

SYNERGIES BETWEEN CORPORATE AND PRIVATE BANKING: MARKET OPPORTUNITIES IN THE RELATIONSHIP BETWEEN THE OWNER FAMILY AND THE OWNED FIRM.

by Stefano Caselli

INTRODUCTION

The research developed in the previous chapters has examined the complex nature of the distinctive and structural features of the family owning one or more businesses as well as the map of the financial requirements emerging from the combined evaluation of the enterprise and the owner family. In particular, the last study has allowed us to outline a logical reference framework in order to proceed with the verification and the correspondence between the system of requirements and that of the financial services. From this point of view, the explanatory scope of the above approach develops irrespective of the strategic and organizational choices made by financial intermediaries as it appears only subsequently as a general criterion for product positioning. This results in the further necessity to understand the mechanisms and the logics which enable financial intermediaries to define their own positioning by considering the specificity of the family/firm relationship as well as to organically exploit the business opportunity resulting from the family/firm connection.

This overall necessity leads to tackle two different issues that are connected and sequential.

The first issue regards the financial and the assets connections between the family and the firm. This allows us not only to clearly analyze the target functions of the two actors and to re-connect the different areas of requirements to quantitative parameters but also to establish whether the distinctive features of the same financial and assets connections represent an element of interaction potentially useful for the financial intermediary.

The second issue regards the financial operations which, due to their own nature or their being consistent with financial and assets connections, are bound to trigger important synergies between the systems of products typically designed for the corporate and the private area. In other words, the critical aspect of the intermediary's positioning choice is solved as long as the scope and the nature of the operations are synergetic and comprehensive of the corporate and the private area.

THE RELATIONSHIP BETWEEN THE OWNER FAMILY AND THE OWNED FIRM: GENERAL PRESCRIPTIONS.

The financial structure of family business, which has been analyzed in the first chapter of the research, presents a distinctive character that reflects both size-specific and country-specific factors. If the former are intrinsic in the concept of small and medium size, the latter depend on the financial and industrial organization of the respective country. This means that the structure of corporate liabilities is characterized by an aspect common to any economic system, though showing some differences from country to country which can be gathered into a homogeneous reference path.

From the analytical point of view, the high volume of bank debts characterizing average corporate liabilities - above all for SMEs - finds a reference in the prescriptive logic of corporate finance so that the ratio between debt and equity is established on the basis of the compared evaluation between failure costs and the fiscal advantages deriving from opening different financing channels. If this applies to any typology of firms, in the specific instance of small and medium-sized enterprises both the notion of failure costs and that of fiscal advantages may be broadened so that on the one hand their strictly economic meaning is even strengthened and on the other the value of mutual interdependency connections between the owner family and the owned firm can be included.

Failure costs resulting from the direct relation between the financial leverage increase and the funding average rate increase applied by lenders - once the "market" acceptability threshold of the business risk has been exceeded¹ - must include also the costs deriving from the owner's loss of business control. Despite the difficult measurement of such costs, the notion of family failure assumes a strong operating value as the change in the family-firm direct relation may generate drawbacks not only in terms of future missing profits but above all in terms of explicit and social costs resulting from the failure or from breaking the existing relationships within the family. The above costs are referred, for example, to forms of dramatic and unexpected subdivisions of the family wealth due to the exit of one or more family members as a result of the changed ownership and the entry of external partners.

As for fiscal advantages, the distribution of the tax shield established by the policy maker affects directly the net rate of financing sources and the cash-flow distribution upon tax payment. This means that the firm's allocation of liabilities and its mid-term financial planning are strongly conditioned by the rules on deductible expenses and the fixing of

¹ *The growth of the firm debt relation may lead to exceed a psychological and functional threshold, beyond which the firm stakeholder system judges risk intolerable. This step does not necessarily lead the firm to failure, but it may generate additional costs due to the exit of some financiers, to the growth of the cost of money applied by other lenders, to possible reactions on the part of suppliers and customers. On this issue see Bradley M., Jarrel A.G., Kim E.H., "On the Existence of an Optimal Capital Structure: Theory and Evidence", in "The Journal of Finance", n. 3, July 1984 e Kane A., Marcus J.A., Mc Donald L.R., "How Big is the Tax Advantage to Debt", in "The Journal of Finance", n. 3, July 1984.*

incentives or selective criteria. The differentiation of rules is not limited to the distinction between debt and equity, but also to debt distinctions as to the origins of the debt or to contractual forms². Moreover the incidence of the fiscal advantage can be rated in relation to the bank debt, the market debt and the different forms of fund raising among partners as well as to the length of financing and the distinction between leasing and debt. In any case the distribution of the tax shield does not exhaust the comprehension of fiscal advantages as the analysis should be extended to the performance of the family assets and thus to the relative impact of fiscal variables. This is necessary as family members allocate their financial resources according to whether they aim at the capital, at financing the firm or at investing their assets. Therefore the comprehensive review of tax variables requires a process of joint maximization of the fiscal advantage for both the firm and the family.

The general relation which opposes failure costs and fiscal advantages can be formally expressed, considering the above mentioned interactions between the family and the firm. Hence we can write

$$Kf_{firm} - Kf_{family} \geq \Delta taxshield(Debt - Equity)$$

where Kf_{firm} indicates the firm's failure costs and Kf_{family} those of the family. The above relation can be expressed more correctly by describing a series of elements. In the first place, the concept of tax shield should be suitably analyzed on the basis of quantitative and time parameters in order to have it effectively quantified. This can be obtained by means of the concept of debt weighted average cost and equity cost after taxes. So doing, not only can the tax shield be financially evaluated but the same variable relating to the pricing of financial resources as expressed by the capital market is thus included in the evaluation of the allocation of corporate liabilities. In addition the identification of the above parameters is not sufficient when we turn from financing to the investment of resources which becomes binding when the firm and the family dimensions are joint. Here, the debt after tax weighted average cost must be bound to the after tax average return lenders would obtain if they decided to invest in debt but in a different form³. Equally, the equity after tax cost must be bound to the after tax return lenders would obtain if they made another investment in equity. The bound must be interpreted as the enter and exit condition of the owner family on both equity and debt. In the first case, if the owners expect higher returns from investing in debt not related to the owned firm but to the market as a whole, debt fund raising will develop outside the family. In the second case, if the

² For a description and exhaustive evaluation of the different forms of impact of fiscal variables on the structure of firm liabilities see Dessy A., "Capitale di debito e sviluppo delle imprese", Egea, Milano, 2001.

³ A significant example in this respect can be the comparison between the cost of capital obtained through the form of shareholders' financing and the return on the investment in bonds. In both instances, the legal form consists in investing and raising debt funds, but due to the presence of different fiscal rules, the investor's profitability may turn out to be different at a parity of conditions. See Tagliavini G., "Costo del capitale, analisi finanziaria e corporate banking", Egea, Milano, 1999.

owners expect higher returns from investing in equity not related to the owned firm but to the market as a whole, equity fund raising will tend to develop theoretically outside the family on condition that the cost of fund raising is lower than the cost of debt.

In the second place, family failure costs must be analyzed by considering the different components characterizing their nature. Then the three identified components have a development dynamic that is a dependent variable of the variations in the firm's equity.

The first component is the expected loss of returns due to the owner family's non-participation in the business capital. This loss is considered both in strictly monetary terms, (i.e. loss of future dividends) and in broader terms (i.e. loss of possible influence on the distribution of the same)⁴. This means that the above variable is directly correlated to the growth of equity in the presence of the family more profitable investments in other bonds. In this case, the absence of profitable investments in the firm deters any further re-investment of resources and the growth of equity can be guaranteed only by subjects outside the ownership. Therefore, the renunciation to the equity growth is the only means to reduce the expected losses due to the non-participation in the business capital.

The second component regards the costs of portfolio re-allocation as a result of the changes in the firm ownership. The different weights and balances within the family resulting from the changes in the assets invested in the firm or from the entry of new partners may produce transaction costs because of the necessity to re-establish the lost balances. Anyway, the definition of new balances produces both explicit costs and losses due to the unexpected disinvestment of assets.

The third component regards the "social" costs that may have a direct or indirect monetary impact. This component is an extension and somehow a completion of the second one as it emphasizes the expenses borne by the family as a result of the changed social relations among the various members of the family. The growth of equity generates imbalances which have not only immediate monetary but also relational consequences, which may reveal different economic effects in the course of time. Quite often such effects are lower profits for the firm due to the non-exploitation of business opportunities because of the presence of latent or actual conflicts within the family. Yet, the amount of social costs is a direct function of the complexity of the family, that is of the number of generations and the number of people directly involved in the business management system. The presence of multiple family nuclei does in fact extend the size of potential conflicts and the amount of transaction costs to be faced to solve the same.

As a result of the three variables, the previously mentioned formula changes as follows:

⁴ It is worth noticing that if family failure costs include expected losses due to non-participation to business capital, by symmetry firm failure costs must also include the firm missing profits due to the investment of debt rather than equity. This happens when the presence of ambitious development plans requires a massive employment of "patient" capital so as to guarantee the risk of the same plans and the uncertainty of cash-flows dedicated to the repayment of lenders. Although this approach is theoretically correct, in the practice it is difficult to identify in advance the category of "ambitious plans" and its formalization in terms of non-profits.

$$Kf_{firm} - (EL + K_p + K_s) \geq r_d - r_e$$

where Kf_{firm} indicates the amount of the firm's failure costs, EL the expected loss due to non-participation in business capital, K_p the amount of portfolio re-allocation costs, K_s the amount of "social" costs, r_d the after tax cost of debt and r_e the after tax cost of equity.

The relation reveals the arbitrary nature of the choices regarding the structure of the business capital in the presence of family ownership. This leads to the fact that the growth of capitalization can be justified either by system fiscal policy factors so that the second part of the relation generates a differential that is favorable to equity and higher than that of the first part of the relation or by family corporate governance factors, which significantly reduce the cost component Kf_{family} relative to the first part of the relation. In addition, SMEs' size profile makes the presence of any governance capacity unlikely both in terms of business and social relations between the family and the firm as well as within the family itself, so that family failure costs are considerably reduced. Moreover, the absolutely low capitalization, which is produced by the presence of family failure costs and at parity of differential between r_d and r_e , makes EL , K_p and K_s components more sensitive to the changes in equity. As a result, a sort of vicious circle is likely to be activated so that the limited amount of equity tends to direct the choices regarding the structure of business capital toward the area of debt.

The relevance of debt, which is characterized by size-specific and family-specific factors, is nevertheless further strengthened in Italy by a fiscal policy structurally favorable to debt with reference to the second part of the relation. From the functional point of view of the system, this is consistent with the remarkable development of bank financing circuits as reference structures for the support of corporate investment choices.

The consistency between firms' selection criteria of financing sources and the development path of the financial system produces a series of important drawbacks in the approach modes adopted by financial intermediaries in the attempt to meet the requirements of small and medium-sized enterprises. In this context there are a number of prescriptions which enable us to understand and compare positioning choices as lending represents the corporate reference product – which is strengthened by the action of a non-neutral fiscal policy – as long as it feeds the process of fund raising and guarantees the achievement of a dynamic balance between capital structure and ownership relations. Prescriptions can be summarized as follows:

- the importance of the credit function makes credit underwriting the financial intermediary's access key to firm financial requirements and family-firm relations;
- the importance for the firm to have financing sources available makes credit underwriting the tool leading to the firm's "contractual capture", thus leaving some areas for cross selling and origination in relation to non-credit products;
- credit becomes the "balance beam" of family corporate governance and gives the financial intermediary the possibility to develop a deep knowledge of the corporate system and therefore of its risks.

The specificity of the three components described above points out that within the financial system banks have a competitive advantage with corporate customers which makes them different from the other subjects as their own organizational and structural characteristics guarantee *ex ante* a stronger control of the credit function. This can be observed under three different aspects. First of all, irrespective of the counter-position and of the choice between the specialized and the generalized model of supply, the institutional specialization of the credit function gives the bank stronger incisiveness in corporate financing as a result of the monetary value of the services provided. The financing monetary profile not only allows the bank to play *a priori* the insider role of corporate financial flows, but it also becomes SMEs' instrument for reducing the complexity – in terms of knowledge and costs – and the information asymmetries of the financial system. Secondly, the monetary function potentially allows conveying cross-selling policies which multiply the areas for the identification of more and more complex requirements. The ability to understand these areas is of major importance for financial intermediaries to extend their range of services. The control of the monetary function gives banks a potential asset that gives them the chance to increase their volumes and margins on a constant basis in the course of time. Thirdly, the actual geographical distribution of banks allows them to better penetrate local economies and better monitor local enterprises. If this aspect is less relevant for big firms, for small and medium-sized enterprises the bank's "local distribution" represents a key factor for the creation and the development of market relations. The local nature of the divided bank contains the latent power of originating the entire range of financial operations. This can be exploited by the bank as the element triggering an all finance supply process which is typical of the "pure" universal bank or it can be exchanged with external economies in terms of creation and development of a network of specialists who, according to their product competencies, re-compose the internal complexity of the all finance supply in the market.

The relationship between the owner family and the owned firm: the nature of assets and financial connections.

Distinctive aspects.

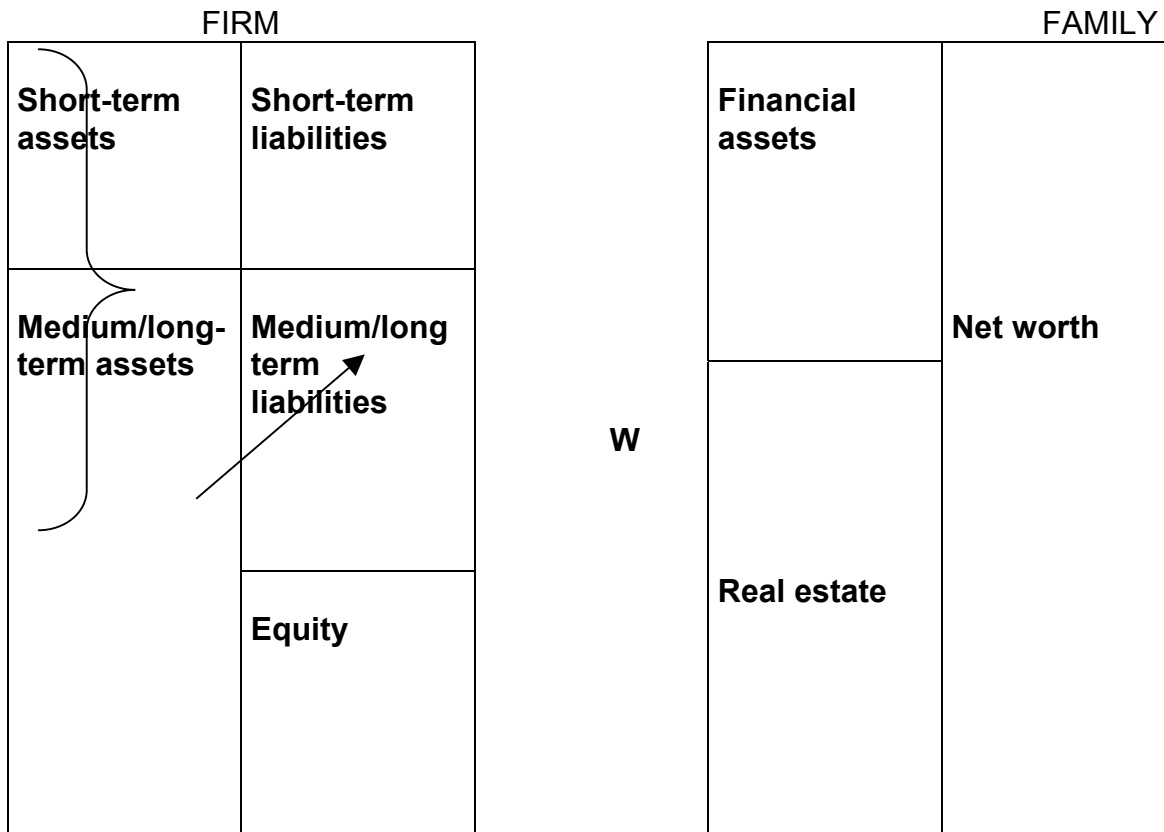
The system of assets and financial connections which develops between the owner family and the owned firm moves from a substantially simple reference frame (see table 1): the matching of the firm/s assets statement/s and that of the family shows that if, on the one hand, the firm represents one of the financial assets in the family portfolio, on the other hand the firm liabilities need to be backed in the fund raising process and the family can meet this requirement by using its own financial resources in the form of debt or equity.⁵ This means that if in the first case the family-firm connection is on the level of assets and

⁵ *As a matter of fact, for the purpose of a more accurate and exhaustive review of cases, the allocation of real assets in the form of capital increase should be included among the various financial operations characterized by the allocation of resources to the firm.*

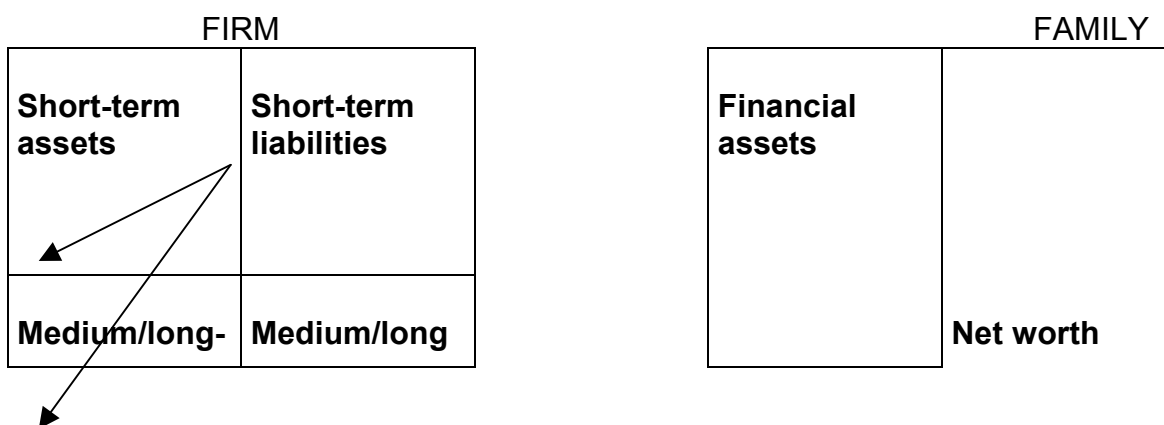
thus assumes the value of maximum aggregation, in the second case the family-firm connection is financial and thus assumes the value of family individual investment operations.

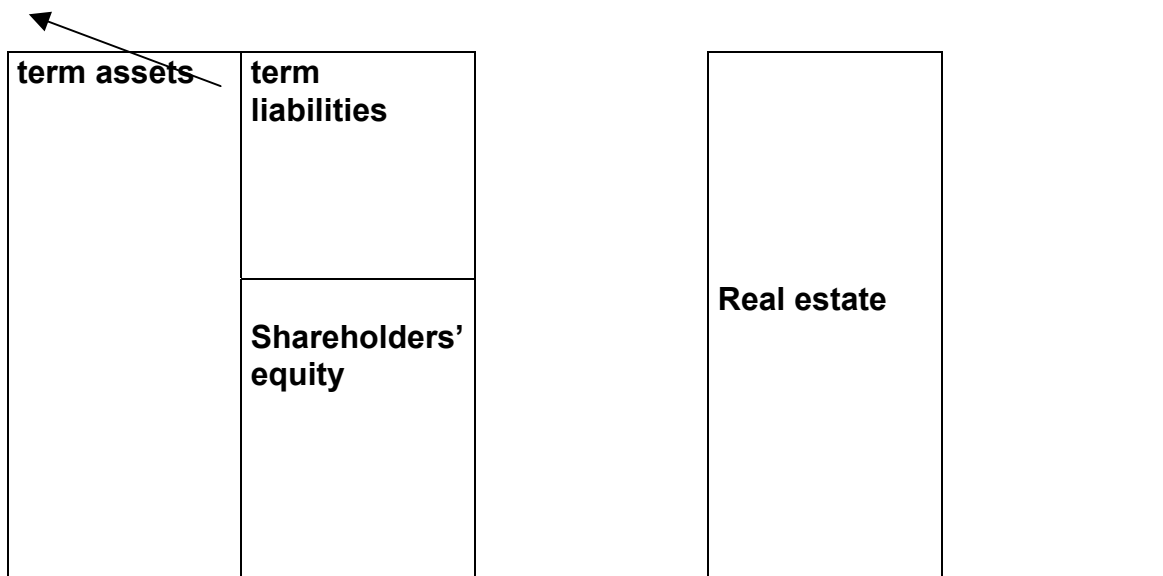
Table 1
The family-firm connection system: the assets and the financial perspectives

The assets perspective



The financial perspective





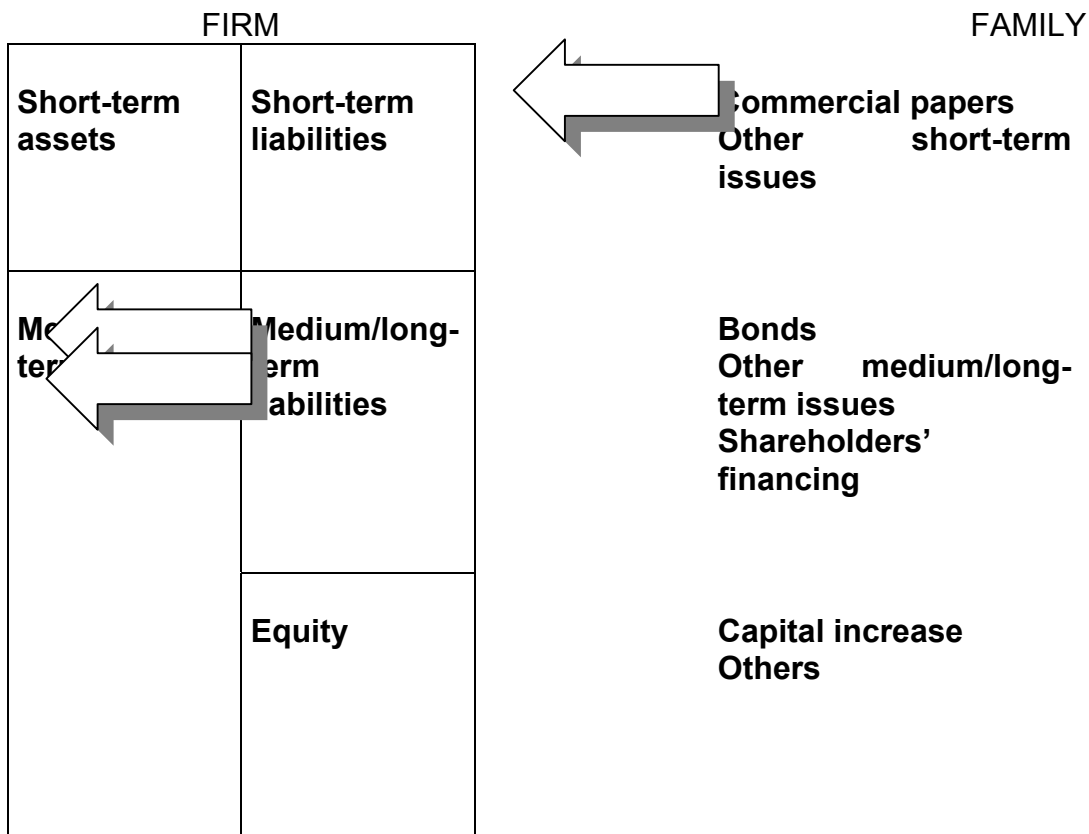
The reference to the financial and assets perspectives obviously serves to clearly identify the different criteria which connect the corporate and the family system. Yet, two important elements should be focused in order to better explain this mode of interpretation.

In the first place, the financial and assets perspectives tend to interweave, as the firm's financing choices affect its value at a parity of risk. This means that a specific financing strategy developed by the family for the firm necessarily generates an induced effect consisting in the growth of the firm value and therefore of the family net worth. This is true irrespective of the returns profile of the specific financing choice and of its contribution to the development of the family financial assets.

In the second place, within the financial perspective, the possible forms of lending financial resources to the firm are highly differentiated. This depends on the different destination of financial resources (short-term liabilities versus consolidated liabilities) and on the different contractual forms which, in that specific time and legislative context, can be actually used⁶. This means there is a direct correspondence between the firm requirement areas and the family allocation criteria of financial resources, whose joint profitability will need evaluating in the course of time (table 2).

Table 2
The family allocation criteria of financial resources

⁶ It should be noted that, irrespective of the specificity of the family different direct financing tools, it is possible to employ indirect or triangular forms of financing, where the family provides its own guarantees to a third party financing the firm. This scheme can be used with any contractual form of financing



Taking for granted the natural overlapping of financing processes and wealth creation processes in general terms, the specificity of the assets and financial profiles requires a deeper analysis of the internal rules which characterize, on the one hand, the family selection of financing operations within the firm financing process and, on the other, the investment of the value produced within the family assets portfolio.

The relationship between the owner family and the owned firm: the financial perspective.

The financial connection between the owner family and the owned firm can be fully understood by analyzing two distinguished and sequential elements:

- the modes of development of the firm external financial requirements;
- the impact of fiscal variables on the economic area in relation to the firm-family exchange of financial resources.

The actual development of the family financing operation implies the verification of two different conditions.

The first is that the firm financial profile should be, at that specific time, consistent with the specifications of the family portfolio strategy in terms of size, length and risk. If not so, the necessary requisites for the exchange would be missing, except for the hypotheses of

necessity and extra-ordinariness that are sometimes connected with the impossibility for the firm to raise additional funds from financial markets and banks. In this case, the phenomena of credit rationing or the firm structural difficulty would increase both the risks and the costs of “firm failure” (K_{firm}) – as identified in the previous paragraph –, thus urging the family to make a financial exchange with the firm. On the contrary, should there be neither the requisites for the exchange nor a particular tension for K_{firm} , the company would try to raise funds outside the family system.

The second condition – if the first one takes place – is the profitability of the exchange for the firm and the family. This means that the more asymmetrical the impact of fiscal variables on the borrower and lender’s profiles the larger the optimization areas for the family-firm exchange in terms of after tax return on the investment as well as of after tax cost of financing. Therefore an ideal continuum could be traced: at one end the maximum economic area for the exchange and on the opposite end the absolute absence of economic area. The maximization of the economic area is characterized by the presence of a fiscal system according to which any financing operation is able to produce a fiscal advantage equal to the expenses incurred and, correspondingly, no taxes on the lender returns. Vice-versa the economic area is absent when no financing operation is able to produce any firm fiscal advantages and, at the same time, produces taxes on the lender returns. It is evident that the reality of facts falls somewhere in between the two ends in a different way, in the course of time, from country to country, depending on the financial means and the fiscal strategies followed by policy makers.

The specific analysis of the modes of development of external financial requirement (FFE) moves from the traditional interpretation model, according to which the dynamics of the firm internal sources and investments can be connected effectively with its development path in the course of time. This is according to the analytical relation referred to the $t - t-1$ time interval:

$$FFE_t = V_t \left[\left(\frac{CI}{V_{t-1}} * \frac{\Delta V}{V_{t-1}} \right) - \frac{CF_t}{V_{t-1}} \right]$$

where FFE indicates the firm external financial requirements referred to the time interval t and $t-1$, CI is the capital utilized to produce the turnover and CF is the cash flow produced by the firm in the same time interval. The study of this relation allows us to identify the firm different stages of development (start up, introduction, development, maturity, saturation, decline or recovery) and to outline the corresponding trend of the formula variables so as to find the size and the trend of the firm FFE ⁷. Such stages of development fall within the

⁷ For a deep analysis of the relations between FFE dynamics, the variables included in the formula for determining FFE and the trend of the firm development cycle, see relative literature (Mottura P., “Condizioni di equilibrio finanziario della strategia d’impresa”, in *Finanza, Marketing e Produzione*, n. 1, marzo 1987 e Caselli S., Gatti S., “Il corporate lending”, *Bancaria Editrice*, Roma, 2003).

mapping of requirements by firm “contextual situations”, which have already been examined in the previous chapter.

Although the approach is correct, and often utilized in corporate valuation practices above all at start up and introduction stages, in order to understand the financial profile of the family-firm relationship, two additional complexity elements must be introduced. In the first place, the owner family – except for small scope situations – confronts itself with not just one but a portfolio of firms and corporate projects, sometimes branched by groups according to different criteria. In the second place, the logical criteria of “start up” and “introduction” must be suitably analyzed on the basis of the concepts of sector or undertaking, considering the owner’s degree of knowledge of the same.

With reference to the first critical aspect, the presence of more FFEs generated by different firms and by individual projects within the firms is likely to produce a logical unbalance between the aggregate FFE and the family ability to meet a relevant portion of such requirements. If this is true in statistical and absolute terms, at a dynamic level the phenomena characterizing the management of the different FFEs lead to a partial internal compensation. This develops through market transfer policies or organizational and partnership solutions which, by exploiting the centralized treasury, the pool or of the group structure, lead to the re-distribution of credits and debits among the owned firms. As a result, the aggregate FFE becomes a net rather than gross total and allows the family to measure more effectively the scope of its commitment as well as to better design the relationship between the set of firms and that of external lenders. In addition, the determination of a net FFE must not lead to neglect the causes of the financial phenomena, that is the asynchrony, the size and the risk of the different stages of development achieved by the different firms being considered since these phenomena establish the profile of actual repayment of financing sources.

With reference to the second critical aspect, the different stages of development experienced by the family-owned firm or firms represent the indispensable support for the analysis and interpretation of the risk generated by any choice of FFE financing and, as a result, of financing choice in general. A specific evaluation in this direction requires the introduction of additional parameters, which make the valuation of the different stages more accurate as they are related to the typology of the firm sector and to the relationship between the firm and the sector itself (table 3).

More specifically, at start up and initial stage of development, the risk profile of the undertaking and the resulting verification of compatibility with the family portfolio of financial assets is closely connected with the different hypotheses of entry into the competitive arena. In this sense, the three different hypotheses illustrated in table 3 correspond to decreasing risk profiles at parity of conditions. In the first hypothesis, the family may decide to undertake a sector start up with one of its enterprises, thus tackling high risk levels. This requires the massive investment of family resources, which can be sided by the presence of other investors if the interest in the start up is considerable and if the entrepreneur’s reputation is capital-capturing. The strong unbalance of the family portfolio on the risk-side requires a careful re-allocation of not only financial but also real asset classes, if the size of the investment is liable to affect the family asset-side to a remarkable extent. In the second hypothesis, the family may decide to enter an already

existing but not known sector, with a new enterprises. In this case, the risk profile of the undertaking is more closely connected with the lack of experience in the sector and only partially with the sector dynamics. As a result, financial resources do not come necessarily from the family, but also from the financial system, in the form of traditional debt. In the third hypothesis the family may decide to enter an already existing and known sector with a new enterprise. This usually results in a substantial risk reduction – at a parity of sector profile – and may encourage the family to make radically different financing choices, which range from the full exploitation of the financial leverage to the massive investment – in debt or equity – in an undertaking where the characteristics and the rules of the competitive dynamics are well known.

Table 3

The relationship between the firm different stages of development, external financial requirements and the impact of family investment choices

Firm development stages	Possible relations between firm and sector			FFE profile	Risk profile	Compatibility with family financial portfolio
	Hypothesis A: new firm and new sector	Hypothesis B new firm in unknown sector	Hypothesis C: new firm in known sector			
Start up	Entrepreneur enters sector start up with one of his firms.	Entrepreneur enters an already existing sector for the first time.	Entrepreneur enters a known sector.	Always positive depending on intensity of capital required by sector commodity.	Potentially high, depending on size and length of positive FFE area. Risk degree decreases when moving from hypothesis A to hypothesis C.	The risk-return combination is usually set at high risks and high expected returns. Such relation tends to moderate when moving from hypothesis A to hypothesis C.

Development	Firm and sector start up produces first positive results, depending on revenue growth.	Firm through phase of revenue increase in an unknown sector.	Firm through phase of revenue increase in a known sector.	Positive but decreasing. The size of operating FFE depending on revenue increase speed.	Potentially decreasing depending on positive FFE reduction and on firm capacity of cash-flow creation. Risk profiles of three hypotheses are closer.	Gradual risk level decrease may push the family to introduce additional capital.
Consolidation and maturity	Differences among three hypotheses are less marked. Consolidation choices may push the firm to make acquisitions, develop holding structure, internationalize or to establish final and physiological dimension.			FFE becomes negative in relations to current activity. New financial requirements may result from consolidation choices.	Risk is no longer connected with financial structure and expected fund repayment but with industrial management and consolidation choices.	If necessary, family receives flows of repayment and/or return on invested resources. Participation is highly compatible with management of financial portfolio. Possible additional investments depending on consolidation choices.

Re-structuring	Firm activity is no longer aligned with sector dynamics or sector shows signs of saturation or potential decline.	FFE may become positive again.	Risk increase depending on reasons for re-structuring.	Re-structuring stage urges family to invest new resources also as virtuous signal to financial system..
Decline and crisis	Firm is no longer able to compete in the sector or the sector is facing crisis or structural decline.	FFE is positive.	Risk is high and drives to radical choices, such as market exit or firm liquidation.	Crisis may need the family to employ new resources and a to make definite choice on participation role.

The analysis of the economic area is instead focused, at a parity of evaluation, on the size and the risk of FFE financing choice, on the family-firm profitability profile in making a financial transaction. In this sense, the criterion of the economic area must be considered a general guide for making choices, with the physiological and recurrent possibility of making sub-optimal choices in front of necessities and obligations resulting from the firm financing requirements and from the family investment choices. The determination of the economic area must be based on the analysis of the body of fiscal rules locally enforced regarding the criteria of cost deductibility for the borrower and the taxation of returns for the lender. In Italy, the above regulations show a quite steady and well outlined configuration (table 4).

Table 4
The borrower's and lender's tax profiles in the Italian tax system as of 30.06.2003.

The borrower's fiscal profile

Financing sources	Reference taxes		
	IRPEG or IRPEF ⁸	IRAP	VAT
Debt	Interest rates and charges fully deductible.	Interest rates fully non-deductible. Charges fully deductible.	Not applicable.
Leasing	“Average rental” and charges fully deductible if lease maturity is at least equal to half the period of ordinary depreciation allowance of the asset. Real estate is an exception as leasing maturity is at least 8 years.	Only value of the asset and charges fully deductible if leasing maturity is at least equal to half the period of ordinary depreciation allowance of the asset. Real estate is an exception as leasing maturity is at least 8 years.	All the contract components are VAT taxable.
Equity	The fiscal effect is established according to equity variations occurred between 30.9.1996 and 30.06.2001, through the DIT mechanism.	No effect.	Not applicable.

The lender's fiscal profile

Investment modes	Recipient's legal status for purposes of IRPEG or IRPEF taxation on financial profits	
	Individual person	Corporate body
Debt	12.50% final tax rate or 27% if annual return is 2/3 higher than BOT annual average return.	Taxation upon income tax return.

⁸ The indistinctive reference to IRPEG and IRPEF intends to show that tax deductibility rules relating to the three areas of financing sources, for which a different fiscal treatment is provided, are identical. As a result, however, the impact on the fiscal income statement will be different depending on IRPEF average rate for partnerships.

Equity	12.50% final tax rate or taxation upon income tax return and use of tax credit .	Taxation upon income tax return and use of tax credit.
---------------	--	--

With reference to the borrower, the fiscal policy maker distinguishes three forms of financing sources, i.e. debt, leasing and equity⁹. The debt component benefits from a net fiscal effect equal to 29.75% (that is 34% of IRPEG after 4.25% of IRAP) whereas leasing shows a fiscal structure that cannot be defined *a priori* but is dependent on different factors such as the typology of asset, the borrower's VAT profile and the maturity month of the operation. As a result, according to the different cases, the fiscal profile of leasing is definitely better or definitely worse than the debt. Finally, equity scarcely and partially benefits from the effects resulting from the DIT in the 1996-2001 period. This means that, up to now, the investment of equity does not produce any fiscal advantages for the firm and thus, at parity of conditions, it represents the most costly strategy.

In this connection, it should be underlined that although the reference context of the fiscal variables is characterized in the Italian system by high volatility, regulations governing the deductibility of interest rates for financing sources and the three categories of "debt, leasing and shareholders' equity" have remained quite stable in the course of time. In addition, it is necessary to verify the possible introduction, starting from 2004, of a mechanism of thin capitalization aimed at, on the one hand, reducing debt relative profitability starting from a given level of the financial leverage employed by the firm and, on the other, at re-directing the investment of financial resources from the debt logic to that of equity.

With reference to the lender, the fiscal system distinguishes rules on the basis of the recipient's legal status (individual person or corporate body). In the case of the corporate body, the taxation criterion seems more unfavorable as returns on the investment of resources fall into the corporate income formation and therefore are subject to IRPEG or IRPEF taxation of the corporate body. This means that the family investment of dedicated vehicles for financing its firm/s is discouraged. On the contrary, the allocation of resources as individual person leads to final tax rates of 12.50% and 27% in the case of debt. In this sense, if the percipient shows a high IRPEF rate, there is a partial area of benefit as the taxation of financial returns is lower than the personal one and therefore the withdrawal of assets becomes facilitated. On the contrary, in the case of equity, the taxation of dividends upon income tax return facilitates the withdrawal of assets owned by individuals with a low personal IRPEF rate.

⁹ For an accurate and exhaustive review of fiscal effects on corporate lending choices, see Caselli S., Gatti S., "Il corporate lending", Bancaria Editrice, Roma, 2003.

The combined analysis of the lender's and borrower's profiles enables us to draw a map of possible exchange behaviors between the firm and the family, by taking into account the fiscal asymmetries developing in each profile.

The first consideration regards exclusively the asset borrower. The presence of three reference categories – four in perspective with thin capitalization – produces interesting areas for investment changes and financial planning, above all as to the confrontation between medium-term debt and leasing. Vice versa, such areas do not appear in the short term and once again the lack of profitability is confirmed for equity investment as it is connected with no kind of fiscal advantages.

The second consideration regards instead the asset lender. The possibility to finally tax debt returns on the basis of two rates, which are largely lower than the maximum IRPEF rate, actually creates a kind of “profitability aisle” in the investment of resources. However, it is necessary to check whether these profits can be effectively spent for the purpose of making an exchange with the owned firm, by moving the reference context from the short to the medium term.

In terms of short-term financing choices, the family source is in competition with any other financing source in the market. This means that the objective functions of the firm and of the family are radically different, as the firm aims at the lowest rate and the family at the highest within the monetary system. It is therefore difficult to match the different requirements, apart from the case where carry out strategies, that is when the family utilizes the debt lever to obtain dividends at a lower rate. In this instance, the allocation of resources in the form of debt becomes a tool of family financial strategy rather than a corporate financing tool as capital allocations and withdrawals are a kind of “vehicle” to produce profits which represent deductible costs for the firm – differently from dividends – as well as income taxed at a fixed rate for the recipients. Therefore, the intensity and the usage of the criterion described must take into account the more general restriction of a risk of elusion which can potentially occur if the amount of profits is not on line with the “reasonability” of the market rates¹⁰.

In terms of medium-term financing choices, although the family source is always in competition with the other financing sources in the market, the nature and the different degree of the commitment as against a short-term operation can reduce the interest conflict of the rate. This means that the family may well diminish the pressure on the return target if a short-term debt represents a tool for creating corporate value. Finally, the profitability of the family-firm exchange may vanish if leasing can actually produce remarkably higher fiscal advantages in comparison to those of debt.

The third consideration is finally more general. The comparison between the structure of financing sources and the investments modes from the fiscal point of view acquires the

¹⁰ *The use of thin capitalization aims at preventing partners' non-physiological and non-reasonable use of debt.*

described profile only if exchange criteria are referred to the domestic context. This means that the quest of fiscal asymmetries can extend the exchange reference context by creating dedicated vehicles which, from the part of either the borrower or the lender or of both, allow carrying out asset transfers characterized by lower profit taxation and higher expense deductibility. The design of a structured operation must obviously produce advantages that are steadily higher than transaction costs, by taking into account risks connected with the volatility of the relative fiscal provisions.

The relationship between the owner family and the owned firm: the assets perspective

The understanding of the family-firm relationship is based on the simple observation that shareholding is one of the family's portfolio components, where all its financial and real assets are allocated¹¹. This means that, irrespective of the different degree of "affection" and "commitment", shareholding has the same value as any asset class from the point of view of risk and return as well as of its capacity to contribute to the growth of the wealth in the course of time. If this is absolutely true from the point of view of the form, from that of the substance the position of shareholding within the wider context of family assets is based on a prior analysis of its distinctive and differentiating elements in comparison with other forms of alternative investment.

The understanding and the precise collocation of shareholding within the family portfolio is based on four fundamental rules which characterize its dynamics in the course of time:

- the controlled enterprise/s is/are characterized by a specific risk profile and above all by a specific trend which is related to the trend of its/their own sector cycle. As a result, correct asset allocation must act on the other components of the family portfolio by carefully checking (or removing) any possible cycle synchronies with shareholding. This is carried out to reduce dangerous synergies in terms of risk and, in a broader financial and assets planning, to establish which parts of the financial portfolio might be specifically dedicated to meeting the firm FFE;
- shareholding creates a powerful induced effect which is connected, on the one hand, with the possibility to invest other portfolio components in order to proceed to financial transactions for the enterprise in the form of debt or equity (portfolio expansion effect) and, on the other, with the possible investment/commitment of financial or real assets in the form of a guarantee backing the growth of corporate lending (portfolio compression effect);
- shareholding tends to produce a strong "hostage effect" because of which a large part of family energies and attentions are prevalingly directed to corporate management rather than to the management of financial or assets portfolio;

¹¹ Reference is obviously made to shareholdings that require the family direct commitment from the operating, affective and ethical point of view. Vice versa, shareholding without such characteristics are just investments in financial assets. This distinction is clear in the presence of a quite limited number of firms. If the family assets are of quite relevant dimensions and the shareholding system has international and branching features, this distinction becomes more confused and more arbitrary.

- shareholding is nevertheless aimed at producing value in the course of time and at increasing family wealth.

The combined analysis of the above aspects is decisive to assess the scope of the assets connection between the family and the firm and to evaluate the structural diversity of shareholding in comparison to the other classes of investment. From this point of view, two main points should be underlined.

In the first place, the family-firm connection with the development cycle highlighted in the context of the financial perspective must be extended to the assets variables relating to the firm corporate value and guarantees. This is because FFE trend and the relative financing choices directly condition the corporate value in the same way as the relative support to the debt strategy stimulates the investment of a share of assets to support the settlement of the relative obligations. Therefore, rather than establish strict relations between the above measures, it is necessary to verify constantly and case by case how relations develop between the family and the firm dynamics in relation to the different development stages of the firm itself (table 5).

Table 5

The relation between the firm different development stages and the assets perspective of the family-firm relationship

DEVELOPMENT STAGES	FIRM		FAMILY	
	FFEs	DEBT/EQUITY	VALUE	GUARANTEES
Start up (hypotheses A, B, C)				
Development (hypotheses A, B, C)				
Consolidation and maturity				
Restructuring				
Decline and crisis				

In the second place, the shareholding value increase must be properly analyzed on the basis of the family objectives. This means that, differently from the other classes of investment, the meaning of the shareholding value changes in relation to the utilization function required by the family. In other words, the meaning of value and wealth is provided with usability according to the targets of the family assets management. Therefore, two macro-situations are to be distinguished: the former regards the meaning of value in a narrow sense, the latter regards the meaning of value in a broad sense.

In the first case, the concept of value refers to the measurement of the present value of future income flows, in the typical logic of a market oriented evaluation. Although the above approach is correct and can always be used to control portfolio assets evolution, it does not bear a specific meaning of usability in the “continuity” life stages of the family and the firm. Vice versa in the “discontinuity” life stages of the family and the firm, the meaning of value mentioned above has a clear and specific aspect of usability and necessity. In particular, in the context of family “discontinuity”, the meaning of value in a narrow sense becomes necessary as the firm must be evaluated. This occurs in situations relating to succession, turn-around and transfer of property. In these instances, wealth must necessarily have a marketable meaning as it may be exchanged and utilized. Obviously, the criteria for value measurement will be conditioned by and take into account all the different contextual situations urging for such evaluation. In the case of firm discontinuity, the meaning of value in a narrow sense is that of a signaling instrument for the financial system. In the stages of start up, strong development, consolidation through acquisitions or of re-structuring and crisis, the need to involve external lenders – in the perspective of lending and equity – requires the profile of the firm to be completely and organically evaluated. This means that the value measurement in a narrow sense represents the typical and necessary means.

In the second case, the concept of value refers to the spendability and utilization of the assets produced by the firm. Here the condition of continuity in the development stage of the firm and the family moves the meaning of usability onto the firm capacity of producing assets that can be used by the family in the course of time for the most different purposes: consumption, expenses, investment in financial assets, investment in real assets. Obviously, this is true if the firm is able to produce additional income and the family is interested in withdrawing the same income. The utilization process of firm assets can occur in quite different ways, partially influenced once again by the relative fiscal variables.

The first mode is based on the *carry out* logic in the form of interest receivables or dividends, according to the size and the characteristics of the economic area emerging from the firm and the family. The second mode is based, instead, on the transfer of typically family expenses into the firm, so as to benefit from cost deductibility. This obviously depends on the type of expenses and on the type of business purpose characterizing the family firm/s. The third mode is finally based on the transfer of family investments into the firm, so as to benefit from the tax advantage resulting from the depreciation of investments that have been carried out. The second and the third modes share the aspect of the *carry in* logic, that is the utilization of the corporate vehicle to benefit from the fiscal leverage as a supporting instrument in the family expense and investment processes.

SYNERGY PRODUCING OPERATIONS BETWEEN CORPORATE AND PRIVATE BANKING

The identification of the typology of relationships developing between the family and the firm in the financial and assets perspectives represents an important scheme of analysis to

establish the necessary conditions for the implementation of the supply on the part of financial intermediaries. In other words, the understanding of the mechanisms governing the financial transfers between the firm and the family as well as the firm's contribution to the growth of the family wealth are the necessary conditions for the supply of dedicated services to the family business.

The logic link separating the available financial and assets perspectives from positioning financial requirements in the map consists in the identification of the financial operations and situations which are characterized by remarkable synergies and overlapping between corporate banking and private banking designed services, irrespective of the positioning choice and the nature of the financial intermediary willing to approach the family business.

The research of synergies and overlapping areas requires a direct link between the specific aspects of financial and assets connections and the specific aspects of both the family and firm financial requirements. This is necessary to clearly identify the "playing ground", that is the map of business areas the financial intermediary can successfully enter. The map can be classified on the basis of two different parameters (table 6):

- the typology of investment in the overall family portfolio (asset class);
- the typology of the subject interested in the investment (owner class).

As for the asset class parameter, the observations made in the previous paragraph about the "diversity" characterizing firm investment lead us to distinguish family assets into two macro-areas: one regards the firm as such and the other the portfolio after investments in the controlled firm/s. The portfolio must be then divided into sub-areas according to the following:

- investment in financial assets;
- investments in real estate;
- investments in other profit business (arts, precious metals, commodities, jewels);
- investments in instrumental goods (cars, airplanes, ships, other transports);
- investments in non-profit business (charity, social services, etc...).

With reference to the owner class, the identification of the family as the generic, but correct, holder of property interests and rights must be divided into two different categories: on the one hand the family, that is as a coalition of individuals headed by one leader or by a restricted number of members with acknowledged charisma, and on the other the individual members of the family, that is the holders of specific rights and interests, irrespective of the assets structure of the family as a whole. It is apparent that such distinction becomes more important as the number of family members and generations increase.

Table 6

Reference scheme for the identification of synergies between corporate banking and private banking

		OWNER CLASS	
		FAMILY COALITION	FAMILY MEMBERS
ASSET CLASS	FIRM	Family wealth invested in firm, in the various possible forms	Wealth of family individual members invested in one member's owned firm, in the various possible forms
	PORTFOLIO	Family wealth invested and collectively utilized in financial assets, real estate, instrumental goods and in profit and non-profit business	Wealth of family individual members invested and individually utilized in financial assets, real estate, instrumental goods and in profit and non-profit business.

The analysis of the asset class/owner class matrix offers not only a comprehensive perspective of the internal aspects of the family-firm relationship but above all allows specifying that the nature of synergic operations relies on the capacity of wealth transfer inside the four sections of the matrix, with the final goal to increase the overall wealth or to achieve its more effective internal allocation. This is apart from *technicalities*, which are specific of the single partial aspects of the overall portfolio (financial asset management, real estate management, advisory on art investments, etc.). From this point of view, strongly synergic operations can be grouped into three main categories:

- leasing on real estate and instrumental goods;
- advisory on family discontinuity management;
- corporate finance operations connected with assets transfer requirements.

The specificity of leasing operations, as the synergy-creating tool in wealth transfer, is its fiscal asymmetry in the depreciation process¹². This means that, at a parity of conditions,

¹² For an exhaustive review of leasing operations see Caselli S., "La valutazione del costo", in Carretta A., De Laurentis G., "Il Manuale del leasing", Egea, Milano, 1998.

the passage from the status of owner to that of lessee reduces costs significantly. The lower the asset depreciation rate, the stronger the effect. As for real estate, apart from the lowest depreciation rate in the Italian fiscal system (13%), there is the lease eight-year minimum life. If the potential lessee's income allows him to pay leasing rentals, for example by renting the same real estate, or he has a sufficient critical mass under the profile of taxable income, the transfer of the family real property into the firm represents a powerful wealth creating tool¹³. In this respect, the situation proposed in table 7 is a useful exemplification as it shows how real estate leasing allows the owner-family to increase the returns of the real assets owned by individual persons.

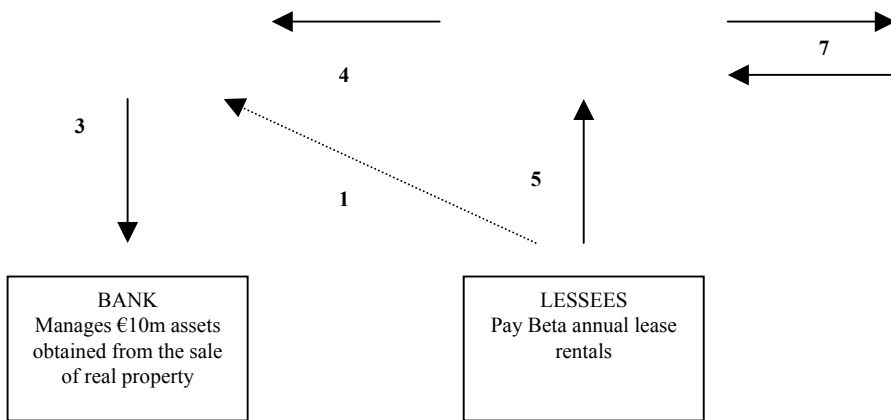
The reference to advisory for the management of family “discontinuity” cannot be directly associated to just one contract and one operation. It rather indicates the capacity of the financial intermediary to grasp and gather all the different and deep effects that may result from the occurrence of a relevant event in the life of the owner family. Succession, turn-around and transfer of property are the emblematic situations in this respect. Apart from the individual financial operations that may be employed on the part of both the family and the firm – as outlined in the mapping of requirements in the previous chapter – the distinctive element for synergy-creation is the counterpart's commitment, that is his ability to propose himself as the partner who, at the same time, is the “transaction third party”, the “confidential reference” and “privacy guarantor”. This allows the advisor to have a central role among the actors and the financial, legal and fiscal operations that are performed in relation to the customer' needs.

The functions characterizing the advisor's role are multiple and cannot be listed in an exhaustive manner. Yet, some specific tasks certainly stand out and are more recurrent : write the “family agreement”, which defines social and property relationships within the family in order to preserve its prosperity and identity; establish corporate governance connected with the event of discontinuity; establish fiscal governance connected with the event of discontinuity; identify counterparts in the event of business transfer and entrance of new partners; identify the management in case the structure is opened to members outside the family; develop mentoring and tutoring for younger family members who are about to enter the firm.

Table 7
Rea- estate leasing for value creation within the family-firm relationship: an example



¹³ For a more detailed analysis of the various organization hypotheses of real-estate leasing operations, see Caselli S., Gatti S., “La finanza strutturata in Italia”, Newfin, Università Bocconi, in corso di pubblicazione.



Family Alpha owns a large real estate (about €10m). The estate includes housing and office premises, which are leased to third parties. The rentals flow is equal to €600,000 per year (1). The family pays IRPEF on this flow at the highest marginal rate and has no chances to deduct various expenses resulting from the management of the real estate. Therefore, the investment net return is about 2.40%/year, without considering risks and charges resulting from possible extraordinary maintenance. A leasing operation becomes possible as one of the family businesses has real estate management included in its business purpose. Family Alpha transfers its real estate to firm Beta (2) for a value of €10m. Family Alpha has reached its first goal, that is have a financial mass to be allocated in more profitable investments compared to the initial 2.40% (3). To face capital outflow, firm BETA sells the acquired real estate to a bank (4) and at the same time stipulates an eight-year leasing contract for a total amount of 10m. The resulting effect on Beta is particularly interesting: in the first place lease rentals collected by Beta (5) are channeled to the bank and thus employed to pay a relevant share of leasing rentals (6); in the second place, the high acceleration of the leasing contract produces a relevant mass of deductible expenses, thus reducing significantly Beta's fiscal drag; thirdly, Beta's real estate management costs become deductible. At the end of the leasing contract, Beta becomes the owner of the property (7) and continues to collect leasing rentals (5). Family Alpha achieves a second goal: real estate management costs are now deductible and Beta value increases as a result of the fiscal drag reduction and of the purchase of the real estate. The overall financial evaluation of the operation leads us to observe that in the course of the leasing contract, family Alpha has at least doubled its assets as it has financial assets available (€10m) and the ownership of real estate for an overall value of €10m.

Corporate finance operations show a hybrid nature in multiple operations: they involve exclusively corporate financial aspects as well as family assets management and governance profiles. This has already been focused in the previous chapter, where several requirements areas of the family and the firm have highlighted the need to resort to corporate finance operations. Owing to the great variety of cases and technicalities of single operations, the next chapter will be dedicated to a more specific and exhaustive review. Here it is worth remembering that also in this case the synergy element is given by the presence of wealth transfer flows within the "asset class-owner class" matrix.

REFERENCES

- BANK OF ITALY, "Fiscal Rules", Research Department Public Finance Workshop, Rome, 2001.
- BANK OF ITALY, "The Impact of Fiscal Policy", Research Department Public Finance Workshop, Rome, 2002.
- BRADLEY M., JARREL A.G., KIM E.H., "On the Existence of an Optimal Capital Structure: Theory and Evidence", in "The Journal of Finance", n. 3, July 1984.
- CASELLI S., "La valutazione del costo", in Carretta A., De Laurentis G., "Il Manuale del leasing", Egea, Milano, 1998.
- CASELLI S., GATTI S., "Il corporate lending. Manuale della gestione del credito alle imprese: organizzazione, valutazione e contratti", Bancaria Editrice, Roma, 2003.
- CASELLI S., GATTI S., "La finanza strutturata in Italia", Newfin, Università Bocconi, in corso di pubblicazione.
- CIPOLLONE P., GUELFY A., "Tax credit policy and firms' behaviour: the case of subsidies to open-end labour contracts in Italy", Temi di discussione, n. 471, march 2003.
- DESSY A., "Capitale di debito e sviluppo delle imprese", Egea, Milano, 2001.
- KANE A., MARCUS J.A., MC DONALD L.R., "How Big is the Tax Advantage to Debt", in "The Journal of Finance", n. 3, July 1984.
- MAZZOTTI E., MONETA A., "Investment Banking, Merchant Banking e Asset Management", Franco Angeli, Milano, 2000.
- MOTTURA P., "Condizioni di equilibrio finanziario della strategia d'impresa", in Finanza, Marketing e Produzione, n. 1, marzo 1987.
- TAGLIAVINI G., "Costo del capitale, analisi finanziaria e corporate banking", Egea, Milano, 1999.

About the Author

Stefano Caselli, Associate Professor of Banking & Finance at the Institute of Financial Institutions and Markets, "L.Bocconi University", Milan and Professor at Credit and Insurance Department of SDA, the Management and Business School of "L.Bocconi University", Milan.

Contact person:

Prof. Stefano Caselli
Institute of Financial Institutions and Markets
"L.Bocconi" University
Via Sarfatti, 25
20136 Milan (Italy)

Tel: +39 02 58366104
Fax: +39 02 58365920
E-mail: stefano.caselli@uni-bocconi.it