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Succession Planning

Do Most Family Businesses Really Fail by the Third Generation?

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Summary. Perhaps the most commonly-cited statistic about family businesses is their failure rates. Most articles or speeches about family businesses start with some version of the "three-generation rule," which suggests that most don't survive

beyond three generations. But... **more**

If you're a fan of the HBO show *Succession*, or if you're aware of the conflicts playing out publicly and perennially among some of the most visible family businesses in the world — think the Murdochs or Sumner Redstone's family— you might assume that family businesses are more fragile than other forms of enterprise. Indeed, that's the conventional wisdom: Many articles or speeches about family businesses today include a reference to the "three-generation rule," which says that most don't survive beyond three generations.

But that perception could not be further from the truth. On average, the data suggest that family businesses last far longer than typical companies do. In fact, today they dominate most lists of the longest-lasting companies in the world, and they're well-positioned to remain competitive in the 21st century economy.

A Single Study, Decades Old

Where did that three-generation idea come from? A single 1980s study of manufacturing companies in Illinois. That study is the basis for most of the facts cited about the longevity of family businesses. The researchers took a sample of companies and tried to figure out which of them were still operating during the period they studied. They then grouped the companies into thirty-year blocs, roughly representing generations. Only a third of family businesses in this study made it through the second generation, and only 13% made it through the third.

A few observations about the study:

First, its core findings are often described incorrectly. Many describe the results to say that only one-third of family businesses make it *to* the second generation. But the study actually says that one-third make it *through* the end of the second generation, or sixty years. That's a thirty-year difference in business longevity, so choose your words carefully!

Second, the researchers found that 74% of family businesses made it for at least thirty years, 46% lasted for sixty years or more, and 33% survived for ninety years or longer. What the study didn't say is how that compares to other types of companies. A study of twenty-five thousand publicly traded companies from 1950 to 2009 found that on average, they lasted around fifteen years, or not even through one generation. In addition, tenures on the S&P 500 have been getting shorter. If the average company joined the index in 1958, it would stay there for sixty-one years. By 2012, the average tenure was down to eighteen years. A Boston Consulting Group analysis in 2015 found that public companies in the United States faced a five-year "exit risk" of 32%, meaning that almost a third would disappear in the next five years. That risk compares with the 5% risk that public companies faced in 1965.

Finally, the study provides no insight on why some businesses disappeared. Family disputes and business problems surely did hurt some of them, but in other cases the owners may simply have sold their business and started a new one. That's far from "failing."

The Three-Generations Myth

There are lots of versions of the three-generation myth out there. It's at the root of the expression "shirtsleeves to shirtsleeves," which suggests that the money made by one entrepreneurial generation is gone by the time of their grandchildren. It's present, too, in the Brazilian saying, "Rich father; noble son; poor grandson." Many countries have some version of that saying.

The three-generation myth is so pervasive that it can become a self-fulfilling prophecy for family businesses who believe the odds of long-term success are stacked against them. That's what almost happened to one successful business family we advised, which was told by an independent board member that to ensure they survival of their business, they should *not* hand it down to the next generation.

The siblings cared deeply about their business and the people who worked there. They also very much valued the idea of leaving the business as a legacy for their family rather than cashing out and giving the next generation the proceeds. So when they were ready to retire, they agonized over whether to sell the business to their long-standing non-family managers or to pass ownership to the next generation. The board member's advice had them believing that they had to choose between making their company last and keeping it in the family. But they sensed that this was a false choice, and so they decided to give family ownership a try.

It was a wise move: The siblings are well into transferring ownership to the next generation, and the business is thriving with help from non-family managers who are bridging the gap between the retiring owners and their successors.

So is there anything to the three-generations myth? Certainly, some families go from rags to riches and back again, but on average, they do not. Those who climb to the top of the wealth ladder tend to stay there for a long time. That's what Gregory Clark, an economist at University of California, Davis, found when he conducted extensive research on social mobility over generations: Rich families typically stay rich, and poor families stay poor. Eventually there's a regression to the mean, he wrote, but "the process can take 10 to 15 generations (300 to 450 years)." Similarly, when economists from the Bank of

Italy studied tax records in Florence in 1427 and 2011, they found that today's top earners were "already at the top of the socioeconomic ladder six centuries ago."

In short, even if your family business does fail, there's little need to worry that the wealth that it has created for you will evaporate.

Thinking in generations, not quarters

The longevity of family businesses is important not just to their owners but also to the economy. According to the U.S. Census Bureau, family businesses — companies in which two or more family members exercise control, concurrently or sequentially —represent about 90 percent of American businesses. Ranging in size from two-person partnerships to *Fortune 500* firms, these businesses account for half of the nation's employment and half of the U.S. gross national product.

Can family businesses continue to be the dominant source of employment nationally and globally over the long term? The answer is yes.

The reason for that is the choices they make. Rather than being obsessed with hitting quarterly earnings targets, as public companies are, family businesses tend to think in terms of generations, which allows them to take actions that put them in better position to endure the tough times.

For example, Robinson Lumber Company, established in 1893 and based in New Orleans, is today owned and managed by the fifth generation of the founding family. At the heart of their success is a way of doing business that puts long-term survival above short-term profits. The company sells a combination of wood products that, if one were building a company from scratch, would not make sense to combine into one business. Species, colors, and other trends come in and out of fashion over the years, so typically while some of the company's products are doing well, others aren't. At those points in time, it might be most profitable to abandon the unpopular products in favor of the current performers, but to do so would put the company at risk of irrelevance when tastes change again.

Also, like many family businesses, Robinson Lumber doesn't borrow much from the bank. Debt is a great way to fund growth and goose return on equity, but it also puts the company at risk during the inevitable downturns in the economy. Family businesses last longer because they are able to pay the price that longevity requires.

A bright post-pandemic future

Compared to widely held public companies, family businesses tend to thrive when times get tough. The pandemic has provided evidence of this. Though few businesses have been immune to the challenges of the pandemic, family businesses seem to be emerging in better shape than their competitors.

In December of 2020, we surveyed family businesses all around the globe (140 respondents from five continents representing more than 25 industries) and found an optimism that they not only had weathered the worst but an expectation that they will gain ground in the months ahead. Sixty-eight percent of those surveyed believe that they will have more efficient operations when the pandemic is over. And more than half believe there will be new business opportunities, more efficient decision-making processes, and learning opportunities for the next generation. Even at the height of the pandemic, a full 25% of those surveyed believed that their market share would not only survive but increase in the years ahead.

Family ownership brings a competitive advantage in situations that demand resiliency rather than rapid growth. Family businesses, with owners close to the business, can adapt quickly to changing circumstances and balance the imperatives of navigating through the current crisis with the implications for the long-term in mind. That means working hard not only to preserve cash but also to ensure the well-being of employees and communities. In many studies, family companies have been shown to be better employers and community citizens than their non-family–run peers. That's a distinct competitive advantage, one that represents capitalism at its best.

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