

Recent scandals at family-held companies such as Parmalat, Hollinger and Adelphia reinforce a common misperception that family firms operate at a disadvantage to other companies. Bain & Company's Robin Buchanan, Cyrus Jilla and Martha Stack, MBA '01D, explain what sets the best of family firms apart from the rest.

# The family secrets



**E**ven in this age of professional managers and institutional investors, families remain a driving force in business. Family firms make up more than two-thirds of the world's companies, including such global giants as Ford, Carrefour and Samsung. In Western Europe, they contribute as much as 65% of gross domestic product. Families run most public companies in Asia. In the US, businesses controlled or substantially owned by families represent more than a third of those companies listed on the Fortune 500 and account for half of GDP.

## Both public and private family firms have innate strengths that give them an edge over their public company counterparts in the long run

Despite their importance, family firms haven't always lived up to their potential. Average annual shareholder returns for US public companies with

majority family ownership lag six percentage points behind those of the overall S&P 500, according to Bain research. However, the same analysis also reveals a cluster of family businesses that consistently outperform their peers, achieving results that place them among the world's business elite. In fact, family firms can and should outperform their public company counterparts over the long run by capitalising on their inherent advantages and embracing the best elements of good governance. Doing so requires more than simply addressing the traditional challenges of succession planning and fragmented ownership.

### Seizing the advantages

Both public and private family firms have innate strengths that give them an edge over their public company counterparts in the long run. These include their ability to take a long-term view, their flexibility in attracting and motivating outstanding managers and their entrepreneurial cultures. The best family firms capitalise on these advantages to deliver outstanding results year after year.

Top performers also recognise that without a strong executive hand, family-run organisations can drift towards poor resource allocation, lax decision-making and weak or contentious governance. The best companies therefore maintain strong managerial discipline, making sure that their capital works hard and their boards remain effective. They also put in place clear succession plans and simple ownership structures to provide a foundation for long-term success.

### *Taking the long-term view*

Concentrating ownership in family hands shields managers from short-term shareholder pressure to hit quarterly targets. Executives at family firms are less bound by the demands of the stock market or the ups and downs of economic cycles. As Ferruccio Ferragamo, CEO of Italy's Salvatore Ferragamo fashion house, puts it, "When times are tough, we can still go on the offensive, gaining advantage over the competition."<sup>1</sup>

<sup>1</sup> Neubauer, Fred, and Alden G. Lank, *The Family Business: Its Governance for Sustainability* (New York: Routledge, 1998).

Cargill, the US commodities giant, has used the power of the long-term view to propel its growth. Since it was founded in 1865, the company has taken risks and invested aggressively even where returns have been slow to develop. That approach has helped the firm grow to become the largest agricultural company in the world, twice the size of its nearest competitor, with 74% of its business outside the US. Recently, Cargill made a move into India, enduring seven years of losses before turning the corner to profitability. Noting that “not every risk will go our way”, CEO Warren Staley told *Forbes* magazine, “I’d hate to have to manage this company worried we’ll miss an earnings forecast by a penny a share and have 40% clipped from our value.”<sup>2</sup>

#### *Motivating managers*

Family firms often have greater leeway in setting incentives, enabling them to attract and motivate top employees in ways that other companies cannot. Family companies have other advantages in the talent market as well. Longer CEO tenures can make family firms more stable and less prone to internal political battles, and the values associated with their brands – stability, longevity, loyalty – often appeal to recruits.

Family-held Estée Lauder places a high priority on bringing in new talent. The company routinely acquires small, trendy fashion and cosmetics firms in order to draw creative outsiders into its fold. Ten of its 18 current brands have come from acquisitions. According to chairman Leonard Lauder, the entrepreneurs who originally built those brands remain in charge of them.

“In each case,” Lauder said, “we have given them operational [and] marketing assistance. ... But they’re the boss and they compete against each

other.”<sup>3</sup> Though other large public companies take similar approaches to expanding their product lines, few have held on to so many leaders of acquired businesses.

#### *Sustaining entrepreneurial culture*

All family-run companies were founded by entrepreneurs. The most successful ones maintain their entrepreneurial energy as they grow. Not bound by bureaucracy, their managers make decisions and take actions quickly. Their employees focus on doing their jobs instead of playing politics. Virgin is a well-known example of an entrepreneurial, first-generation family company that has rapidly pioneered new markets. “We can decide something in the morning and have it running in the afternoon,” CEO Sir Richard Branson said.<sup>4</sup>

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Kyobo Life, the Korean insurance company, has managed to extend its entrepreneurial drive. Its founder, Yong Ho Shin, was an innovator who introduced the world’s first education insurance policy. Recently, under the direction of his son Chang Jae Shin, the company became the first Korean insurer to sell property and casualty and life policies over the Internet, allowing it to grab a large share of the rapidly growing online market. Kyobo

Life has also introduced aggressive pay-for-performance incentives, which remain controversial in Korea. Such entrepreneurial moves have helped the company become one of the largest Korean insurers, with assets of US\$26 billion and annual premium income of US\$6 billion.<sup>5</sup>

#### **Maintaining managerial discipline**

Being insulated from the pressures of the public market does give family businesses great latitude and flexibility, but there’s risk as well. Sometimes owners and executives can begin to believe that they don’t need to justify return on capital or pay attention to the strength of their management teams. They are wrong on both counts. Although stock-market pressure can distort managerial behaviour in destructive ways, heeding investor concerns usually exerts helpful discipline on executives.

#### *Making capital work hard*

The top-performing companies look at balance sheets not as static indicators of performance but as dynamic tools for growth. They expect all deployed capital to earn strong returns, and if it does not, capital is redeployed. Here, private equity (PE) firms provide an instructive model. Like family businesses, PE firms are protected from the short-term mentality of the markets. However, they never take their eye off shareholder returns. A long-term view, their experience shows, is only an advantage when combined with a strong focus on increasing a business’s value.

Leading family companies, such as De Beers in the diamond industry and Cargill, show similar discipline in deploying capital, even though their investment horizons are much longer than those of most PE firms. De Beers, for instance, has taken a number of steps to make its capital work harder. Following a strategic review in 1999,

<sup>5</sup> [www.kyobo.co.kr/english/new\\_03.html](http://www.kyobo.co.kr/english/new_03.html)

<sup>3</sup> “The Secret to Estée Lauder’s Good Looks: Savvy Marketing and a Global Reach” (Knowledge@Wharton, November 6, 2002).

<sup>4</sup> Dick, Robert, and Manfred F.R. Kets de Vries, “The House that Branson Built: Virgin’s Entry into the New Millennium” (INSEAD, Fontainebleau, France: 2000).

<sup>2</sup> Weinberg, Neil, and Brandon Copple, “Going Against the Grain” (*Forbes*, November 25, 2002).

the company worked to decrease its asset base, most notably reducing the working capital tied up in its stockpile of diamonds by several billion dollars. This has helped to increase massively the company's return on capital.

#### *Maintaining an effective board*

Populating the board with yes-men or interfering amateurs can damage any business. Experienced, independent-minded directors are needed to keep a company on track. The top family-run companies, just like the best public firms, expect their boards to challenge management constructively as well as to provide support and encouragement.

Sir Adrian Cadbury, a long-time advocate of rigorous governance in family firms, has underscored the value of independent directors. He recalled that the questions posed by outsiders during his tenure as Cadbury chairman "were sometimes uncomfortable", especially when it came to decisions about selling parts of the business in order to invest in other areas. "They were not questions we would necessarily have raised from within the business," Sir Adrian said. "It was up to the executives to provide the answers. But from this dialogue between insiders and outsiders on the board, a bolder and ultimately more successful strategy was hammered out."<sup>6</sup>

Other high-performing family firms incorporate independent directors into larger board operations. The LGT Group, the financial services firm owned by the Princely Family of Liechtenstein, uses a two-level structure. In addition to its corporate board, which includes independent directors, a family council called the Prince of Liechtenstein Foundation governs LGT. The foundation also includes independent members who

participate in major business decisions. That governance structure has helped LGT benefit from strong professional management, while ensuring that independent outsiders contribute to the company's overall direction.

#### **Foundation for enduring success**

Time is not kind to family businesses. First-generation companies with a family member at the helm are the strongest performers, according to a study of US family-controlled companies published in the *Journal of Finance*. Over time, however, performance tends to fade as the concentration of ownership becomes diluted.

## **The common principle is that family firms establish a clearly understood structure to ensure that ownership does not become diffuse, contentious or otherwise ineffective**

How can family companies maintain the drive necessary to promote growth and profitability? One essential element is establishing an effective shareholder structure. As firms pass from one generation to the next, they must concentrate decision-making power in the hands of a few rather than spread it among dozens of family members. To accomplish this, family members might elect a family council to run the business, set up a trust to oversee ownership or agree that in each generation, some family members buy out others, which keeps ownership concentrated.

No single approach has proven most effective. The common principle, however, is that family firms establish a clearly understood structure to ensure that ownership does not become diffuse, contentious or otherwise ineffective. George W. Mallinckrodt, the president of the UK asset management firm Schroders, said family companies need a kind of "Magna Carta" that clarifies "how the business will be run, how decisions will be made and how conflicts will be resolved".<sup>7</sup>

Second, businesses must plan diligently for succession, the single most important issue for family firms. Allowing a company to fall into the hands of an inexperienced younger family member can be devastating. Consider the cautionary tale of Wang Laboratories, which invented word processing, one of the first "killer applications" of the computer age. It slid into bankruptcy after a new generation took over.

SC Johnson, one of the leading US consumer-products firms, owes part of its success to a rigorous approach to succession. Now in its fifth generation of family leadership, the company uses a family council to chart succession plans. SC Johnson carefully manages the careers of younger executives, family members and outsiders alike. Before assuming his job as chairman, H. Fisk Johnson held five senior positions in the firm as well as additional posts at other companies. He spent three years on SC Johnson's board and worked closely with his predecessor, the late Sam Johnson. Moreover, the company's day-to-day operations continue to be overseen by a talented non-family executive, William Perez, who has been president and CEO since 1997.

Like other successful family firms, SC Johnson has learned to make the

<sup>6</sup> Sir Adrian Cadbury, *Family Firms and Their Governance: Creating Tomorrow's Firm from Today's* (Egon Zehnder International, 2000).

<sup>7</sup> All quotes unless otherwise cited come from interviews conducted by Bain & Company.

most of its competitive advantages. The ability to take a long-term view, remain flexible in attracting and motivating outstanding managers and maintain entrepreneurial culture are powerful levers in the hands of skilled family owners. When these advantages are

coupled with strong governance, family-run companies often outperform their rivals. In the end, superior performance is the best way to ensure that a family firm stays in the family for generations to come. **IQ**



**Endnote**

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**Link**

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## Family firms: From myths to realities

By Christine Blondel, INSEAD Senior Programme Manager

The article written by partners from Bain & Company brings more facts and examples to the current "rehabilitation" of family firms in the world. Until recently, family businesses largely suffered from a negative perception in the public eye. This perception is quite at odds with reality: the overwhelming majority of businesses (at least 80%) are family businesses, and lately, a growing number of studies have even been able to affirm the "unthinkable", namely that the performance of family-controlled firms on average exceeds that of non-family firms.

INSEAD too, within the context of its Initiative for Family Enterprise, has contributed to this growing evidence on family firms. Our research has, for example, established that patrimonial firms, which we define as firms where the largest shareholder block is ultimately controlled by families or individuals, represent more than half of the Paris and Frankfurt stock exchanges. A recent study has shown that family firms outperformed their non-family counterparts on the Paris stock exchange over the period 1993 to 2002.

In another project, we interviewed long-lasting, successful firms. This allowed us to identify points common among them, which complements those advantages identified in the Bain & Company research: strong values of work and stewardship; resilience in hard times; entrepreneurship and the ability to renew the business; clear and explicit rules for ownership,

management and governance; and the realisation of the importance of strengthening family relationships and ownership commitment.

Our research also centres on the notion of fair process, or justice. It focuses on the fairness of the decision-making process, rather than the fairness of the decision generated by the process. It is important in the success of any company (as illustrated by Chan Kim and Renée Mauborgne's research), but it is particularly so for family firms, where issues of justice are rendered more complex by the interaction of family, ownership and business spheres.

Through our research initiative, we also develop cases that dig into family business issues and success factors, such as family dynamics, continuity, successors' dilemma, finance and governance. They serve as a basis for discussions in our educational programmes, which include roundtables for large family firms, an MBA elective and the Family Enterprise Challenge, a four-day executive programme for business families.

The research and teaching materials were made possible thanks to the support of donors. Convinced of the need for a better understanding of family firms, the Wendel family and the CGIP company (now known as Wendel Investissement) endowed the Wendel Chair for the Large Family Firm at INSEAD. Further contributions, such as the Tetra Laval Research Fund for the Large Family Firm, the Berghmans Lhoist Chair in

Entrepreneurial Leadership and several alumni gifts, also continue to provide significant support for future work.



**Further reading**

Blondel, C., N. Rowell and L. Van der Heyden, "Prevalence of Patrimonial Firms on Paris Stock Exchange: Analysis of the Top 250 Companies in 1993 and 1998" (research supported by BNP Paribas).

Corstjens, M., K. Maxwell and L. Van der Heyden, "The Performance of Family-Owned Firms in the French Stock Market 1993-2002".

Klein, S., and C. Blondel, "The Sale of the Family Business: Entrepreneurial Project, Strategic Decision, or Expropriation" (research supported by Sand Aire).

Van der Heyden, L., C. Blondel, and R. Carlock, "Fair Process: Striving for Justice in Family Business."



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