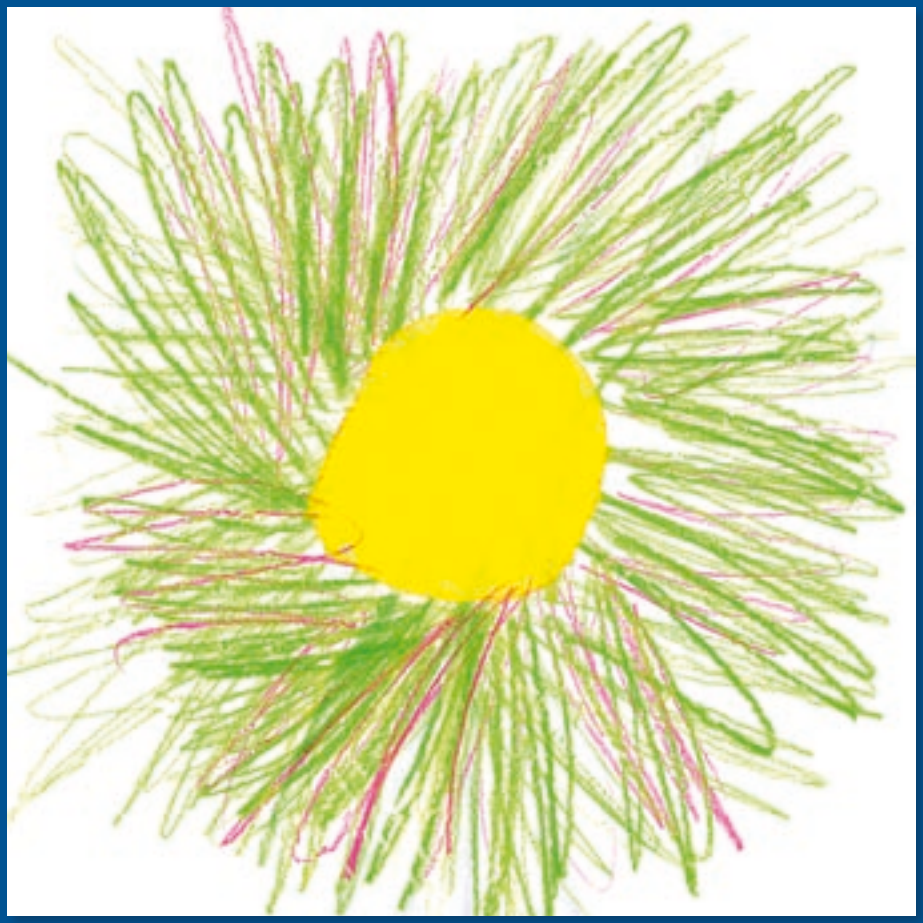

Noam Oppegaard, age 5

9 LEADING THE FAMILY BUSINESS

Why creating an owner strategy must come first for family businesses.

The winds of global change have long since reached our family businesses. Many of them conduct business around the globe. Their competitors are no longer conventional, publicly owned companies, but increasingly private equity companies and the firms they own. To lead their companies and families into a successful future, owner families must first create their owner strategy before their business strategy.

Peter May

Family businesses are the oldest and most common type of business. As long as people have worked for themselves, they have done so with and for their families. This changed along with the second wave of the Industrial Revolution. Some of the massive investment projects of this period required more capital than individual families could afford. The corporation was developed as a result, along with a management philosophy that still influences the way we think and work today. It is based on the separation of ownership, management and control, with the actual power being vested in the company's management board. In this model, the owners are relegated to a role of disturbing the management as little as possible.

This understanding of management is completely alien to family businesses. This is why the family business has largely been a ridiculed outsider in the field of management theory. Many experts agree with American economist Alfred Chandler, who referred to family businesses as an imperfect preliminary stage on the path to the manager-run, publicly owned company.[1] As a result, qualified research on the phenomenon of family business started later than that on other businesses and focused almost exclusively on its supposed flaw – namely the owner families and their impact on the company.

From ridiculed outsiders ... to the favorites of management theory

Now, all of this is changing. From being ridiculed outsiders, family businesses have become a fashionable subject for management theorists. In 2003, American researchers Anderson and Reeb published a study that turned conventional management theory upside-down.[2] They examined the long-term performance of the corporations represented in the Standard & Poor's 500 Index. They found that companies in which the founders or their families maintained a strong influence experienced significantly higher increases in value compared with their competitors. The findings were so surprising that the study was repeated shortly after on other leading Western stock indices. The results were the same. After the studies were released, *Newsweek* even spoke of the "family factor" as a secret to success[3]

In general, concentrated ownership can be advantageous for a company's development because it reduces the lack of shared interests between management and owners, also referred to as the principal-agent conflict. The recent performance comparisons mean that the advantages of reduced principal-agent conflict are obviously greater on average than the possible disadvantages resulting from the affiliation between the company and the owner family.

Time for a paradigm shift

This realization can change both management theory and the way family businesses are viewed. The general field of management theory will have to focus more on the subject of concentrated ownership, as opposed to dispersed ownership, and theory on family businesses will have to broaden its scope beyond its current almost exclusive emphasis on family business governance and the conflict between family and company. The changed perspective will finally allow the development of a comprehensive management theory of family businesses, embracing both an owner strategy for the owner family and the impact of this strategy on the businesses they control.

The division into owner and company strategies isn't an entirely new approach. So-called private equity companies have long practiced this. These companies bundle the interests of their owners to formulate clear goals and strategies from the perspective of their investors, which they then attempt to implement in the companies they manage. Despite the fact that the average return on investment in private equity firms (so far) is much higher than a comparable investment in shares of publicly owned companies, conventional management theory has struggled with this phenomenon as well as with the family business. Again, one fundamental reason for this may be the lack of consideration of the owner perspective.

Although this may currently seem like a risky statement, it is possible that the traditional publicly owned company will play a minor role in the battle for the most successful type of business over the next few years. The big fight will be between family businesses and private equity companies. Both share the phenomenon of concentrated ownership, but they differ significantly with regard to the goals and

realization of their ownership roles. It will be interesting to see which gets the upper hand.

What it means for family businesses

To avoid falling behind from the start, it is essential that owner families behave as professionally as private equity companies. This includes defining their ownership roles as well as the consequences of this in much greater detail than in the past. To do so, it is necessary to separate the owner perspective from the company perspective. The more involved owner families are with "their" businesses, the more important it is to clarify these two dimensions. The owners own the company (or shares in it). If their share of the company is large enough, they can control the company by filling the positions of power, defining the firm's direction and determining its conduct. At the same time, they represent a separate organizational unit, which can pursue other interests besides the company (e.g. other holdings, investments or even philanthropic causes).

The differentiation between owner family and the business itself leads us to the truly novel aspect of the new perspective – the distinction between owner and company strategies. A so-called family business needs (at least) two strategies – an owner strategy for the owner family and company strategies for the companies dominated by the owner family (*see* **Figure 9.1**).

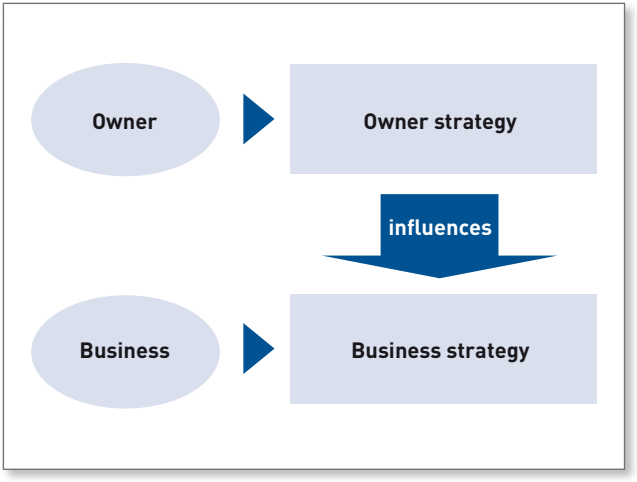

Figure 9.1 | Owner Strategy and Business Strategy

Formulating an owner strategy

The owner strategy allows the owner family to handle their ownership role and their business in a more professional manner. The family should be guided by the following questions (*see* **Table 9.1**).

Topic	Important questions	Possible answers (examples)
Membership	Who can become a shareholder?	Descendants of the founder
	How do we want to deal with in-laws/next generation?	Participation in family governance events
Values	What values should apply within the company/companies we own?	Maintain family ownership, "business first," responsible dealings with employees and business partners
	What values should apply within the owner family?	Respect, tolerance, fairness, reliability
Aims	What objectives should apply within the company/companies we own?	Growth, profitability, financial stability
	What objectives should apply within the owner family?	Establish governance rules, ensure commitment and unity of the owner family
Business model	What business model do we prefer (and why)?	Classical family business (concentration on one company)
	What consequences are the owners confronted with as a result of this?	Asset diversification is essential to reducing risk (shared or individual?)
Influencing the family business	What role is the family willing and able to play within the company?	CEO or chairman (dependent on the qualifications)
	What governance rules should be established?	See Family code
Managing the owner family	What steps do we have to take in order to ensure the commitment and unity of the owner family?	Family code Family education Family days Family office Family philanthropy

Table 9.1 | Important Questions for the Owners of a Family Business

Each owner family has to answer these questions individually. This poses a major challenge. After all, owner families and the type of entrepreneurial involvement they pursue are far less homogeneous than investors in private equity companies and the firms they control. The structure of the owner family can range from sole owner to family dynasty over generations. The owners may decide to change their business model and transform the founder's business into a family holding or family office to further diversify their risk. The owner family's influence can also vary from direct control by the entrepreneur him- or herself or a member of the owner family (managing shareholder) to the more limited role of directing the supervisory board or even withdrawing to a position of being merely owners (*see* **Figure 9.2**).

Each of the three dimensions and each stage within a dimension brings up different questions and requires different solutions. The sole owner faces different challenges to a sibling partnership. The owners of a classical family business must – in terms of its risk diversification – ask themselves different questions to those of a family that owns a broadly diversified family holding. Equally, there is a difference – with regard to governance issues – between a family that runs the company it controls and a family that has its company run by non-family members.

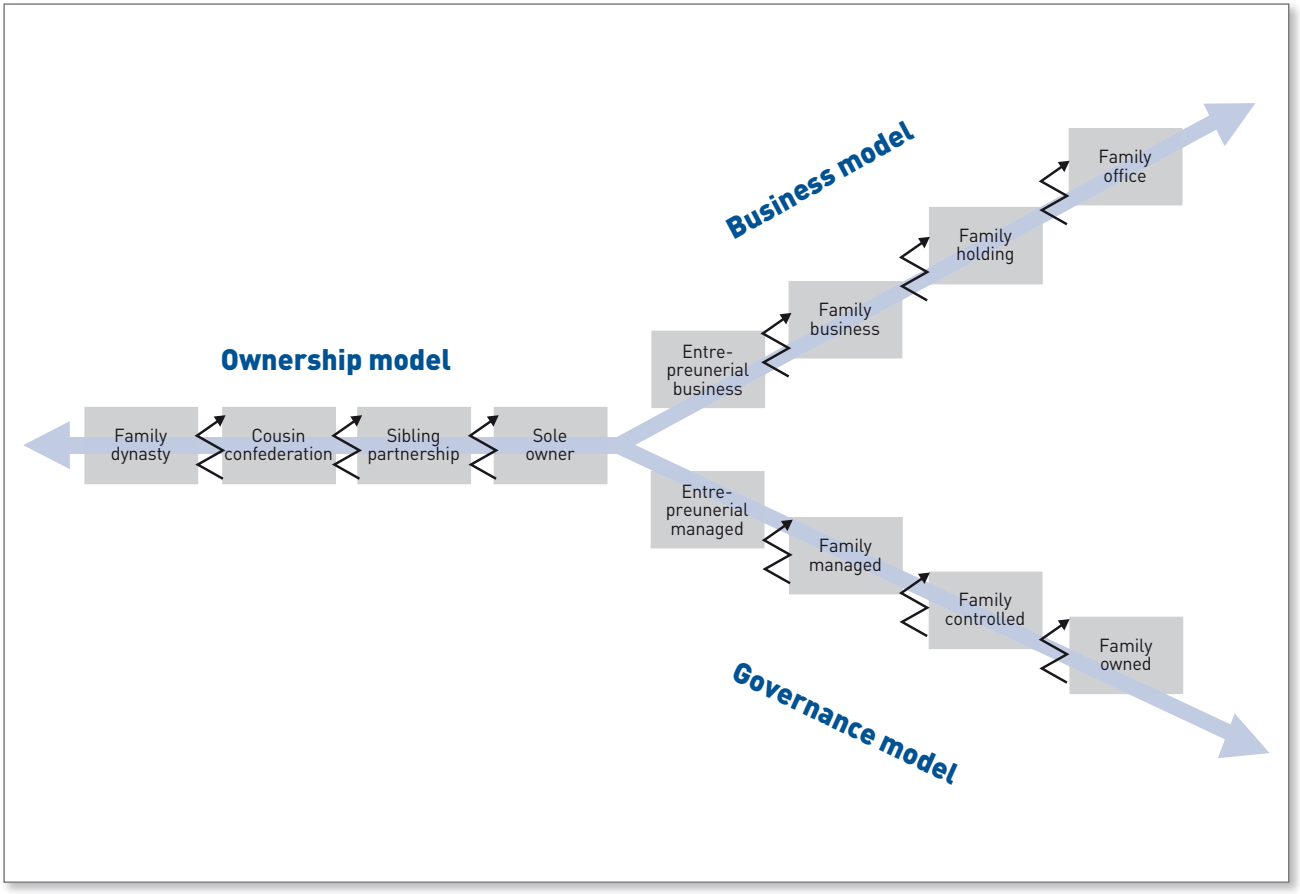

Figure 9.2 | Three Dimensions of an Owner Strategy

A family that wishes to develop a customized owner strategy should first:

- Clarify what stage it is at in the ownership model, the business model and the governance model.
- Draft the specific questions relating to this level.
- Answer the question as best as they can.

How owner strategy influences business strategy

The strategies employed by dominant owners affect the companies they control – especially their culture, strategy, financial behavior and corporate governance. While the types and extent of this influence are as individual as the owner families and their owner strategies, they differ significantly from other forms of concentrated and non-concentrated ownership. Concentrated ownership by a family is essentially characterized by the following differentiating attributes, each with its own unique challenges:

- **Dynastic intention:** The owners want to maintain the dominant influence of the family, usually over generations. As a result of this dynastic intention, the owners' overall business dealings are based on a long-term perspective. The owners are critical of anything that could endanger the family's dominant position. This basic stance of ensuring the independence of the family business limits the resources available to it.
- **Relation:** The ownership structure is characterized by a reduced voluntary type of membership and familial relationships between the owners. This combination creates a unique area of conflict. On the one hand, family businesses can seize the opportunities that arise from reducing the principal-agent conflict. On the other hand, they need to keep owners from using their power in an unprofessional way and prevent private conflicts from affecting the business.

Below we define a few typical behaviors of family-dominated companies that seem to explain their success. It is the result of an approach to management that accommodates the general findings of management theory as well as the special features resulting from the concentrated ownership by the family and their owner strategy. The best family businesses around the world succeed in using the advantages of family ownership and controlling their supposed disadvantages, or even transforming them into assets.

Values, goals and corporate culture

The owner family's long-term orientation contrasts with a fixation on short-term owner interests in the form of single shareholder value thinking. Long-term corporate management relies on capitalizing on trust between all the important stakeholders. For this reason, the corporate culture of successful family businesses is frequently aligned with values that aim to establish and secure trust. This strategy has proven successful. New studies show that family businesses have superior corporate cultures, which have a positive impact on company success.

Strategy

In order to achieve success in the face of limited financial resources, family businesses will often choose markets in which they can achieve a strong position without investing a great deal of capital. Hermann Simon, one of Germany's most influential management thinkers, found over 1,000 so-called hidden champions in Germany alone.[4] These companies – in industries as diverse as power saws (Stihl) and fish food (Tetra) – have globally leading positions in often very small markets. They all operate according to a simple wisdom: "It's better to be a big fish in a small pond than to be a small fish in a big pond."

When it comes to growth, successful family businesses prefer strategies that involve less risk and little capital. It is far more common for family businesses to achieve sustained growth through the multiplication of a successful business idea, as opposed to pursuing the quick wins promised by expansion through mergers and acquisitions, which involve higher risks and require more resources.

Financing

The desire to maintain the dominant influence of the family over the long term also influences how family businesses deal with financing. Family companies tend to be critical of options that would accelerate an increase in value through risky leveraging. Instead, they focus on maintaining a solid equity base, which often makes up 35% to 50% of total capital.

For the same reasons, most family businesses are reluctant to accept financing options that involve relinquishing ownership rights. Internal financing, conventional borrowing and asset-side management play a far more important role.

The frugality observed in many family businesses also belongs here. Some entrepreneurs, such as IKEA founder Ingvar Kamprad, are the epitome of thriftiness, for example flying economy or traveling second class on trains. They know that money you've not spent is money you don't need to borrow.

Governance

An essential part of corporate governance in family businesses is the involvement of the owners in the management and controlling structures. Nobel Prize winners Fama and Jensen alluded early on to the decision making advantages generated by eliminating or reducing the principal-agent conflict.[5] In relation to customers, employees and other stakeholders as well, owners who function as managers or supervisory board chairs can capitalize on a potential for trust, which a temporary "agent" would not receive.

This potential for trust increases the longer the office holder remains in his position. The average length of service for a manager in a family-dominated company is significantly longer than in other types of companies. In his study, Hermann Simon discovered that most of the directors of the family-owned "hidden champions" have served at the helm of their companies for 25 years or more.[6]

Compelling recent studies show that qualified family members in responsible positions do not pose a competitive disadvantage for family businesses.[7] In the first two generations, the average model owner-CEO is practically unbeatable. Nevertheless, the best family companies have defined binding corporate governance rules to ensure that all company decisions are made in accordance with professional criteria. These rules, which represent a voluntary self-restraint in owner power, are the result of a responsible owner strategy and supplement other instruments established to manage the owner family (family governance). Guidelines that ensure professional ownership are the key to maintaining the economic superiority of the family business model.

Owner strategy – a winning formula?

The owner perspective determines the behavior of family businesses to a high degree. This is even more obvious when you compare the typical behavioral patterns of family-dominated businesses with those of firms owned by private equity companies and other financial investors. It will be exciting to see who comes out on top in the competition between the different systems. For people who believe in the economic benefit of values, sustainability and trust, it's not really an open question in the long term.

Regardless of the outcome, the new thought behind owner strategy on the one hand and company strategy on the other will change the way we think about strategy. Perhaps we should differentiate between general management theory, which would cover behavioral guidelines for all types of companies, and a special management theory defining principles that apply to companies based on their type of ownership. This would put family businesses irreversibly on the map of management theory and help improve our owner families and their family businesses. That would be a big step.

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1 Chandler, Alfred D. *The Visible Hand: The Managerial Revolution in American Business*. Cambridge, MA: Belknap Press, 1977.

2 Anderson, Ronald C. and David M. Reeb. "Founding-family Ownership and Firm Performance: Evidence from the S&P 500." *Journal of Finance*, Vol. 58, Iss. 3, 2003.

3 *Newsweek*, April 2004, p. 44/45; see also: *Business Week*, November 10, 2003, p. 102

4 Simon, Hermann. *Hidden Champions des 21. Jahrhunderts*. Frankfurt/New York: Campus Verlag, 2007.

5 Fama, Eugene F. and Michael C. Jensen. "Separation of Ownership and Control," pp. 301–325, and "Agency Problems and Residual Claims," pp. 327–349, *Journal of Law and Economics*, Vol. 26, Iss. 2, 1983.

6 Simon, Hermann. *Hidden Champions des 21. Jahrhunderts*. Frankfurt/New York: Campus Verlag, 2007, pp. 335–342.

7 See Ward, John L. "Unconventional Strategy: Why Family Firms Outperform." *Unconventional Wisdom, Counterintuitive Insights for Family Business Success*. Ed. John L. Ward. Chichester: John Wiley & Sons Ltd, 2005, pp. 1–11.

QUESTIONS TO ASK

If you own a family business, you should be able to answer the following questions:

- Have you already defined your owner strategy?
- What are your key statements on:
  - Membership
  - Values
  - Aims
  - Business model
  - Influencing the family business
  - Managing the owner family?
- What impact does your owner strategy have on the management of your family business?
- Do all parties involved in the business know your owner strategy and its impact on the family business, so that they are able to act in alignment with it?