 2023, thus inhibiting larger leveraged buyouts (LBOs), which platform deals tend to be.[1]

The slowdown in deal activity lends itself to PE firms leveraging technologies and operational efficiencies to find deals. In particular, generative AI is showing potential to transform and accelerate deal activity. Generative AI-powered tools can summarize vast amounts of data to help select the right deals more quickly. They can develop alpha-generating resources such as deal sourcing maps, outreach strategies in just minutes, and expand narrow or niche lists to include similar acquisition targets.[2]

U.S. Private Equity Activity Deal Flow by Year



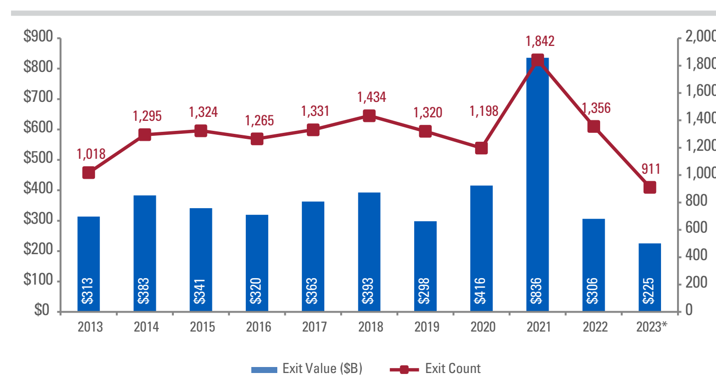
*As of December 31, 2023.
Source: PitchBook.

U.S. PE exit activity continued to decline through the end of 2023 as GPs struggled with prolonged inflation and unfavorable valuation trends. 1,121 companies were exited for a value of $234.1 billion, which is 17.7% and 33.4% below pre-pandemic averages, respectively. Exit activity in fourth quarter 2023 was the weakest for the year, with 256 companies exited for $44.7 billion in aggregate. This represents a decrease of 3.2% and 21.5% quarter-over-quarter (QoQ), respectively.[3]

While most portfolio companies are either nearing or have passed the average five-year timeframe for PE exits, there is optimism that exits will start to see a rebound in 2024. However, the slowdown has created a shift in focus toward value creation across existing portfolios.

In 2024, GPs will take a more hands-on approach as they look for ways to cut costs, optimize capital structures to drive greater cash-flows, and enhance the unique properties of each asset for greater market penetration.[4] Generative AI will also be deployed as a value driver in the portfolio, accelerating traditional levers like cost takeout, top-line transformation and revenue growth.[5] This will likely put many PE firms in a stronger position as exit opportunities eventually make a comeback.

U.S. Private Equity Exits by Year



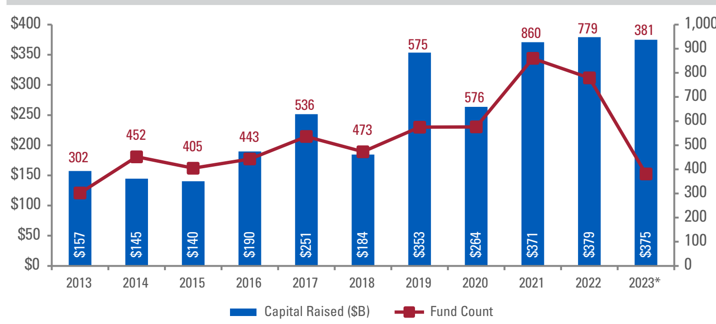
*As of December 31, 2023.
Source: PitchBook.

[1] *PitchBook.*
[2] *AlphaSense.*
[3] *PitchBook.*
[4] *AlphaSense.*
[5] *E&Y*

2023 proved to be a more difficult fundraising environment than in previous years. A sluggish exit market postponed a return of capital from older funds to LPs. The lack of available capital extended fundraising timelines and pushed GPs to explore diverse avenues for fundraising.

Despite these headwinds, the total capital raised throughout the year amounted to $374.8 billion across 381 funds, on par with the record-setting figures of 2021 and 2022. This indicates LPs' sustained commitment to the asset class, which is buoyed by its robust long-term prospects and a history of resilient returns in economically volatile periods.[6]

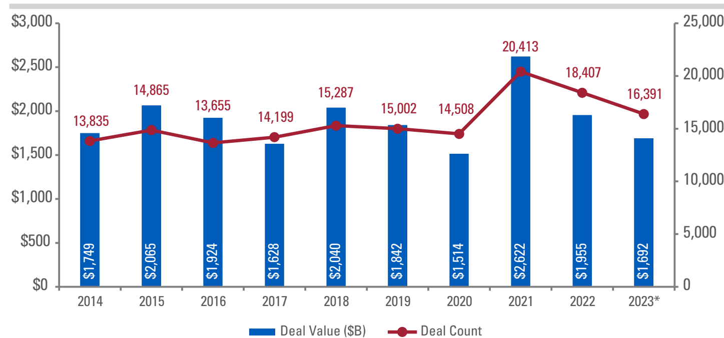
U.S. Private Equity Fundraising by Year



*As of December 31, 2023.
Source: PitchBook.

For the full year of 2023, the M&A market was subdued. The total deal value reached $1,691.8 billion, down 13.4% YoY. The total number of transactions (16,391) also marked a significant decline of 11.0% YoY. This continued downward trend can be attributed to higher interest rates, a widening gap in valuation expectations between buyers and sellers, and heightened geopolitical tensions—all of which have collectively impeded the pace of dealmaking. Still, these headwinds appear to be moderating somewhat as inflation is fading and interest rates are now expected to decline in 2024.[7]

North America M&A Activity



*As of December 31, 2023.
Source: PitchBook.

According to Goldman Sachs, key themes for strategic M&A in 2024 include:

- An elevated focus on M&A as a strategic lever
- Amplified activity across growth sectors
- Continued simplification of business models
- Increased activity outside of the U.S. and reemergence of cross-border activity
- Return of sponsor dealmaking, including on the sell-side
- Growth of AI-driven M&A
- Continued volume surge in resources, energy transition, and infrastructure

Conclusion

As we progress further into 2024, we continue to watch inflation and global growth developments closely, while also monitoring for the impacts of balance sheet, runoff, a potential Fed pivot, and the U.S. presidential election. The difference in projected rate cuts between the Fed and investors may also result in heightened volatility in the near-term and may impact equity prices.

In the credit market, the general consensus from primary dealers is for the Fed to begin the rate and balance sheet reduction process toward the end of 2024 and finish in the middle of 2025; moving forward, we remain on the lookout for any additional policy adjustments as determined by economic data. After narrowing throughout 2023, spreads for corporate bonds across various rating classes ended the year below their respective 20-year historical averages. The bond market is cautiously optimistic about the economic prospects of corporate borrowers. Meanwhile, fourth quarter 2023 marked the seventh consecutive quarter of domestic banks tightening their standards and we are watchful of this potential indicator of a recession.

Amid slowdowns in PE dealmaking firms have leveraged technologies and operational efficiencies to find deals, in some cases turning to generative AI which has a potential to transform and accelerate deal activity. There is optimism that PE exits could see a rebound in 2024; however, the slowdown in exit activity has shifted focus toward value creation across existing portfolios. Finally, headwinds impeding the pace of M&A dealmaking in 2023 appear to be moderating now that inflation is fading and interest rates are expected to decline in 2024.

[6] *PitchBook.*
[7] *PitchBook.*

SHIFT YOUR MINDSET: INNOVATION IN FAMILY BUSINESS

By Benjamin Persofsky / Executive Director of the BBH Center for Family Business

Throughout the lifetime of a family enterprise, there are moments when a need or opportunity arises to evolve one or more of the businesses. Perhaps the core products and services have had a long life and there is concern that the value proposition may be compromised, or it is at risk of being eroded by competitor innovation. Or an industry trend may be heading away from the importance of the company's core product(s) because of changes in consumer preferences. Whether the future is becoming more uncertain or there is general desire to identify new frontiers of value, it is often at these junctures that business owners start to shift their mindset toward intensifying innovation.

For operators and owners who aren't accustomed to continuing innovation, this moment introduces some questions and big decisions, such as:

- Do we invest in building or buying new things that are close to our existing businesses? Or should we go with something completely new that has greater growth potential?
- Do we invest measuredly in some of our own ideas that we believe are aligned with early trends, or should we fund someone else's ideas?
- Should we acquire these new businesses or build them ourselves?
- How much attention are we going to allocate to these initiatives overall?
- How much capital should we allocate?

For those with limited experience innovating, these questions can stymie a start altogether.

Despite some initially challenging questions, privately owned enterprises start on this path with several key advantages. They typically have a stable investor base, capital is often ready to deploy, they have technical know-how, and they have networks to draw upon. When these four key supports are in place, attention can turn to defining one's innovation strategy. Below are some key considerations in formulating that strategy.

Where to Invest

Private enterprises that have served sectors and industries for extended periods of time build a deep understanding of the opportunities that surround those businesses. The people who focus on those areas often have knowledge of where solutions can be developed that don't exist today, so it can be fertile ground to start. Initial questions include evaluating the gaps in the market – where are they? Are there extensions to existing products of the operating business that have attractive growth and value profiles? The costs of building new capabilities can sometimes be limited and incremental if the new products and services rely on an infrastructure similar to that of the existing business, so they can be quite advantageous to pursue.

For others, however, there is a different reality, with unfavorable characteristics surrounding one or more existing businesses – margin erosion caused by commoditization and/or increased competition, product obsolescence risk, or

Owners must also accept risk of the unknown - whether that industry or business will create or sustain the value that is anticipated."

declining market demand. In those cases, it may make sense to pursue investments in other, uncorrelated areas. While existing market knowledge may not be helpful in this instance, there may be effective business approaches or time-tested values that can create a competitive advantage in a new market. The benefits of ownership and capital also remain.

In the latter instance, there comes a need to ask the honest question: Are we the best people to build this new and unfamiliar capability, or should someone else do it? There is a gradient of approaches to consider. One is to acquire new capabilities through merger. The intention with that strategy is to integrate those newly acquired capabilities into the legacy business to leverage the talent and know-how in the combined enterprise. For this to work, however, the legacy and target businesses need to have cultures that will pragmatically fit together post-merger.

Another approach is to acquire an emerging business and leave it as a standalone operating entity. Here, the owners must rely on the strength of the management team to execute on their vision. Owners must also accept risk of the unknown – whether that industry or business will create or sustain the value that is anticipated.

Emerging industries and businesses are tricky when the industry/business has little track record, or where an investor has little domain expertise. It can be unsettling for business owners who are not accustomed to this kind of uncertainty. In fact, it's challenging for people who do it professionally.

"Picking unicorns isn't easy," says Scott Kupor, managing partner at Andreesen Horowitz, one of the largest venture capital firms in the United States. An investor may have a thesis about an industry and its impact, but it isn't always clear which businesses will come out a winner. "One of the biggest mistakes that can be made here is getting the category right but picking the wrong company," Kupor says. Taking a broad investment approach to an emerging industry during early stages increases your chances of finding your way to value creation.

[The rising generation] observes the enterprise with a broader, desensitized view. They think about what can be done to further build the enterprise for their lifetime. With that comes new ideas about where to find new value."

Attitudes Toward Risk

Depending upon the individual, the prospect of innovating can be viewed as a path to salvation or a money pit. Perceptions are usually driven both by intergenerational dynamics and individuals' risk tolerance.

Leaders in control can have profiles of many types. They can be "builders" – figures who take big risks on big ideas that start with little resources and grow them into large businesses through perseverance. They can be "improvers" who refine the big ideas and make them bigger and better. Then there are "maintainers," who see opportunity in an existing business to improve profit, scale infrastructure, and navigate changes in the business landscape.

Depending on the type of leader and their time horizon of ownership, the attitude toward risk can vary. Builders are often more willing to put capital at risk with less data because they have strong convictions in their vision for the future and how the business will change it. It doesn't matter if the enterprise has "been there before" because they have a clear idea of how the business will fit regardless of what exists today. Improvers will tend to be slightly less interested in unfamiliar risk. They will be comfortable with bigger bets when they see the relationship between the existing enterprise and the new venture. Maintainers are typically least comfortable with taking risky capital positions, yet they are often conflicted because they can see risks to a maturing business. Nevertheless, they know they need to do something.

Then there comes the intergenerational dynamics. Rising generations can feel more comfortable taking risk because they might have decades to wait for an investment return to materialize. Conversely, the controlling generation may struggle to see how groundbreaking ventures will ever become profitable. These clashes in comfort levels make it important that the two generations devise a strategy that allocates

resources toward things that may never pan out during the lifetime of the generation that is currently in control, recognizing those investments are being made for the benefit of future generations.

Capital Allocation

Innovation capital is inherently risky and gets riskier the further one gets from the things they know and understand. So how do you strategically allocate capital to it given the level of uncertainty? We again turn to Kupor for insight on how professional venture capital investors think about this issue: "We like to make investments incrementally. We will make initial investments in ideas we think have promise. As those businesses hit success milestones, we'll make follow-on investments. This allows us to increase our position as conviction in the business increases." He goes on to note that funds also have constraints on how much capital they can invest by virtue of how much they raised.

Family enterprises usually face similar constraints, because there are limits on how much an ownership group either can or wants to deploy into innovation initiatives overall. "It's critical to preserve capacity to make follow-on investments with the businesses that shine Kupor says." For family businesses, this means thinking bifurcating capital into these two buckets and shaping the investment selection around this approach.

Embracing Family and Failure

In family businesses, a desire for innovation is often driven by a rising generation. They observe the enterprise with a broader, desensitized view. They think about what can be done to further build the enterprise for their lifetime. With that comes new ideas about where to find new value.

As with most things involving family, there are some irrational aspects that must be considered. When a next generation member asks an elder generation for resources to invest in innovation, it can be received with inherent positive or negative bias. The positive bias is, "I want to do everything I can to support the next generation and help them flourish. I'll give them anything they want." The negative bias would be, "The next generation is disconnected from reality. They don't understand the world yet. They don't know what they are doing." Acting extremely in either direction has consequences. Providing resources without limitation reduces the likelihood of a discipline around investing and filtering quality. If the next generation is barred from thoughtful experimentation, no opportunity can be seized.

Relatedly, failure in innovation is expected, and it is crucial that it be a welcomed outcome by all of those who are involved. Regardless of whether it is a family member or a professional investor, many fail with innovation, and fail often. The key is identifying when it is optimal to fail and how it will look. For example, if a number of investments must be made with limited data points on the probability of success, it should be expected that multiple investments will result in a permanent loss. The strategy for acceptance is that if enough thoughtful investments are made, the few that make it will more than recover the losses on the others. As follow-on capital is invested, so too is the need for greater visibility and increasing vigilance to think about the overall capital risk position. If an investment progresses, the option set to be considered is always to hold, invest more, or exit. Decisions here must always be dynamics based on all available information.

Growing Value for Future Generations

Innovation and entrepreneurship in family enterprises is essential. To the extent it is an embedded activity by ownership and management, investment activities can help position the enterprise to protect and grow value for future generations. If it's not an existing activity, owners need not fear starting. Thinking through where to invest – looking internally and externally for opportunity, considering attitudes of owners across generations in devising a strategy, using capital allocation to new ventures thoughtfully, and embracing failure as an expected outcome – will create an environment where investment in innovation can thrive. It's a great way to collaborate across generations, and when it's driven by rising generations, watch them have great success while carrying on the family legacy.

Reach out to our Center for Family Business if you are interested in discussing this topic further.

This article was originally published in Family Business Magazine.

Are You Ready? What to Know About the Corporate Transparency Act

By Beth King, President of the BBH Delaware Trust Company

The Corporate Transparency Act (CTA), which went into effect on January 1, 2024, is far-reaching and may impact more than 30,000,000 private businesses. Here, we cover the key facts of the CTA and how to navigate it to best prepare you for the year ahead.

What is the CTA?

The CTA requires certain reporting companies to report the personal information of all beneficial owners to the Financial Crimes Enforcement Network (FinCEN). This legislation was enacted under the 2021 National Defense Authorization Act and stems from legislative, policy, and international pressures to increase transparency and enhance efforts to combat money laundering and terrorism.

Put simply, the CTA functions as a comprehensive business ownership reporting regime that requires most private companies to disclose the personal information of who owns and/or controls the company. Under the CTA, *reporting companies* must provide FinCEN with information about the entities and identify all *company applicants* and *beneficial owners*.

A reporting company is an entity created by filing a document with the secretary of state or similar office. The CTA will apply to both domestic and foreign reporting companies.

- *Domestic Reporting Companies* are corporations, LLCs, business statutory trusts, or other similar entities created within the U.S.
- *Foreign Reporting Companies* are entities formed under a foreign country's law that are registered to do business within the U.S.

The company applicant is the individual who directly files the document creating the reporting company, or who is primarily responsible for directing the filing.

Beneficial owners are defined as any individual who either directly or indirectly:

1. Owns or controls at least 25% of the ownership interest in a reporting company; or
2. Exercises substantial control over the reporting company

It's essential to perform due diligence if you think you or someone you know may qualify as a beneficial owner.

Beneficial Owners and Trusts

While a trust itself is not a reporting company, many people involved in trust structures, including trustees, advisers, settlors and beneficiaries will be considered beneficial owners under certain circumstances.

For example, where a trust owns 25% or more of a reporting company, the following individuals are considered beneficial owners:

- All trustees, advisers or people with the ability to make investment decisions or to control the disposition of the reporting company
- A settlor of a revocable trust
- A settlor of an irrevocable trust where the settlor has the right to substitute assets (a power that is commonly given to settlors to make a trust a "grantor trust")
- A beneficiary who is the only person with the right to receive distributions of income and principal
- A beneficiary who has the right to demand or withdraw substantially all of the assets

The Corporate Transparency Act (CTA), which went into effect on January 1, 2024, is far-reaching and may impact more than 30,000,000 private businesses."

Moreoever, regardless of the trust's percentage of ownership, all fiduciaries or people who exercise substantial control over or make important decisions about the reporting company will be considered beneficial owners.

What are the reporting deadlines?

The obligation to report beneficial ownership began on January 1, 2024. The reporting deadlines to submit beneficial ownership information (BOI) to FinCEN differ depending on when the entity was created:

- Entities created prior to January 1, 2024 have until January 1, 2025. These entities do not need to provide information on company applicants.
- Entities created on or after January 1, 2024 and before January 1, 2025, have 90 days.
- Entities created or registered on or after January 1, 2025 have 30 days from actual or public notice the company's registration is effective.

Exemptions

There are a total of 23 categories of exempt entities, most of which are already subject to thorough federal and state regulation. Exemptions include governmental entities, publicly traded companies, insurance companies, registered investment companies, banks, credit unions, and other financial institutions, tax-exempt organizations (e.g., registered charitable organizations), or a large operating company. The latter is defined as an entity that employs more than 20 full-time workers, has a physical presence in the U.S., and has reported more than $5 million gross receipt sales on the prior year's tax return.

Taking Action

To ensure preparedness for the CTA, consider the following steps:

- Inventory your entities: Do you need these entities? Do you anticipate adding and/or needing more entities?
- If the CTA applies to you, log onto FinCEN and submit all necessary info within the deadlines. The report will require the company's name, address, and EIN, as well as the name, residential street address, DOB, and photo ID of each beneficial owner (and company applicant for entities created after January 1, 2024).

A full list of exemptions and reporting requirements can be found on FinCEN.gov. For more information on how the CTA might affect you, reach out to your relationship manager.

Wealth and Well-Being

Pillars of Persistence:

Strategies for Building Work Ethic and Determination

By Ross Bruch, Senior Wealth Planner

Perseverance and diligence are traits that significantly contribute to success, not just in personal development but also in sustaining family enterprises. In today's dynamic environment, preparing both children and family business heirs to navigate these challenges is essential. Recent research by Dr. Julia A. Leonard, a noted child developmental psychologist and Yale professor, offers invaluable insights and strategies for nurturing these crucial qualities.

Integrating the studies' findings into your daily life and business practices can cultivate a resilient, adaptable, and industrious next generation of business owners.

Study One: Struggle and Persistence

In a 2017 study, Dr. Leonard and her fellow researchers investigated the relationship between children witnessing adult efforts and their own willingness to persist in challenging tasks. The research categorized children into three groups:

1. One observed an adult persistently struggling with a task
2. One saw an adult effortlessly complete a task
3. One wasn't exposed to any adult effort

The children were then asked to solve a difficult problem and the researchers measured how many times the children attempted to complete the project before giving up. The children who observed the adult's struggle demonstrated significantly higher persistence in their efforts than either of the other cohorts, suggesting that adult modeling of behaviors shapes early development of persistence and effort.

Study Two: Observed Effort

A related 2019 study further explored how adults' demonstration of effort and persistence tangibly affects children's approach to challenges.

Children observed adults engaging in tasks requiring varied levels of effort, with some tasks being completed successfully and others ending in failure. Adults were told to make statements related to the tasks (e.g., "This will be hard"), offer encouragement, or not comment at all. After observing, the children were given an impossible task, and how long and hard they worked on it was an indication of their persistence.

Similar to the first study, researchers found that children displayed greater persistence after witnessing adults successfully complete the tasks compared to observing failure. Significantly, children showed the highest levels of persistence when adults also explicitly discussed the importance of effort. Phrases that set expectations, provided pep talks, or highlighted the value of trying hard were particularly impactful, especially when combined with successful demonstrations of tasks.

The study underscores the importance of not only teaching persistence, but also building an understanding of effort through example.

Study Three: Intervention

Finally, in a third study conducted in 2021, Dr. Leonard explored the impact of adult intervention on children's persistence in challenging tasks — in particular how children's perseverance is affected when adults take over tasks instead of allowing children to struggle and solve problems independently.

“By modeling perseverance, positively framing challenges, and balancing support with independence, family business leaders can enhance the capacity of the next generation to face difficulties.”

The findings revealed that children show reduced persistence in tasks when adults intervene and complete the tasks for them, compared to when children are allowed to face challenges on their own. Children placed in the group in which adults took over showed significantly less persistence when presented with an impossible task (a puzzle box that could not be opened) than those in groups where adults taught and/or allowed them to learn independently. This underscores the critical importance of encouraging children to independently tackle and work through challenges, with adults providing support only when necessary.

Broadening the Perspective

The insights from these studies are not only valuable for parents but are also particularly relevant for family business owners looking to cultivate a strong work ethic, motivation, and persistence within their successors. Dr. Leonard’s research offers a blueprint for fostering environments that support growth into persistent, adaptable individuals. By modeling perseverance, positively framing challenges, and balancing support with independence, family business leaders can enhance the capacity of the next generation to face difficulties.

Below are seven strategies informed by these studies which can help lay a solid foundation for lifelong learning, success, and the sustainable continuation of family business legacies.

1. **Share Personal Stories of Perseverance:** Narrate instances from your own life where hard work led to success, focusing on the challenges faced and how you overcame them. This makes the concept of hard work more relatable and inspiring.
2. **Discuss the Long-Term Benefits:** Regularly discuss how hard work today can lead to improved opportunities and outcomes in the future, connecting present efforts with future rewards. Gradually introduce individuals to increasingly difficult tasks and responsibilities to push their boundaries and develop resilience.

3. **Support Without Solving:** If someone in the successor generation faces a problem, resist the urge to solve it for them. Instead, offer guidance and support, encouraging them to find solutions on their own. This fosters independence and perseverance.

4. **Set Collaborative Family Goals:** Engage in setting goals – business-related and otherwise – that the whole family can work towards, such as a community service project or a collective hobby. This teaches teamwork alongside perseverance.

5. **Celebrate Achievements and Learn from Failures:** Make it a point to celebrate achievements and discuss what was learned from any failures. This reinforces the idea that the journey is as important as the destination, and openly sharing experiences with failure demystifies it; it can even be framed as a necessary step toward success

6. **Link Hard Work to Individual Passions:** As the next generation is growing up, help them see how hard work applies to the things they love doing, whether it's sports, arts, or science. Effort is linked to improvement and enjoyment.

7. **Encourage Risk-Taking Within Reason:** Don't shy away from taking on tasks with risk of failure, where the stakes are low but the learning potential is high. For a younger group, this could involve trying a new sport or participating in a school competition skill; for the next generation entering the family business this could be learning a new role or leading a project within the enterprise.

Conclusion

Incorporating these research-backed strategies into daily interactions with the younger generation can transform the way they view challenges and their own capabilities. Family business owners have the unique opportunity to model these traits, equipping the next generation of business leaders to face challenges with grit, motivation, and determination.

If you are interested in learning more about how BBH can help prepare the next generation for business ownership, reach out to your BBH relationship manager.

We the Family:

THE BENEFITS OF CREATING A FAMILY CONSTITUTION

Many families thrive by establishing a roadmap for navigating wealth, business, and legacy transitions over time. As families evolve and successive generations wonder how they can become contributing members of the family's business, wealth, or philanthropy, family leaders often find a benefit in putting basic guidelines in place to govern how the family will work together and resolve potential conflicts in the future.

These guidelines can take the form of a family constitution – a document that sets forth the family's values and principles, defines the objectives of the family, and outlines how the family will make important decisions.

Family constitutions can address a variety of situations, including:

- Family businesses
- Family offices
- Family philanthropic endeavors

In fact, any family who wants to set forth a system of shared values, mission, and history and/or a decision-making framework can benefit from the process of creating a family constitution.

Within the context of a family business, a family constitution can be even more crucial in smoothing transitions over time. A family business constitution can help the owners and employees of the family business understand its competitive advantages and what makes its culture unique and sustainable. It can also address and define the various roles of individual family members, both inside and outside the family business. However, many families struggle with how to do this. Here, we outline our recommendations for creating a family constitution to enable seamless business and wealth transitions.

Process Over Product

Many families interested in a family constitution may believe that the implementation process is as easy as a call to the lawyer to get a constitution drafted and in place. Family constitutions that have been drafted without sufficient input from the family often create more problems than they resolve.

A family constitution is not a one-size-fits-all set of dos and don'ts, but instead, a uniquely personal document that reflects a deliberate, thoughtful process that must occur within a family. In the most successful cases, it is the process of discussing, debating, and ultimately enacting the family constitution, rather than the end result, that produces the most enduring benefits to the family.

Creating a family constitution provides members with a wonderful opportunity to come together, identify and articulate their values, and set forth a roadmap for future generations to follow in preserving and honoring the family mission and goals. The process of drafting and establishing a family constitution can bring a family closer as participants learn more about each other, the family's history, and shared motivational values.

Although formulating, drafting, and finalizing a family constitution is a significant undertaking, it invariably proves to be a rewarding process that pays dividends for generations to come. A strong family constitution can help anticipate potential problems and provide a set of guidelines to address obstacles when they ultimately arise. Because of the careful deliberation and time invested in creating a family constitution, the document can also become an incredible source of family harmony, love, and pride going forward.

Most effective family constitutions exhibit several common principles:

A Focus on Clarity and Values

Traditional governing documents such as shareholders' agreements, company bylaws, and even estate planning documents are characterized by technical language necessary to achieve desired legal, tax, and administrative results. This language is not appropriate for a family constitution, which is not legally binding.

Instead, the family constitution should have accessible and personal language. Even in the context of a family business, a family constitution should put the family first and focus on continuity and harmony over the long term. Family constitutions that attempt to insulate a business from family feuds by removing the personality and color that defines a family often end up fueling strife. Instead, the family's philosophy and values should be the cornerstone of the document.

If the family constitution's theme is that consensus building and core values are paramount, the family will collectively support the success of the business.

A good way to put the family first in the family constitution is to include an entire section discussing values. After all, how can future generations be expected to uphold the family's values if the family does not take the time to articulate them? It is the family's values or mission statement that will serve as the balm to new and unanticipated challenges in the family and its business in the future.

An Emphasis on the Family History

Bush Brothers & Company (of the Bush's Beans fame) provides a simple, concise example of its family's values at the end of its corporate mission statement: "Together, we will live by the values of integrity, responsibility, trust and caring as exemplified by our founder, A.J. Bush."

Bush's values statement is powerful not only in its clarity and brevity, but also because it identifies an important historical figure within the family. Recalling and memorializing the family's meaningful characters and stories are effective means of identifying and investigating the sources of its core values.

Rooting the family values in history and personalities can produce a far more meaningful and enduring statement of those values than simply asking each family member what his or her values are and why. Discovering and documenting the family's common values is a logical first step in the process of creating the family constitution. While each person's sense of the family's values may be different, families are often surprised by the common threads that arise once they take the time to engage in an open discussion about those values.

It is important to keep in mind that enacting a family constitution can be a long, process-oriented endeavor. For some, talking about how to make decisions and creating mechanisms for resolving conflict is not "fun," so adding an element of family color and history can enliven the conversation and prevent family members from becoming disengaged with the process.

Adrienne Penta, the executive director of the Brown Brothers Harriman (BBH) Center for Women & Wealth, recently addressed the topic of opening the lines of family communication around values and shared history. As she notes, "Your family wealth story can elucidate why you make the choices you do about spending, saving, investing, and giving. Attitudes about wealth are framed by the messages delivered to us – whether intentional or unintentional – by those who came before us."

A Framework for Making Decisions and Changes

No family can predict the future, and no family constitution can accurately address all the obstacles and changes the family is likely to face. Rather than creating a set of rules that aim to prevent conflict or strife, a well-drafted family constitution should instead set forth a process for developing policies, making decisions, and managing conflict.

In creating the family constitution, the family should test-drive various methodologies to make decisions and resolve difficulties. For example, the family could anticipate a problem that might arise in the future and engage in a mock implementation of the proposed decision-making framework to see how successful it is at resolving that particular issue. This process will help the family adjust its processes to reach the best result.

A family constitution could address how a family is to make decisions in any of the following areas:

Governance

- Criteria for board members
- Makeup of board
- Frequency of family meetings
- Membership criteria for family council or family association
- Funding of family meetings
- Communications and relationships between board, family, and management
- Strategic goals (e.g., growth, debt, etc.) for business
- Selection of professional advisors
- Successor selection process

Family Office or Business Employment

- Qualifications
- Conditions (e.g., leaves, part-time, etc.)
- Reporting relationships
- Compensation, benefits, perks, and expenses
- Performance review
- Titles
- Severance
- Retirement

Ownership

- Conditions for ownership and voting rights
- Dispute resolution process
- Dividends
- Redemption process
- Business valuation methodology
- Estate plan communications, coordination, and agreements
- Marriage contract arrangements

Remember that the family constitution will not create specific and binding rules for these topics but will instead set forth a framework and guiding principles for making future decisions regarding each area.

A Living, Breathing Document

Families should anticipate the need for change in the future and set forth a process for amending the family constitution. It is unrealistic to expect a single, unrevised family constitution to withstand the many changes that will occur in the future. Simple cultural and technological changes can often make provisions in a family constitution irrelevant or inappropriate. Moreover, future family members may not feel an allegiance to a constitution that they did not have a hand in creating.

Rather than establishing strict rules that must be followed by all or, the opposite, superficial guidelines that do not add much depth, a better approach would be to revisit the family constitution every five to 10 years or, at minimum, every generation.

Family members can then decide whether the constitution should be renewed, amended, or revised entirely. Regular review of the family constitution prevents significant issues from going unaddressed for too long, which can result in resentment and strife. Some families insist that the family constitution sunset at a certain point so that new leaders within the family can be empowered to leave their own mark on the family's values and mission. While this is not necessary for every or even most families, perhaps each generation should be encouraged to revisit and update the family's statement of values.

Starting Small: A Family Mission Statement

Many thoughtful families understand the benefits of a family constitution but are not yet willing or able to invest the time to formulate a comprehensive family constitution. Rather than preparing a family constitution that is not well formulated, a busy family could consider starting with a family mission statement. A family mission statement is essentially just one part of the family constitution – the family values statement – abbreviated.

The concept of a family mission statement is borrowed from corporate America. Many successful businesses have short but impactful mission statements meant to articulate what

makes their brand unique. Translating this practice to the family setting, a mission statement broadly captures what the family believes – its superpower, so to speak.

For example, Steven Covey, author of "The 7 Habits of Highly Effective People," formulated his family's mission statement by asking his wife and children what he thought their family was all about. Specifically, he asked them: "What makes you want to come home?" and "What embarrasses you about our family?" The Covey family ended up with the following mission statement:

"The mission of our family is to create a nurturing place of faith, order, truth, love, happiness, and relaxation, and to provide opportunity for each individual to become responsibly independent, and effectively interdependent, in order to serve worthy purposes in society."

A family business mission statement could be a hybrid of the corporate and family mission statement. For example, Longaberger, maker of Longaberger Baskets, has a mission statement that speaks to the core of what makes both the family and the business tick: "to stimulate a better quality of life."

While a mission statement may seem like a small piece of the puzzle, a simple statement that encapsulates what motivates and inspires a family can truly lay the groundwork for a more complete family constitution in the future.

The process of creating a family mission and ultimately a family constitution will vary depending on each family's unique needs and goals, as will the plan for communicating information about the mission and constitution to successive generations.

BBH can help establish a customized framework and process for each family to follow. Please contact a wealth planner or relationship manager to begin the process.

INSIDE **BBH**

2024 FLORIDA INVESTOR DAY

In early February, clients, friends, and BBHers gathered in Palm Beach and Naples, Florida for the 2024 Investor Day conference. Thank you to all who joined for a successful and insightful event!

The day opened with remarks from Jeff Meskin, BBH Partner and Head of Private Banking. Following this was a lecture from the event's keynote speaker, Dmitri Alperovitch, Chairman, Silverado Policy Accelerator, Co-Founder of CrowdStrike, and author of "World on the Brink: How America Can Beat China in the Race for the Twenty-First Century."

Scott Clemons, BBH Partner and Chief Investment Officer, gave an update on the markets and economy in 2024, after which Scott Hill, BBH Principal, Director of Research and Portfolio Manager, BBH Large Cap Equities led a panel discussion with Neil Hohmann, BBH Partner, Head of Credit Alternatives, and Fixed Income Portfolio Manager.

Guests also enjoyed a panel with Dev Kantesaria, Founder and Portfolio Manager of Valley Forge Capital Management, and Cory Whitaker, Founder of Bowie Capital Management. Justin Reed, BBH Partner and Chief Investment Officer, and Ilene Spitzer, BBH Deputy Chief Investment Officer, moderated. Following closing remarks from Kathryn George, BBH Partner, guests networked, built relationships, and had some fun at a cocktail reception.

As always, we enjoyed this opportunity to bring our clients together, and we look forward to gathering again soon!

If you are interested in learning more about upcoming BBH events, reach out to your relationship manager.

140 Broadway
New York, New York 10005-1101

OWNER TO OWNER

Brown Brothers Harriman & Co. (“BBH”) may be used as a generic term to reference the company as a whole and/or its various subsidiaries generally. This material and any products or services may be issued or provided in multiple jurisdictions by duly authorized and regulated subsidiaries. This material is for general information and reference purposes only and does not constitute legal, tax or investment advice and is not intended as an offer to sell, or a solicitation to buy securities, services or investment products. Any reference to tax matters is not intended to be used, and may not be used, for purposes of avoiding penalties under the U.S. Internal Revenue Code, or other applicable tax regimes, or for promotion, marketing or recommendation to third parties. All information has been obtained from sources believed to be reliable, but accuracy is not guaranteed, and reliance should not be placed on the information presented. This material may not be reproduced, copied or transmitted, or any of the content disclosed to third parties, without the permission of BBH. All trademarks and service marks included are the property of BBH or their respective owners.

© Brown Brothers Harriman & Co. 2023. All rights reserved.

PB-07169-2024-02-23 Expires 3/31/2026