

For better, for worse

How to keep the family business vibrant across generations



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If family firms want to sustain their dynamic progress across multiple generations they need to have a professional approach to governance and management – a task that, in its multifaceted complexity, poses a major challenge in terms of leadership. It is all about balancing the interests of the company with those of the family and efficiently exploiting the special strengths of this kind of business. In what follows, the authors describe how the challenges of building a family firm over generations can be mastered.

IT WAS the takeover that proved fatal. Until 2006 the Japanese construction company K.K. Kongō Gumi was the world's oldest enterprise, a family firm dating back 1,428 years. A 17th-century scroll over three meters long documents the corporate history over many generations. According to this time-honored source, the company was originally founded in 578 A.D. by a carpenter named Kongō, from what is today Korea, to fill an order for the construction of a Buddhist temple in Ōsaka. The temple still stands. Over the centuries the family built many more prominent edifices in Japan, specializing in temples and shrines. Masakazu Kongō was the 40th and final family member to guide the fortunes of the firm. Shortly after being taken over by Takamatsu Construction Group, in January 2006 Kongō Gumi was wound up.

The longest corporate history in the world

It is surely no coincidence that the longest corporate history in the world should belong to a family company. And similarly it is no coincidence that this history should come to an abrupt end with the loss of the firm's independence. The example of the long-standing Japanese company teaches two obvious lessons: first, longevity is not reserved for stock corporations but is perfectly possible for family companies too; and second, preserving the company's independence would appear to stand surety for a long life. Those that con-

tinue for generation after generation produce superior performance compared to publicly traded companies and are not constrained by a 'quarterly' mentality. Nevertheless, despite their very real economic significance, many family owned companies fail after just a generation or two.

The reasons are less likely to be of an economic nature and will more probably be found in the *conditio sine qua non* of this type of company – the family. At its best the company's biggest asset, unless managed with the same care and attention as the company itself, the family can rapidly become its most oppressive burden. Every handover to the next generation, every major investment decision, the appropriation of profits, the responsibility for losses – these and many other potential sources of discord among family members loom large around every corner. After all, why should entrepreneurial families be less quarrelsome than any other group of relatives? The consequences of their disputes, however, can be more serious and far-reaching. Conflict is widely held to be the greatest destroyer of value in family firms.

So in a family company, good management means far more than having a far-sighted mission, formulating a wise strategy, and deploying it superbly through a carefully selected workforce. Family firms need all of this and more if they are to survive and prosper in the long term, but at the same time, management must devote at least as much energy and attention to the cares and concerns of the family shareholders. If family-owned companies are out to sustain dynamic progress across generations, they need to manage the inherent conflict between family and business on a consistent basis, a complex and multifaceted task. Finding an equilibrium that leverages the best aspects of both family and business is the art of family business management. But while management of family companies is more demanding, the results are often worth the extra effort.

The best of both worlds

Studies show that well-managed family businesses are more profitable, more successful in the long run, and more enduring than other types of company. The secret of their success lies in the ability to combine the best of both worlds: family and business. Their strengths doubtless include the close emotional ties between the owning family (and often the employees) and their company, coupled with a degree of loyalty to the owning family that public companies, for example, can only dream of.

In a crisis in particular, this combination will often bring remarkable returns as the shareholders declare themselves willing to dispense with dividend payments for a prolonged period or perhaps even inject fresh capital from their own resources. In the same spirit, employees accept pay cuts and play their part in resolving the problems. Management need not think in terms of quarterly reporting but can generally afford to focus on a longer-term horizon, which will lead to a more sustainable company. CEO tenure also tends to be longer, making for a high level of continuity and dependability. And as employees remain loyal to the company for long periods, they help build and retain a strong knowledge base that ultimately endows many family businesses with immense innovative capabilities and outstanding products that often make them market leaders in their specific segment.

In addition, family companies often have a strong, shared value base, combined with a greater sense of social responsibility that extends beyond the welfare of the workforce. They are deeply rooted in their home region where they often act as patrons of the arts or engage in politics.

The many strengths are offset by several typical weaknesses, such as a lack of transparency within the company and towards the outside world and a degree of splendid isolation that invariably detracts from the competitiveness of the business. There is often a lack of clearly defined accountability and responsibilities as the company transitions from the founder stage. In some cases there is also a marked absence of clear-cut rules and job descriptions that could distinguish the roles of management, family, and owners. This may be understandable, given that relatives rarely define codes of conduct for their dealings with one another, but in the worst case the cocktail of emotions, sympathy and antipathy, personal interests, and different economic expectations can drive the company into existential difficulties. Family companies by their very nature will have problems and those that don't prepare in advance to deal with these contingencies by defining rules and a code of conduct find it very difficult to survive across generations.

Three dimensions

In many cases, without outside help families are unable to strike a balance between their emotional ties to the company, the economic realities facing management, and the potentially disparate personal interests of the



Thomas Struth, The Ma Family, Shanghai 1996

various shareholders. This is why independent, objective and trusted external advice is often critical in handling conflicts while maintaining family harmony. The decisive goals for any professional governance system in a family business must be to defuse potential conflicts or, better still, prevent them arising in the first place, and to ensure an ongoing increase in shareholder value. In this respect, there are three key dimensions to consider:

- The *family* dimension – this is about reaching consensus over the rules that govern family affairs and a clear understanding of how and in what form these rules are anchored in the company. Also, the family should agree on a definition of their shared values. The core goal of family governance is to ensure the cohesion of the family.
- The *ownership* dimension – the structure of company ownership should be such that there is an adequate capital base for future growth while ensuring that the family retains a controlling interest in the company;
- The *management* dimension – the aim here is to ensure well-structured corporate governance and a dynamic, thriving business portfolio in line with family values.

In practice, this means that the family draws up a set of rules acknowledged by all of the parties concerned and governing the conduct of the family and the management of the company – rules that will minimize the potential for family conflict yet increase the enthusiasm of the family for business ownership.

The company and its owners must have a clear, shared view of the commercial goals that the company is out to achieve and it must be clear which managers are

responsible for reaching these goals. In addition, they must act to safeguard the company's long-term future by engaging promptly in targeted succession planning. These are demanding tasks and ambitious goals that call for an integrated and above all unbiased approach. Formulating and implementing an appropriate governance framework is often made far easier by involving external advisors. They have the advantage of not pursuing a personal agenda within the company and – given the right specialist qualifications and experience – can provide objective and independent opinions and advice. Of course every family must find its own answers, but the search for those answers can be greatly facilitated by an independent mediator who asks the right questions. In complex decision-making situations in particular, an external advisor who enjoys the broad-based trust of the owners will greatly increase the chances of reaching a consensus that the family alone could not – or could no longer – achieve.

A framework for the family

If, as the World Bank's International Finance Corporation (IFC) reports "most family businesses have a very short life span beyond their founder's stage," then even surviving this initial critical phase is an ambitious goal. More ambitious still is ramping up the business into new dimensions, expanding into new markets and sophisticated innovations that call for major investments. But as the IFC Family Business Governance Handbook says, "Family businesses can improve their odds of survival by setting the right governance structures in place, and by starting the educational process of the subsequent generations as soon as possible."

Egon Zehnder International – Global Alliance Partner of FBN

Egon Zehnder International's long-standing commitment to family businesses is reflected in its recently concluded strategic partnership with the Family Business Network (FBN). The network with its motto "By families, for families" acts to support the long-term success of family businesses and currently unites over 3,400 family-owned companies around the world.

As an exclusive Global Alliance Partner in the area of talent identification and development, and family and business governance, Egon Zehnder International cooperates with 27 local chapters of FBN.

FBN's other alliance partners include Credit Suisse, Ernst & Young, and the IMD business school.

The lack of professional behavior and independence on the part of the board is the decisive reason why the first non-family CEO in family firms so often fails.

Given the major differences in size, structure, and strategic direction of family companies, there can be no such thing as a one-size-fits-all recipe for good governance structures that meet the specific needs in each case, but there are at least points of reference and guidelines from which companies can take their lead. The first step is to coordinate the interests of the family with those of the business while keeping them clearly segregated. The challenges involved should not be underestimated, because the two parties are tracking the target from entirely different viewpoints – preserving the legacy on one hand, growing the company on the other, as risk aversion clashes with calculated risk taking, and that is just one example. Building a consensus around the purpose and vision of the family is the essence behind drafting a family governance code. This serves as the basis for harmonizing the family and business goals and is designed to complement corporate governance guidelines.

To underpin the important emotional ties between family and company, which would otherwise be diluted from one generation to the next, the family governance code should include elements that promote the integrity of the family and foster its interest in the company. These could involve regular shared events such as family meetings, as well as precise rules governing communication and information flows within the family. Insofar as possible, there should also be rules on how to resolve conflict. Without this framework it is all too easy for the kind of power vacuum to arise that outside corporations or investors seeking acquisition targets love to exploit.

With a view to good family governance, every family of entrepreneurs or owners should not only ask itself the uncomfortable questions but also come up with considered responses, because each of these questions harbors potential hazards if they are not jointly discussed and resolved before circumstances force the family's hand. It is important for every family to answer the following questions in a collaborative forum that is best facilitated by an outside advisor:

- What is it that makes us unique as a family? What values and principles do we stand for and how should these be reflected in the culture of our company?
- Do we have a vision of how our company should develop? If so, how can the family ensure that management shares this vision and drives it forward?
- Who decides on involvement of the family in business, capital allocation, profit distribution, dilution of the family holding, etc.?
- What mechanisms do we have for reaching agreement among ourselves? What shape do our exchanges with the management of the company take and who is responsible for this?

The outcome of these deliberations could be, for example, the formulation of a family constitution, establishment of a family council or the setting up of a shared office that maintains close and continuous contact with executive management.

The role of the board

The longer a family company exists and the larger it becomes, the greater the need for a supervisory body with at least an advisory remit, which at some point, however, would take on a supervisory function.

A board of this kind makes little sense, however, if it is initiated by the chairperson as a kind of organizational must-have that exists to rubber-stamp his or her decisions, or if the dividing line between the responsibilities of the board and management are not clearly defined. In our experience it is also problematic when the board is made up entirely of family members. In a constellation of this kind, a non-family CEO will have little chance of overcoming an opposing family view, even with the most rational of arguments. Similarly, with this kind of board line-up, the CEO can hardly expect any objective assistance in dealing with the owning family. In our experience, the lack of professional behavior and independence on the part of the board is the decisive reason why the first non-family CEO in family firms so often fails.

Besides bringing the much-needed wisdom and outside perspective in today's complex business environment, outside directors help attain the vital equilibrium between family and firm. A board that is carefully compiled in line with considered search criteria and is well networked can build bridges between owners and management and help communicate to management the values, visions, and strategic parameters defined by the family – particularly important if the management team is made up of non-family executives. The board controls and oversees management in the interests of the family and the business, but if necessary will also intervene to protect management from excessive financial claims or power games on the part of the owners. But the board is no less important in promoting the cohesion of what is, particularly in family business with a long tradition, often a highly diverse group of family shareholders. There will be highly active, deeply involved shareholders here, and others who prefer to live off their shares in a passive role. Here it is the board's integrative powers that are called for. The board is also responsible for the single most important recruitment decision at the company – the appointment of the CEO. To that extent the board also takes on an important strategic role for the company in respect of succession planning.

So what does the ideal board look like? As a result of the board appraisals that we have conducted at Egon Zehnder International for listed companies over recent years, we have been able to arrive at findings on the ideal composition of the board – results that can also benefit family firms. The best boards demonstrate the following strengths:

- Strong strategic skills and experience.
- A good blend of IQ and EQ that enables them to creatively solve problems.
- Independent thinking and the courage to voice an opinion on critical decisions.
- Results-orientation. The board understands what drives the profitable growth of the company and fulfills its responsibilities with diligence and discipline.
- The board members are aligned with the values of the company.
- They engage in constructive give-and-take with one another and have a natural orientation towards teamwork.
- They are curious by nature and willing learners.
- They see themselves as sparring partners for the CEO and management.

A board of balanced composition and capable of forming its own judgments can help management and owners attain ambitious goals and create genuine added value. Particularly when it comes to decisions on emotive issues for the family of owners, a board whose objectivity, professionalism and wise judgment ensures it acceptance among all concerned can help defuse potential conflicts. One such situation arose when the CEO of a family firm that we were advising, himself a family member, wanted to abandon the company's original field of activity because it was draining vitality from the business as a whole and the company had since diversified successfully into other markets. Feeling that they were betraying the legacy, some members of the family hesitated to cut these roots and resisted the move. The intervention of the board and the respect it enjoyed with all of the parties ultimately led to a decision in line with the CEO's wishes, without causing a rift in the family.

Ambitious goals call for talented leaders

As a company introduces new, ambitious goals, it is not only the board members who face a more demanding role but also – and in some cases by a whole new order of magnitude – top management. Family firms show an above-average tendency to recruit management talent from within. Familiarity and trust play a big part in appointment decisions. They are often driven by comfort with the candidate and not necessarily by his or her competence. And if rising stars are not family members, then the feeling is that they should at least have rubbed shoulders with the family in the course of a prolonged period on the payroll. This blinkered approach can lead to problems in ensuring that the right people are in the right seats, with an ultimate knock-on effect on the company's performance.

Family businesses often have no objective standards by which to measure the performance and skills of their management team. They have no means of benchmarking their executives objectively against other top managers in the market. On account of certain introspective tendencies, however, they tend not to notice this shortcoming until it is too late. New objectives or even just the aspirations of a new generation in terms of size and scale or a change of strategic direction can also mean that new competencies are suddenly needed which the company does not have at its disposal. Worse still, with no clear appraisal criteria in place, the com-

pany may not even be aware that these competencies are lacking.

As many family companies have reached out beyond their domestic markets and today join battle in the global arena, they need a top management team that is experienced in dealing with the demands of such scenarios and can act and react accordingly. Periodic assessment of the management competencies to deliver on the future objectives of the company is critical to ensure that the right capability is being built to drive the required business performance and outcomes. It is equally important that family and non-family managers are part of this process. More often than not, it is the inability of family companies to focus in a timely manner on building the talent pipeline in the company that constrains its growth.

A proven methodology should be applied to arrive at an objective appraisal of the existing competencies and future potential of a company's management lineup. Once the company has defined the skills its management will need in order to meet its short- and long-term objectives, a management appraisal will clearly point up the gaps that exist both in the personal competency profiles of individual managers and in the cumulative profile of the management team. Through the appropriate development plans for in-house talents or selective hiring from the outside, these gaps can then be effectively closed.

Time for the next generation

The handover from one generation to the next is a razor-edged reef on which many a family has run aground, causing their companies to sink without a trace. Excessive expectations, false hopes, hubris, a patriarch unable to hand over the reins, different branches of the family vying for dominance – the potential for conflict here is endless. Most families are aware of the challenges but few are willing to proactively discuss and address this issue in a transparent manner, until it is too late. Instead, family businesses need to seize on this as an opportunity to focus on the future and to realign the business and governance structures to meet the future needs of the family and the business environment. Are the current governance principles likely to remain fit for purpose over the next 30 to 40 years in which a new generation will be controlling the fortunes of business and family alike? Will they prove a reliable source of added value? As we mentioned earlier, the selection of a CEO or

chairman of the board is the most critical decision for any business, public or private. In family companies, however, the influence of the CEO may well be greater still, given that tenure is generally far longer than at a listed company. This applies equally to a member of the family and to an external top executive. With that in mind, companies do well to choose with care.

Consequently, at family companies too, succession planning cannot begin soon enough (see also the article on Succession Planning on page 78 of this issue). The more objective, transparent and timely the succession process is and the more carefully selected and prepared the potential candidates are, the less friction losses and setbacks there will be. Above all, though, all concerned must be clear about the fact that, at the end of the selection process, the best candidate must win through – regardless of whether they are family or not. If the transition at the top goes off smoothly, the family business will be ideally placed to benefit from the traditional strengths that make this type of company more successful in the long run and more enduring than others.

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