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Corporate Governance

Why the 21st Century Will Belong to Family Businesses

by Josh Baron

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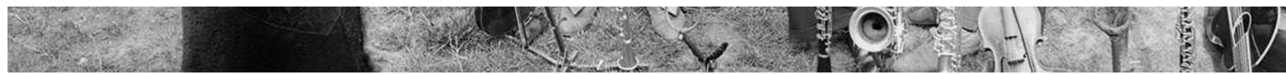

I was recently asked to give a talk about family businesses, and the conference organizer told me not to even mention the "three generation rule." As he put it: "Everyone already knows that family businesses don't last."

He's perfectly right. An oft-cited statistic is that only 30% of family businesses make it through the second generation, 10-15% through the third, and 3-5% through the fourth. These are disheartening numbers.

But let's put them in perspective. How many companies of *any kind* are still around after the equivalent of three or four generations? A study of 25,000 publicly traded companies from 1950 to 2009 found that, on average, they lasted around 15 years, *or not even through one generation*. In this context, family businesses look pretty enduring.

And the numbers are only going to get more flattering. In the context of competition in the 21st century, family businesses have innate strengths over others forms of ownership, especially public companies. For most of the last century, companies confronted oceans of opportunities, which meant that winning strategies revolved primarily around size. Public companies had a clear advantage in the scale economy; they are especially suited to raising capital. But firms today are no longer looking out at endless opportunities. Instead, they have to struggle for their very survival in an intensely competitive world of slower growth, lower returns, and more frequent economic crises. In this brave new world, public companies are losing their dominance: their share of America's GDP, workforce, and assets has fallen by 50% over the last quarter of the 20th century.

For family-owned businesses, the story is rather different. The qualities

often associated with family businesses that were a handicap in the previous century are turning out to be powerful sources of advantage, giving them the potential to be more adaptive to the increasingly intense competition that all businesses are facing. Specifically, family businesses have the opportunity to achieve sustainable advantages in five key areas:

Talent: From Mass Employment to a Higher Calling

For much of the 20th century, success depended on a company's ability to hire, train, and retain ever-larger numbers of employees. This was the era of the company man, where employees exchanged long-term loyalty for a livable wage and a pension plan. In today's knowledge economy, success depends instead on finding, empowering, and retaining the most talented people. Businesses need to do more than offer competitive wages and benefits; they have to provide a "higher calling" that makes clear the intrinsic value of working for their companies. As a recent Bain & Company study put it: "Employees want to work hard because they believe in their company's mission and values, not just because they hope for a large salary or a fast promotion."

Much has been written about values-based cultures, but families are the primary carrier of values, and business families can weave their values into the very fiber of the organizational culture. Our experience has shown that because employees work directly with the owners, there is often a pronounced loyalty effect, which augments the important sense of mission.

Investment: From Other People's Money to Captive Capital

In the scale economy, capital was the lifeblood of success. And given the pace of growth, capital was always in demand. In today's economy, however, the priority has shifted from the quantity to the quality of investment. Outside funds bring with them a pressure to achieve short-term results that trade-off with value creation. A study of leading public company CFOs published in the *Journal of Accounting and Economics*

(2005), found that 78% of these CFOs would be willing to make decisions that destroy value in order to achieve their quarterly earnings targets.

Family businesses don't have these problems because they can obtain "captive capital" that will not easily migrate to other firms. Their owners often think in generational terms – in decades rather than quarters or years. Without external markets to please, they can take a long-term perspective and make decisions on the basis of sustainable economic value. As a result, family equity can come at a very low cost of capital, where businesses can meet the annual needs of their shareholders without having to worry about paying back the principal. What's more, since the money at stake is their own, family businesses tend to be cautious in their spending, and the discipline that comes from frugality is a tremendous advantage when topline growth is harder to achieve.

Reputation: From Profit Motive to Sustainable Footprint

In the 20th century, there were relatively few channels (literally, in the case of TV) by which companies could build their reputations, which enabled the largest companies to control them. It was not unreasonable for Milton Friedman in 1970 to say that the "one and only one social responsibility" of businesses is to raise their profits. In the 21st century economy, the standard has risen considerably. As one client told me, "It used to be that unhappy customers would write a letter. Now, they snap a picture of a defective product, upload it to Facebook, and all of a sudden it's gone viral. We have to stay out in front of our image."

Family businesses have a big head start in building a "sustainable footprint." There is often a personal connection between the family and the communities in which it operates; reputations matter to families. Investments in the community are likely to have social rationale in addition to an economic one. One client built a hotel complex in an underdeveloped area. They could have flown in all the supplies that they needed, but instead they decided to invest in local farmers to supply the

food for the resort. Over a three to five-year period it cost them money, but over a 20-year period this investment will pay off handsomely. With a longer time horizon, tradeoffs between strengthening the community and making profits can simply disappear.

Organization: From Managing Complexity to Rapid Response

The leading companies of the 20th century were behemoths. Henry Ford's company covered the entire value chain from end-to-end, including owning the grazing land for the sheep whose wool was used in seat covers. But instead of managing highly complex structures, the greatest organizational challenge of the 21st century is dealing with change. Companies will need to build the capacity for flexibility, adaptability, and quick/decisive action in response to shifting market conditions. The new mantra is to shorten the distance between leaders and the frontlines.

Family businesses are well-suited to dealing with this imperative of "rapid response." They tend to have nimbler and flatter structures, where information flows quickly and easily in to the leaders and decisions come out. There is also often more of a direct connection from the ultimate decision-makers to their employees. While less adept at delegating, they can more quickly and decisively commit the organization to action. The privacy that family ownership allows also helps executives stay focused on strategy rather than meeting market expectations. In Fortune's last survey of leading CEOs, 84% of CEOs said it would be easier to manage their company if it were private.

Governance: From Separation of Powers to Engaged Owners

Decision-making in large public companies is primarily vested in management, which generally is not composed of majority owners. As a result, ownership of the business is split from day-to-day control, creating what economists call a "principal-agent" problem. The traditional priority for good corporate governance has been to align management incentives with the interests of shareholders, often through

equity-linked compensation plans. But by the end of the 20th century it had became clear that this endeavor has failed. Efforts to make managers act like owners through stock options have backfired, leading to skyrocketing pay, and opening the door to numbers-rigging scandals such as Enron.

The principal agent problem is far less severe in family businesses because they foster "engaged ownership." The simple fact that there are fewer owners makes the oversight of decisions far easier; even family businesses with hundreds of owners are better positioned to provide effective oversight than public companies, whose owners can number in the hundreds of thousands. And when family members with large ownership stakes are also involved in managing the business, incentives are easily aligned.

The public corporation has been the dominant model for business enterprise for most of the last century, and this reflected the fact it was the best solution to a particular set of economic circumstances. But those circumstances are changing and family businesses that manage the five sources of advantage described above are well placed to make the 21st century a family business century.

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