What You Can Learn from Family Business

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To many, the phrase “family business” connotes a small or midsized company with a local focus and a familiar set of problems, such as squabbles over succession. While plenty of mom-and-pop firms certainly fit that description, it doesn’t reflect the powerful role that family-controlled enterprises play in the world economy. Not only do they include sprawling corporations such as Walmart, Samsung, Tata Group, and Porsche, but they account for more than 30% of all companies with sales in excess of $1 billion, according to the Boston Consulting Group’s analysis.

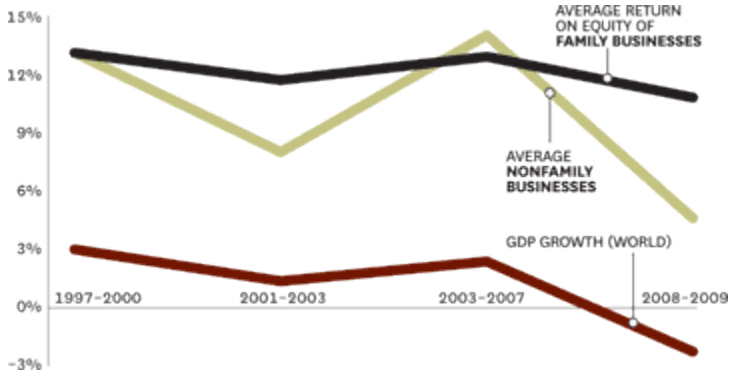
Conventional wisdom holds that the unique ownership structure of family businesses gives them a long-term orientation that traditional public firms often lack. But beyond that, little is known about exactly what makes family businesses different. Some studies suggest that, on average, they outperform other businesses over the long term—but other studies prove the opposite.

To settle that question, we and Sophie Mignon, an associate researcher at the Center for Management and Economic Research at École Polytechnique, compiled a list of 149 publicly traded, family-controlled businesses with revenues of more than $1 billion. They were based in the United States, Canada, France, Spain, Portugal, Italy, and Mexico. In each business a family owned a significant percentage, though not necessarily a majority, of the stock, and family members were actively involved both on the board and in management. We then created a comparison group of companies from the same countries and sectors, which were similar in size but not family controlled. (We didn’t look at Asian companies because so many of them are family controlled that it’s difficult to find a suitable comparison group.) Then we did a rigorous analysis of the ways in which those two sets of companies were managed differently and how that affected performance.

Our results show that during good economic times, family-run companies don't earn as much money as companies with a more dispersed ownership structure. But when the economy slumps, family firms far outshine their peers. And when we looked across business cycles from 1997 to 2009, we found that the average long-term financial performance was higher for family businesses than for nonfamily businesses in every country we examined.

The Long-Term View of Family-Business Performance

Though family-run companies slightly lag their peer group when the economy booms, they weather recessions far better.



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The simple conclusion we reached is that family businesses focus on resilience more than performance. They forgo the excess returns available during good times in order to increase their odds of survival during bad times. A CEO of a family-controlled firm may have financial incentives similar to those of chief executives of nonfamily firms, but the familial obligation he or she feels will lead to very different strategic choices. Executives of family businesses often invest with a 10- or 20-year horizon, concentrating on what they can do now to benefit the next generation. They also tend to manage their downside more than their upside, in contrast with most CEOs, who try to make their mark through outperformance.

At a time when executives of every company are encouraged to manage for the long term, we believe that well-run family businesses can serve as role models. In fact, in our research we were able to identify several companies with dispersed ownership whose strategies mimicked those of family firms. Those companies also exhibited a similar performance pattern: below their peers during upturns but leading the pack in times of crisis. (See the sidebar "It Operates Like a Family Business—*but It's Not.")*

It Operates Like a Family Business—but It's Not

It makes sense that family-controlled companies would focus on resilience instead of performance, but why can't other companies mimic that strategy?

In fact, some do. Consider Nestlé. It follows most of the golden rules of family firms. It slightly underperformed its three major competitors during the economic expansions of 1997–1999 and 2003–2007—but consistently outperformed them in periods of financial stress and crisis. Its leverage is lower: Debt accounts for 35% of its capitalization, versus an average of 47% among its competitors. Nestlé relies less on acquisitions: Annually, newly acquired businesses account for an average of 3.9% of its revenues, versus an average of 7.8% for its competitors. Nestlé is also the most diversified of the world's four food giants, in terms of both geography (67% of its sales come from outside its home region, compared with 56% for its competitors) and product lines (which range from pet food to beverages, and from confectionary to pharmaceuticals).

Nestlé is not a unique example. Essilor, the world leader in optical lenses, is another nonfamily firm that mimics these behaviors. It has a culture of cost consciousness, maintains a very low level of debt, and has little staff turnover. Essilor is highly international—and has made many small acquisitions close to the core rather than pursuing big deals. Like Nestlé, it has weathered the recent downturn exceptionally well. In the United States, Johnson & Johnson isn't a family-owned business, but it acts like one, with a low debt-to-equity ratio, a product line that allows its PR people to tout it as "the most diversified global health care company," and a skepticism toward the large transformational mergers that other pharma players routinely attempt.

For years managers have been advised to "think like an owner." The rules of family business show how to translate that thinking into actual strategies. What Nestlé and other nonfamily companies prove is that it's possible to benefit from these rules regardless of ownership structure.

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So how do family-run firms manage for resiliency? We've identified seven differences in their approach:

1: They're frugal in good times and bad.

After years of studying family businesses, we believe it's possible to identify one just by walking into the lobby of its headquarters. Unlike many multinationals, most of these firms don't have luxurious offices. As the CEO at one global family-controlled commodity group told us, "The easiest money to earn is the money we haven't spent." While countless corporations use stock grants and options to turn managers into shareholders and minimize the classic principal-agent conflict, family firms seem imbued with the sense that the company's money is the family's money, and as a result they simply do a better job of keeping their expenses under control. If you examine company finances over the last economic cycle, you'll see that family-run enterprises entered the recession with leaner cost structures, and consequently they were less likely to have to do major layoffs.

2: They keep the bar high for capital expenditures.

Family-controlled firms are especially judicious when it comes to capex. “We have a simple rule,” one owner-CEO at a family firm told us. “We do not spend more than we earn.” This sounds like simple good sense, but the reality is, you never hear those words uttered by corporate executives who are not owners. The owner-CEO added: “We make roughly €450 million of free cash flow every year, so we try to spend no more than €400 million per year, and we keep the balance for rainy days.”

At most family firms, capex investments have a double hurdle to clear: First a project must provide a good return on its own merits; then it’s judged against other potential projects, to keep spending under the company’s self-imposed limit. Because they’re more stringent, family businesses tend to invest only in very strong projects. So they miss some opportunities (hence their underperformance) during periods of expansion, but in times of crisis their exposure will be limited because they’ve avoided borderline projects that may turn into cash black holes.

3: They carry little debt.

In modern corporate finance a judicious amount of debt is considered a good thing because financial leverage maximizes value creation. Family-controlled firms, however, associate debt with fragility and risk. Debt means having less room to maneuver if a setback occurs—and it means being beholden to a nonfamily investor. The firms we studied were much less leveraged than the comparison group; from 2001 to 2009, debt accounted for 37% of their capital, on average, but for 47% of the nonfamily firms’ capital. As a result, the family-run companies didn’t need to make big sacrifices to meet financing demands during the recession. “People think we are rich and courageous,” one executive from a family firm told us, “but in fact we are cowardly—we leave most of the cash in the company to avoid giving away too much power to our banks.”

4: They acquire fewer (and smaller) companies.

Of all the plays a manager can make, a sparkly transformational acquisition may be the hardest to resist. It carries high risks but can pay large rewards. Many family businesses we studied eschewed these deals. They favored smaller acquisitions close to the core of their existing business or deals that involved simple geographic expansion. There were significant exceptions to this rule—when the family was convinced that its traditional sector faced structural change or disruption or when managers felt that not participating in industry consolidation might endanger the firm’s long-term survival. But generally, family companies aren’t energetic deal makers. On average, we found, they made acquisitions worth just 2% of revenues each year, while nonfamily businesses made acquisitions worth 3.7%—nearly twice as much. Family businesses prefer organic growth and will often pursue partnerships or joint ventures instead of acquisitions. As the HR director of a leading family-owned luxury goods company described it: “We don’t like big acquisitions—they represent too much integration risk, you may get the timing wrong and invest just before a downturn, and more importantly, you may alter the culture and fabric of the corporation.”

5: Many show a surprising level of diversification.

Plenty of family-controlled companies—such as Michelin and Walmart—remain focused on a core business. But despite a generation's worth of financial wisdom that diversification is better done by individual investors than at a corporate level, we found a large number of family businesses—such as Cargill, Koch Industries, Tata, and LG—that were far more diversified than the average corporation. In our study 46% of family businesses were highly diversified, but only 20% of the comparison group were. Some family firms had expanded into new lines of business organically; others had acquired small entities in new fields and built on them. The CEOs we spoke with say that as recessions have become deeper and more frequent, diversification has become a key way to protect the family wealth. If one sector suffers a downturn, businesses in other sectors can generate funds that allow a company to invest for the future while its competitors are pulling back.

6: They are more international.

Family-controlled companies have been ambitious about their overseas expansion. They generate more sales abroad than other businesses do; on average 49% of their revenues come from outside their home region, versus 45% of revenues at nonfamily businesses. But family businesses usually achieve foreign growth organically or through small local acquisitions—without big cash outlays. And they are very patient once they enter a new market. "We accepted that we'd lose money in the U.S. for 20 years, but without this persistence we would not be the global leader today," says one executive from a family-run global consumer products company.

7: They retain talent better than their competitors do.

Retention at the family-run businesses we studied was better, on average, than at the comparison companies; only 9% of the workforce (versus 11% at nonfamily firms) turned over annually.

The leaders of family companies extol the benefits of longer employee tenures: higher trust, familiarity with coworkers' behaviors and decision making, a stronger culture. These businesses have a lot in common with what the academics Karlene Roberts and Karl Weick call "high-reliability organizations," in which long-serving teams of specialists develop efficient team dynamics and a collective mind-set that helps them achieve goals. Says the CEO of one $10 billion diversified group: "We don't have the smartest guys out there, but they know their job like nobody else, and when a problem hits they can act immediately as a team—one that has been there before."

Interestingly, family businesses generally don't rely on financial incentives to increase retention. Instead, they focus on creating a culture of commitment and purpose, avoiding layoffs during downturns, promoting from within, and investing in people. In our study we found that they spent far more on training: €885 a year per employee on average, versus an average of €336 at nonfamily firms.Examine these seven principles, and it becomes clear how coherent and synergistic they are: Adhering to one of them often makes it easier to follow the next. Frugality and low debt help reduce the need for layoffs, thus improving retention. International expansion provides a natural diversification of risks. Fewer acquisitions mean less debt. Money saved

through frugality is invested wisely if the company keeps a high bar on capital expenditures. Instead of working in isolation, these principles reinforce one another nicely.

When we talk with executives at family-controlled firms, they speak derisively about competitors who “bet the farm” or “swing for the fences.” They talk about what keeps them up at night. Though they realize they are missing opportunities by being overly prudent, they hope to generate superior returns over time as business cycles turn from good to bad.

It’s evident that those cycles are speeding up. If that trend continues, the resilience-focused strategy of family-owned companies may become more attractive to all companies. In a global economy that seems to shift from crisis to crisis with alarming frequency, accepting a lower return in good times to ensure survival in bad times may be a trade-off that managers are thrilled to make.