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Perspectives on Founder- and Family-Owned Businesses

October 2014

Perspectives on Founder- and Family-Owned Businesses is a publication written by family-business experts and practitioners at McKinsey & Company.

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Introduction

Heinz-Peter Elstrodt and Jean-Marc Poullet

Welcome to the first issue of *Perspectives on Founder- and Family-Owned Businesses*.

For the past two years, McKinsey's Global Family Business Practice has conducted research on the successes and challenges of family firms. This compendium presents some of our findings, which also draw on decades of experience working with family companies around the world.

In many ways, family businesses are stronger, more vital, and more important than they have ever been. Various estimates peg their share of global GDP at between 70 and 90 percent. While many family businesses are private, about a third of the Fortune Global 500 companies are founder or family controlled, as are 40 percent of the major listed companies in Europe. Family businesses are especially important in emerging markets, accounting for about 60 percent of private-sector companies with revenues of $1 billion or more.

The influence of family businesses is likely to increase. Given the growth of emerging regions, more and more family businesses are destined to become leading companies in the next 10 to 15 years. Our analysis suggests that of the more than 7,000 large companies expected to form in emerging markets between 2010 and 2025, 80 percent will be family enterprises.

What explains this prominence? Family businesses have an edge over other companies, in several ways.

First, owners of family businesses often have long time horizons and a sense of mission that can suffuse and uplift the whole organization. Family ownership can confer a strong competitive advantage through the creation of value-driven organizational cultures that inspire identity, trust, and a sense of belonging among employees. In a sense, they

Research has found that family businesses score better than others on crucial indicators of long-term corporate health.

speak to people's hearts in a way that other businesses do not. In our recent survey of more than 1,200 respondents from family firms around the world, 90 percent of non-family managers reported that family values were present in the organization; 70 percent said that these values were part of day-to-day operations.

Second, family firms are able to reduce certain agency dilemmas. As one owner told us, "All the world is trying to make managers think like owners. If we put in one of the owners to manage, we don't need to solve this problem." An owner-manager can move much more rapidly when there's no need to pass decisions up a chain of command or in front of an uncooperative board. Furthermore, due to family firms' ability to inspire loyalty through their strong cultures, the alignment between owners and managers is greatly enhanced. Our survey shows that these companies' top-management teams score 4.1 out of 5.0 for a felt sense of emotional ownership of the business. That's remarkable, and it helps to explain why other research has found that family businesses score better than others on crucial indicators of long-term corporate health.

A third benefit is that, in emerging markets in particular, founder- and family-owned businesses often have a demonstrable, even dominant home-field advantage. They have a deep understanding of their countries and their industries, as well as considerable regulatory influence, derived from their long-term relationships with constituents across the value chain. Many have proved especially resilient in times of economic crisis.

Finally, there is the gravitas that families bring to deal making. In regions where the conventions of commercial law and corporate identity are less developed, doing business on behalf of one's family can signal greater accountability and a stronger commitment. When a family's reputation is at stake, a handshake can be more powerful than a signed contract.

Those strengths will be needed in coming years because family businesses face critical challenges. One of these is growth. Another McKinsey research project found that the largest conglomerates in China, India, and South Korea are entering new businesses (often in unrelated industries) at a startling pace, entering, on average, one new business every 18 months. Almost 70 percent of these diversifying conglomerates are family owned. As these companies grow and diversify, the business models that have worked so well before may no longer be suitable.

Another and perhaps bigger challenge is succession. Many businesses falter at the first transition, from the founder to the second generation, and only 13 percent survive to the third generation. Improving these odds, which is our mission, is critical. In many areas that have industrialized and privatized over the past few decades, such as China, Eastern Europe, and India, the question of founder succession looms large. In Latin America, the Middle East, and Southeast Asia, many founder- and family-owned businesses were founded in the 1960s and 1970s; these face a second- to third-generation transition. Much of the growth and health of the private sector of these countries depends on how well founder- and family-owned businesses manage their successions.

In this first issue of *Perspectives on Founder- and Family-Owned Businesses*, we present the results of our research on the challenges of succession. In “A succession memo to a family-business founder,” we examine the first transition of ownership and management. “Building a house that lasts: A framework to guide a succession from few owners to many” follows up by taking a close look at the second transition. In both cases, we highlight businesses that have successfully jumped these hurdles; they have much to teach others. We also discuss how to build a governance model that can accommodate even extremely rapid rates of growth—another hurdle for business-owning families.

We are also privileged to present the ideas of three respected leaders, from Asia, Latin America, and the Middle East; in wide-ranging interviews, they discuss what makes their family companies successful, and how they are planning for the future. Finally, in “Gaining strength through philanthropy: How emerging-market families can make a difference,” we offer ideas on how to create a family foundation that gives back to society while also strengthening family values and cohesion.

We hope that you enjoy these articles and interviews and find in them new and pragmatic ideas worthy of your consideration. Let us know if we are succeeding—or not. You can write to us or any of our colleagues at perspectives_on_family_business@mckinsey.com.

Warmly,

Heinz-Peter Elstrodt
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A succession memo to a family-business founder

McKinsey director Heinz-Peter Elstrodt reflects on his experiences in guiding family-business successions to offer founders a playbook for successfully stepping aside.

Heinz-Peter Elstrodt

Dear Kris,

It was a pleasure meeting for lunch yesterday. On my way back to the office I kept recalling what you said about succession in a family-owned business: one day it suddenly occurs to you that the time has come to start thinking about stepping aside as the owner and founder and head of a family enterprise, but knowing when to do it is different from knowing how to do it. You mentioned that it would be helpful if I listed some of the points we discussed and made suggestions on priorities for organizing a succession transition. I base these approaches primarily on personal observations from many founder transitions, as well as on interviews with a number of leading CEOs and executives from family businesses around the world.

Adopt a different mind-set

The first priority, and perhaps the most difficult step, is to change the mind-set that has made you so successful. Founders typically build businesses step by step, opportunity by opportunity. Rarely, if ever, do they move according to some grand plan. The mind-set needed for a successful succession is very different.

You started your business from humble beginnings roughly 30 years ago. Today you have a multibillion-dollar corporation which continues to grow rapidly in size and complexity, diversifying into new fields and continents. You have taken parts of the business public to make use of additional capital, but you have kept the majority of the voting shares. Your children are still young; some are in college, and one of them works in the family company.

You enjoy being the chair, owner, and CEO. You know every nut and bolt of each business and function, you have many direct reports, and you can solve everybody's problems. You have little patience for governance issues, and you rely on a small number of trusted advisors rather than a formal board of directors.

Yet you know that something needs to change, and soon. You find it hard to imagine carrying on as you have been for the next ten years. Some founders find it a challenge to sustain scale and growth. You also said you weren't quite sure what should or will happen with your children in the context of the business you have built, especially since they are growing up in a radically different environment than you did.

What, then, is the right mind-set? It is looking into the future and planning backward, rather than building intuitively step by step. Start by developing a ten-year vision, then work backward from it, instead of incrementally plotting the next step forward. The primary driver of a successful succession is the age of the people involved. Age is pretty much the only factor in life we can predict, and though we'd sometimes prefer not to think about it, knowing where we stand makes planning possible. Then, by establishing and putting in motion an action plan, you can set approaches and time frames and manage stakeholders around critical ownership, corporate governance, and management decisions.

Explore your ownership options

Start from the top down to answer this question: Who do you want to own your company in the future? "Best practice" isn't helpful, since the decisions are highly personal in nature—ultimately they'll depend on your values and principles.

You have three basic options:

1. **Give it away for the greater good.** You can follow in the footsteps of Warren Buffett and Bill Gates and donate the vast majority of company shares to a foundation with a social mission. You take on a second career as a philanthropist. We see this model mostly in the United States, but increasingly also in emerging markets. For example, two entrepreneurs I worked with recently decided to "give it all away." One was motivated to support religious causes and the other was driven by a passion for social ventures, including the creation of a university in his home country. In both cases, the idea was also not to burden their offspring with great wealth and responsibilities but rather to let them live their own lives.

2. **Sell it.** Some founders have a limited opportunity or desire to engage the next generation in ownership. Perhaps there is no one in the next generation to take the reins, or younger family members have little appetite for either ownership or management. The founder may decide to exit altogether and invest the money elsewhere, for example, by creating a family office. In one case, the founder did not want the lifestyle and responsibility associated with running a family business for the next generation and proceeded to sell the business, distributing the cash to his children, who formed a joint family office. Remarkably, a couple of years later, the siblings teamed up and entered—very successfully—a couple of operating businesses. The entrepreneurial DNA was intact.

3. **Keep it in the family.** The more traditional path is to carry forth ownership to the next generation. If you go in this direction, ownership succession has to be structured, and the owner faces three decisions: how and when to distribute the shares, what restrictions to place on their liquidity, and how the next generation should make decisions as owners.

> "In my experience, most owners choose a solution somewhere in the middle. That is, they create an exit option that comes with strings attached."

Let's assume you have discretion over how to distribute your shares. (This is not the case in many cultures, for example, under Sharia.) Your first decision is whether to distribute shares equally or unequally. Unequal distribution might be a way for you to concentrate decision power in fewer hands, to keep the system simple. Timing is another critical factor and should be considered early. In an Asian first-generation business, for example, ownership transfer is staggered. The first batch transfers at age 30 and then at regular intervals before the founder's demise. The idea is to foster responsible ownership without the pressure of overwhelming and sudden wealth. Avoid the worst option: presenting surprise solutions that are written in a will and revealed only after the founder's death—or having no will at all.

As for restrictions on the shares, at one extreme, you can put the shares in a trust, which means that the next generation will not be owners. They will be bound by the deed of trust, which might prohibit them from pledging, transferring, or selling shares and can limit dividends. At the other extreme, you could simply pass on shares with no strings attached. As your company is floated in the stock exchange, your next-generation heirs would then have total liberty to do what they want.

The first approach promotes the idea of stewardship, that there are no real "owners," but that each generation "borrows" the company from future generations, with the obligation to strengthen it for the future. You can also create trust structures to protect the business from the family. This is usually a sign of low confidence—and an indicator that there are more fundamental issues that need to be addressed before you can design the right way to transfer ownership. The second approach is based on the liberal view that every next-generation member should be free to do whatever he or she wants.

In my experience, most owners choose a solution somewhere in the middle. That is, they create an exit option that comes with strings attached. These strings nearly always include systems of rights of first refusal between family members and often come with a penalty on economic value in the case of a sale, for example, a 20 to 30 percent discount for lack of liquidity. Another penalty might be the loss of voting rights when shares are sold outside the family. All this is done to protect the business and the family members who stay committed to it.

Finally, you'll have to work with your children to agree on how they will make decisions in the future: by simple majority, supermajority, or consensus? This will fundamentally influence the life of the next generation. Will each member have a veto, making consensus necessary, or can individuals or groups build voting majorities? If you consider stewardship important, I would recommend that you demand consensus or at least supermajorities for owner decisions—a reasonable formula might be requiring consensus for up to three successors and supermajorities of 75 percent for larger groups of successors. This design makes owners feel the weight of the decision making and fosters a collective approach that encourages stewardship. On the flipside, decisions on the owner level should be limited to a few, including major M&A and divestitures, nomination of board members, dividend policies, and the like.

Prepare the next generation for ownership

Underinvesting in thinking about ownership and what it means for the following generation is often the root cause of succession failure, which sadly plays out in sibling fights. It's natural that siblings compete with one another, but in family firms they have to work as a team. Endless is the list of publicly well-known cases of ugly sibling fights leading to splitting up or even destroying companies.

"Next" generations often reach adulthood while their future role in the business is still undecided. This is a perfect time to systematically prepare them for responsible ownership. This means tackling technical issues, such as understanding governance, shareholders' agreements, liquidity, voting rights, and the like. Equally important are the interpersonal issues—such as how to make decisions together, that is, developing trust and mutual appreciation of each sibling's different skills and personality. Executed well, this team-building effort will help the second generation act coherently and work in a complementary fashion. They will learn to appreciate the different profiles they bring to the table and to avoid conflict and divisiveness. You also have to make them understand something else—this is a process that never stops.

Organize the company for CEO succession

While the ownership issues above are slow-moving items on your agenda where just a handful of key decisions have to be made, the CEO succession follows an entirely different rhythm and requires broad actions over years to come.

Like many other founders, you told me how you have grown up with the company from its birth, and that you know its products and operations better than most managers. You have a preferred style of one-on-one interactions where you quickly solve your subordinates' problems, motivate them, and send them off with a mission. Your management style is amazingly effective and efficient. It is also utterly unsustainable. It is a sad fact that many owner-CEO transitions lead to major crises that can require a complete management change because the CEO transition is not well planned and executed.

Here are a couple of models you can follow to get it right:

1. **Develop a team that shares leadership.** Put simply, founders do not have successors. Almost never can one other person do what the founder has been doing. Rest assured, the next CEO will manage in an entirely different way, with much less knowledge about the detailed workings of the company. Therefore, he or she will have to rely on a competent team and practice participative leadership. This is a huge institutional change, and often there is little preparation in the organization for it.

   Creating a small number of direct reports working as a team with the CEO easily takes five years. It begins with the founder's personal insight: a major change is necessary to guarantee the company's sustainability, even if this hurts efficiency in the short term. The next step is to reflect on whether the key executives will be able to make the move from being operators to becoming members of a top leadership team that shares decisions and responsibilities on strategy. As the founder, it's up to you to create this leadership model and then use it to pass on your personal experience, intuition, and thinking to the next generation of managers. Essentially, you have to stop acting like a hands-on operator and instead become a coach whose mission it is to enable others.

   Handing off strategic thinking and decision making isn't an easy job for many founders. Founders are often the de facto chief strategy officer in their organization. They don't typically share their thinking with others. It's a huge advantage to have a brilliant, intuitive decision maker who acts quickly and decisively without being bound by previous plans or consensus processes.

Unfortunately, this situation too is entirely unsustainable. Often the biggest challenge for management is to learn how to think strategically, since the owner will eventually cease to do the thinking for the organization.

2. **Engage the next generation of family members as managers.** While a multiyear transition unfolds at the top of the house, the next generation in the family is growing up. You could expect them to be bewildered by the vast array of opportunities emerging but also by the daunting potential responsibilities. In many cases, age differences will mean that second-generation family members will be unable to succeed the founder immediately. If a second-generation member is a candidate to become CEO eventually, an interim CEO will be needed to bridge the age gap. Ideally, the interim CEO's role should be as a mentor with the dual objective of managing the company and grooming his or her own successor.

   Nonfamily board members can also be a great resource. In one Latin American conglomerate, a nonfamily board member has coached successors and their relatives through two generational transitions.

   There are many approaches for involving second-generation members running an enterprise. One preferred way is to employ them in the business as early as possible so as to soak up the DNA of the firm. This can be a highly effective way to produce committed and knowledgeable family executives who rise through the ranks to become successful CEOs. In my experience, however, it is much better for the next generation to gain work experience in a "market test" of three to five years working outside the family company. This helps younger managers prove their worth to themselves and others, among other benefits. Either approach depends on the presence of a strong development program and a meritocratic culture in which family members are treated like any nonfamily member and receive sufficient feedback and coaching.

Create an effective board

Creating an effective board of directors can be of tremendous help in carrying out a founder succession. A board seat also offers an attractive role for the founder when he or she ceases to be the CEO. An effective board is the best guarantee for a company's long-term sustainability. That said, effective boards are rare in the corporate world. The most effective ones have two characteristics in common:

1. They include a collection of talent that is both high powered and complementary. The team demonstrates deep expertise in both the industry and functional areas relevant for the corporation. If the board members do not bring skills, experiences, and networks to the table that are unique and that you today don't have, then you, as the chair, will never respect the board.

2. A greater time commitment than is usual is necessary for board members to maintain a deep engagement in strategy and organizational issues.

What does this mean in practice? Picture a core group of lead directors who typically spend 20 to 30 percent of their time supporting the founder in creating an effective governance and management system. Often this team starts with a single trusted adviser and develops from there.

Here's how one founder describes the way he thought about composing his board: "We are in global trading, so we need to understand geopolitics. Therefore we hired a former minister of the exterior for the board. We also engage in complex financing, so we recruited a recently retired CEO of a large investment bank. Our clients are often in the food industry, so we also hired two CEOs of large food companies. The board is small, but I call on the members for advice on all key decisions and expect them to be fully aware of what is going on in our industry and company."

Another owner surprised the market when he hired a senior veteran CEO as chair while he remained CEO for another five years. Why would someone hire his own boss? It was simple, the founder said: "We need an effective governance system, and I have neither the experience nor the time to run a board, so I hired somebody to do it."

Plan properly

While the CEO transition process unfolds, everything changes in the organization: leadership profiles, responsibilities, organizational structures, and processes for decision making. A similar change program takes shape on the governance side. But creating a ten-year blueprint for succession, with all the required governance and management elements, is not intuitive. You must clearly define the blueprint and manage it like any other project. A good plan will have at least four ingredients that you will be responsible for providing:

1. **A time frame.** One great family-business leader set a firm retirement age for himself. At age 70, he will hand the business operation to his sons and take on a nonbusiness role as head of the family council. He set this plan in motion when he turned 60. Working backward, he was able to put all the governance pieces in place, one by one. Oddly enough, he was the one urging his family that it was necessary to start early. The time frame also provided his sons the ability to gain relevant exposure and training across the businesses to prepare for group leadership.

2. **Vision.** Articulating a vision and values is of huge importance in helping you shape your business legacy. It will provide your board and management team with clear direction. And, if you formulate vision and values hand in hand with the succeeding generation, you'll give them a shared purpose and goals, which will encourage them to collaborate as owners and managers.

3. **Values.** The backbone of any generational transition is the ability to capture a founder's essential values while changing a company's modus operandi. This means that you have to articulate the

fundamental values and motivations that drove your success, so that the next generation of owners and managers can continue on that same path. In the words of Whitney MacMillan, the last family CEO of Cargill: “We have had the same values for 125 years, but changed our business every 5 years.”

Typical family values such as entrepreneurship, a long-term view, respect for the individual, and giving back to society can be brought alive by stories of defining events or attitudes displayed by the founder in his or her business. At one company, a son was tasked with gathering stories about his politically active father with the purpose of distilling the father’s core values. The son discovered a truly defining moment: a rival politician had sent a number of public auditors to his father’s company to find “something” illegal or incriminating. Yet they came away empty-handed. The father made it his company’s core value to adhere to every regulation and to follow every rule to the letter of the law. The son emerged from the exercise with a clear sense of the values his father held most valuable in running his company.

4. **A succession manager.** People tend to become more conservative with age. For founders such as yourself, this can mean a strong inclination to maintain the status quo. A founder might be deeply admired and respected by family and employees, but “overstaying” creates tension and frustration. Another irony: there is little others can do to make change happen unless the founder leads it. So while the founder will always be the prime mover of the succession effort, it is best to have another person manage the process. Enlightened firms have put together task forces to oversee the various elements of the institution building that the transition to the second generation entails. Typically, these are trusted advisers or board members, also supported by a senior individual who will manage the project of the transition, drive the process forward and monitor its progress, convene the right people, and create agendas with the relevant content.

Define your new role

Letting go of managing your firm is not an easy task. It is your baby, and it is hard to trust anyone else to care for it. The single most important thing to do is to find a new purpose, a new reason to get up in the morning and something to be excited about. Paradoxically, the most critical decision the founder has to make for the sake of business longevity is the decision to let go.

A fair degree of soul searching is needed to answer the question, “What do I want to do in the next phase of my life?” Your children and spouse, or indeed an old friend, can be of great help in finding new passions, either outside or inside the family business. For some, choices may fall in the social or public arena. Some simply want to enjoy life. For others, positions with either less or no decision-making power in the firm may be of interest. Still others may be particularly gifted at maintaining certain external stakeholder relations that are critical to the business. They might have functional skills that can be applied to special projects. Alternatively, they might see themselves as teachers of the family and business values to new generations. Many founders remain energetic at an advanced age and are willing and able to play major roles. This is great, as long as it is not in the role of CEO or of an overly executive chair—these roles are likely to be detrimental to the ultimate goal of creating a sustainable institution that survives its founder. In my experience, the best approaches focus on the legacy you want to leave behind, which for many founders is the perpetuation of your creation. If you’ve created a succession team dedicated to your goals, don’t be afraid to delegate power. You won’t mourn its loss if your goal is achieving sustainability for the company you founded. Instead, it becomes an important contribution to your legacy, and hence an act to be celebrated.

Changing relationships in the family

Letting go is an emotional process with rational consequences. If the succession approach is overly rational, it will probably fail. This is as much a “heart” as it is a “head” process. Unarticulated and taboo emotions (such as fear of death or intergenerational competition) can stump its progress. One founder addressed the issue of competition by moving to a faraway continent to build up a new business unit when his son took up the role as group managing director. He reasoned that they would probably get in each other’s way if he stayed at home and that they would risk overdependence in either direction. The physical distance he created gave him a chance to build a new relationship with his son—as a mentor and father rather than a manager. Both of them were thus able to grow in their new roles.

The spouse of another founder could not bear the thought of having her retired husband hanging around the house to “bug” her and urged him to stay in his position as long as possible. Not until they had an open conversation to figure out the ways in which they could shape their activities as a retired couple—and devote more time to their personal relationship—was the founder able to let go. Resistance to change can come from many sources, some more visible than others. That is why it is important to consider succession from all angles.

For succession to happen smoothly between generations, it is critical that the incumbent and his successors abandon a parent-child relationship in favor of a more balanced interaction between adults. Ideally, the new relationship should ultimately place more focus on close family ties, which typically have been overshadowed by work-related matters. The superior-subordinate relationship ideally morphs into a hands-off mentoring relationship, which balances autonomy with gentle guidance. The first step in this direction is having an honest and open dialogue about mutual expectations and desires for the future of the business, as well as both individuals’ roles in it.

Kris, I hope these points help you as you ponder the task that awaits you in orchestrating your own succession, and that this memo will serve as a useful checklist as you put your plan in motion in coming months. You’ll shift your thinking from building a business to building a legacy, from managing an organization to creating an institution, from focusing on the present to focusing on a future in which you will no longer be running the business. So much of it depends on your own personal transformation, about making mindful choices, and about knowing what you want your legacy to be.

In the meantime, I’ll reach out to some founders who have made the transition and will be happy to share their experiences with you. And I’ll see you next month at our regular lunchtime discussion.

Yours faithfully,
Heinz-Peter

Heinz-Peter Elstrodt is a director in McKinsey’s São Paulo office. Copyright © 2014 McKinsey & Company. All rights reserved.

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Lessons from the *diwaniya*:
An interview with Sulaiman Abdulkadir Al-Muhaidib

The lessons of the father—and founder—continue to guide the present and future direction of this Saudi conglomerate.

Ahmed Youssef

Founded in 1946, the Al Muhaidib Group is a family-owned and operated Saudi Arabian investment company. The group began as an operating company focused on building materials and then entered the food sector in 1959. It is now a leading investment company with stakes in such major companies as the Savola Group, which supplies two-thirds of Saudi Arabia's edible oils and sugar, and SABB (a joint venture between Saudi British Bank and HSBC Saudi Arabia). The Al Muhaidib Group has also diversified into steel, aluminum, hardware, insurance, power, real estate, and private equity.

Based in Dammam, Saudi Arabia, the group has 15,000 employees and some 200 companies in its portfolio. Sulaiman Abdulkadir Al-Muhaidib, eldest son of the founder, is the chairman; he is also a member of the board of directors of SABB and chairman of the Savola Group. Family members, including his two brothers, hold other key positions. In this interview with McKinsey's Ahmed Youssef, he discusses the importance of trust and how to weave together different generations.

McKinsey: *What are the most important lessons you learned from your father and would like to pass on to future generations?*

Sulaiman Abdulkadir Al-Muhaidib: Our father was a visionary and taught us a number of lessons, which we only came to appreciate as we progressed in our careers. Many of these lessons were derived from the way our father raised us and engaged with us at work. He got us used to a disciplined way of working.

At the beginning of my career, I used to go to the port every day at around 4 AM and wait for the first ship carrying building materials. We would have breakfast with the hardworking frontline laborers. As soon as the ship arrived, we would negotiate with the suppliers before the products were off-loaded. When the trade was completed, we would check around the port for names of agents, sources and destinations of the ships, and materials carried. And we would roam around looking for potential clues about the competition, such as product price tags. Later in the day, we would frequent the different retailers and traders and listen to their conversations; we would spend time at coffee shops where traders discuss and exchange information. In the evenings, we would be at the *diwaniya* (the reception area for business colleagues), pouring coffee and tea for our father's friends and listening to their conversations.

We learned a lot from this, but we only realized it at a later stage. Several lessons stuck with me from that period. First, focus on what matters. After our visits to the traders, my father would always ask us to recount what we heard. Based on that, he would advise us to increase our visits to some stores and reduce visits to others. I realized only later that my father was encouraging us to develop stronger relationships with traders who discussed business and to reduce our exposure to those who were wasting time and gossiping.

Another lesson was about the value of rigorous discipline. There is an Arabic expression: "Fortunes are distributed before dawn." This means that success comes to those that grab opportunities earlier than others. The fact that we used to start early would allow us to get access to the materials we needed, avoiding off-loading and storage costs.

My father believed you should roll up your sleeves. He taught us the importance of being on the front line, not staying in the office, to learn the business. We had our sleeves rolled up every day, engaging with every person involved in our business regardless of rank or status. Whether it was breakfast with the construction teams in the morning or discussions with drivers waiting to carry the loads or spending time with the merchants in their shops, every moment was important and a learning experience. We sought every opportunity to learn our business. We want to embed these values in our children and make them understand the importance of working on the front line.

The importance of building trusting relationships was another lesson. In our relationships, we didn't differentiate between people. From senior executives to frontline employees, every person plays a critical role. Frontline employees are usually much more important when it comes to getting things done because they know the trade. Understanding their challenges allows us to do our business better and gave us credibility with them. We were brought up to respect everyone and to develop trust at all levels.

Finally, choose the right people. "People who don't achieve something for themselves will not achieve something for you." My father always liked this Arabic saying. He wanted us to work with people who are hungry to develop and achieve something for themselves. This was a guideline in choosing the people we work with, the partners with whom we engage. It is also important to instill that in our children.

One more thing impressed me about my father: his foresight. He used to say that he had one wish in his life: to wake up every 50 years from his grave to see how the world and technology have evolved. He believed in investing in the future. I remember once we were considering whether to buy a fax machine, which at that time cost thousands of dollars. My father said no, we should not buy one—we should buy three for each office.

McKinsey: *You mentioned the importance of people. How do you go about finding and working with business partners?*

Sulaiman Abdulkadir Al-Muhaidib: Partnerships can have a highly positive compounding effect on the business, but they are not always easy. We have a few principles that we keep in mind.

First, set a clear direction and role from day one. It's important to accept taking a backseat sometimes, while being the lead driver at other times. Sometimes, we bring the vision and direction, but we need help executing. Other times, we bring the network and market knowledge, while others bring technical expertise. These roles have to be defined and respected. They can be reviewed, if necessary.

Second, partnership is one thing and friendship is something else. Just because a company is a successful partner in one business doesn't mean that partnership can be extended to others. We have several long-standing partners whom we respect and cherish, but they are not in all our businesses.

Third, identify conflict early and try to address it. Letting it linger and hoping that it will solve itself doesn't usually work and can cause more pain in the future.

Also, I've spoken about trust. My father held himself to a high standard. He emphasized that trust needs to be earned with every person. During the days at the port, we built strong trust with small buyers by keeping our commitments. Sometimes after the morning rush, traders would lower prices to complete their inventory. We used to promise our clients we would match that price the next day so that they would not miss out. We kept our word. Building trust requires commitment; it means keeping promises, not just making them.

McKinsey: *You and your brothers are the second generation. There are more than 30 members of the third generation, many of them already influential in the business. And the fourth generation is growing up. What are you doing to ensure that they are ready to be the future custodians of the business?*

Sulaiman Abdulkadir Al-Muhaidib: We have invested significant time and effort working with advisers, executives, and friends to find ways to engage the next generation and to make sure they are equipped to lead the business. We have encouraged the right third-generation members to take roles in our diverse businesses and investments. We are also encouraging them to take risks and be more entrepreneurial. There are a number of other things that we have done and that continue to evolve.

For a start, we exposed the third generation to the world outside Saudi Arabia and equipped them with the right education. Success in our country and region requires interactions with many different nationalities, cultures, and types of people. Hence, we focused on providing them with the exposure that we didn't get when we were kids. Most went to the US, Canada, or Europe for schooling and university. In fact, many of the cousins lived and studied together, starting in their high-school years in Montréal. This exposure to the world from an early age will give them an advantage as they become leaders. We don't leave this to chance.

It's also important to understand where their passion lies and where they can be successful. We have established a formal structure, through our education and development committee, to capture the younger generation's interests and capabilities. We administer standardized tests and we speak to their direct managers (for those employed in or outside the business). We also have sessions with them (with siblings available for consultation) and try to get an understanding of where they can be successful and happy as we slowly guide their careers. Sometimes, for example, starting their career in the family business may not be the right thing. In this case, we help them find roles with banks, consulting firms, investment firms, or in companies that operate in industries we are interested in.

We don't shy away from creating new businesses where we feel the third generation can deliver results. Our father taught us to take risks very early on. My siblings and I remember wanting to enter the wood business. My father didn't challenge us. He just requested that we spend time with the wood traders and the carpenters to understand the business. Then, he let us sink or swim.

We are using the same approach. For example, some third-generation members were successful in investments and are passionate about expanding into venture capital. We believe the market is ready and they are ready. So we are supporting them.

Sulaiman Abdulkadir Al-Muhaidib

Vital statistics
Born on February 23, 1955, in Riyadh, Saudi Arabia
Married, with 8 children

Education
Riyadh University

Career highlights
Al Muhaidib Group
(1976–present)
Chairman (1997-present)

Fast facts
Awarded honorary doctorate from the University of Tokyo in 2012 for his contributions to the Middle East

Board memberships include the National Industrialization Company, the Riyadh Cables Group of Companies, ACWA Power, the Prince Salman Center for Disability Research, and the Centennial Fund, which supports young Saudi entrepreneurs

Passionate about tracing family connections and linking past and future generations; instrumental in bringing together other family-business groups in the region under one umbrella to share ideas and experiences about their businesses and family ties

Finally, family unity is critical for us. It is important that our children feel close and feel some attachment to the family. We have a yearly event where we invite all family members, even newborns. Every event has a theme, and the aim is to keep that family unity. As an example, during one of the events, we encouraged and financed young family members to run their own project for charity. It was wonderful to see all the ideas they came up with. In addition, the cousins and siblings organize their own events and trips, mixing fun and professional development. This is managed through the family council, a forum for second- and third-generation members to discuss such issues as the development of the younger generation, philanthropy, and the like. It is similar to a shareholder council.

McKinsey: *What is your main wish for the family and the business?*

Sulaiman Abdulkadir Al-Muhaidib: I wish for a smooth transition to the next generation. This is the real test. We will do whatever it takes to make it work. Success in the business and the family will come from that.

We have done most of the structural work to prepare the third generation. We have set up the right governance structure. Our board includes both the family and highly respected and experienced external board members. We have established governance within the holding and for our businesses. Our family affairs are in order, and we have an effective family council. Our shareholding structure is solid, and we have started transitioning ownership to members of the third generation—they already hold 20 percent—so they can feel like owners.

This is important, because some members are executives. But being a shareholder is different; it is a much bigger thing than being a manager. Shareholders tend to have a longer-term point of view; they need dividends, not just income. They see the business as a whole, where an executive concentrates on a specific business unit.

Looking ahead, we need to ensure that we select the right leaders to succeed the second generation and that we maintain one another's respect. By that I mean respect in absolute terms and also respect for our traditions. This will allow us to manage the succession and to deal with our conflicts.

We are confident that we are doing the right things. We have a lot to learn, but my brothers and I are committed to making this transition a success.

McKinsey: *What is your biggest challenge in that transition?*

Sulaiman Abdulkadir Al-Muhaidib: I am not so much concerned about the business. We are doing our best to build capabilities that allow our companies to compete. The business environment in Saudi Arabia is favorable, and our national products are increasingly attractive. We are also building our human capabilities—not only of family members but also of executives and employees in our portfolio companies.

The challenge, then, can be expressed as a question: How do we transmit and immortalize the values of our father? My brothers and I lived with our father and mother in the same house. We experienced the stories. Our children and grandchildren have not. At our last retreat, we told family stories, and our kids loved it. It was inspirational. We want this feeling to last with them and across generations. We are considering a book about our father. Maybe this will help. We are open to ideas.

Ahmed Youssef is a principal in McKinsey's Dubai office. Copyright © 2014 McKinsey & Company. All rights reserved.

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Building a house that lasts:
A framework to guide a succession from few owners to many

When it's time for a family business to bring in a new generation, the ensuing complexity can pose a threat to survival. Here's how to improve the odds.

Åsa Björnberg, Heinz-Peter Elstrodt, and Ahmed Youssef

"Every chain is only as strong as its weakest link." The old adage remains apt for family businesses,[1] whose weakest link is typically between the second and third generations of ownership. Nowhere do the dispiriting seeds of value destruction take root as quickly as in this transition, which eventually results in the problematic fact that only about 13 percent of family firms make it past the third generation.[2]

At the same time, perhaps at no other point is there a better chance to renew a family company than during this transition. As the members of the second generation get older and their time horizons shrink, the energy of their descendants can be a force for revitalization. They are thinking 20 and 30 years ahead and may have a better grasp of the contemporary forces that are shaping the economy. It is a tricky period but one with as much opportunity as danger.

What makes this transition so difficult? In a nutshell, siblings in successful second-generation firms are confident in the benefits of family cohesion and are able to manage collective ownership. They are adamant about following the traditions of the founder and preserving the legacy of his or her outsize personality. They tend to value the family business as the best vehicle for investing their wealth.

In the transition to cousins and other third-generation owners, this dynamic begins to change. The owners are more numerous, of course; siblings are few, and cousins are many. And they are more diverse by measures such as age, geography, needs, and interests. What was once a close-knit group of owners takes on more of the look of a broad partnership. As one second-

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[1] We define family businesses as those in which a family owns a significant share and can influence important decisions, particularly the election of the chairman and CEO.

[2] John L. Ward, *Keeping the Family Business Healthy: How to Plan for Continuing Growth, Profitability, and Family Leadership*, second edition, New York: Palgrave Macmillan, 2011.

generation owner put it, “We cannot expect our kids to make all business decisions over a Sunday lunch, like we do.”

The business itself may be changing, too, becoming larger, more diversified, and increasingly complex, presenting new strategic challenges at the very moment when the firm’s management capabilities are under stress. It’s little wonder then that many family firms go off the rails at this point in their evolution.

Improving this record is a pressing challenge. Latin America, Southeast Asia, and the Middle East saw fast economic growth and significant industrialization in the 1960s and 1970s. A number of companies from that era are now being run by elder siblings, many of whom succeeded a single controlling shareholder. The third-generation transition looms large.

In this article, we attempt a comprehensive review of the major challenges of this transition and examine how to turn them into opportunities. First, we consider the dynamics that makes this transition especially difficult. Second, we home in on the four areas where, in our experience, the generational tensions most often emerge, and firms most often fail to deal with them. Third, we lay out a comprehensive governance system that all successful large family-business systems sooner or later have to implement. Finally, we describe the step-by-step process of setting a healthy transition into motion.

It is our hope that family businesses whose third-generation owners are still young will find this article helpful in understanding the difficulties to come; leaders of these companies may want to focus especially on the proposed governance model. For those firms that are already working through this tough transition, we hope that the discussion of the problems that other family businesses are seeing will help them anticipate some of the potential challenges and head them off before they can turn into real problems. In both cases, the goal is a house for the ages: a family firm with the resilience to endure the forces that can undermine its foundations and cause it to topple.

As the family business ages, tensions emerge

When cousins enter the stage, the family must resolve a number of tensions (Exhibit 1). Some of these may have been present all along but were suppressed in the name of family unity. Some may result from the surge in size and diversity in the ownership group and the emotional distance between the third generation and the founder.

In our experience, this crucial transition often exposes (or causes) four critical tensions:

The business as a source of pride and an unquestionable tradition versus the business as a financial investment. This intergenerational tension can bring the very purpose of the family business into question. The fundamental issue is whether the family wants to own a company together. Both centrifugal and centripetal forces (or fragmentation versus cohesion) are at work.

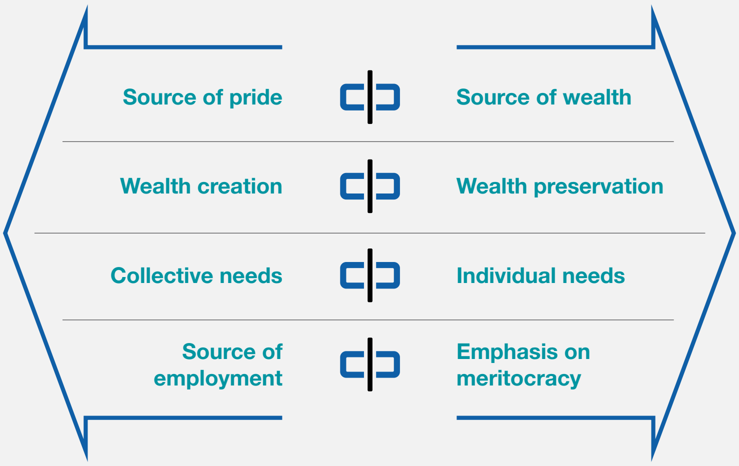
Growth, risk taking, and wealth creation versus liquidity, risk aversion, and wealth preservation. This tension exists between and among generations. Some of the new owners, often those in executive roles, might want to increase the economic value of the business and therefore take risks and forgo liquidity. Others might prefer to focus on dividends. The swing of the pendulum between these two poles determines whether surplus value is reinvested in the firm—that is, whether value is returned to shareholders in the form of regular distributions (liquidity) or retained for the purpose of creating additional wealth. If the balance tilts toward the pursuit of growth, the family would also at some stage probably need to relinquish full control, for example, by selling some stock to outside investors. This tension also prompts questions about the business model. The family must decide if it wants to continue to operate its businesses or step back to become investors first. Second-order questions follow: for example, should the firm have a single investment focus or should it diversify?

The business as a source of employment and power versus the need to have a meritocracy in order to be competitive. Some owners may view the business as a source of employment; in so doing, they put the needs of the family above those of the business. Should the policy on family employment be strict or relaxed? In one family business, painful past experiences of having to fire family members brought about an exceptionally strict employment policy for new generations. In another, the notion of providing for the family and staying close has meant that the entry rules are more open.

The comfort of consensus and collective needs versus individual freedom, agility, and the delegation of power (which requires a great deal of trust and common purpose). This tension often becomes exposed in decision making; some families cherish consensus, but with more owners involved, they are forced to trade that approach for speed. For example, the Odebrecht Group, a third- and fourth-generation conglomerate in Brazil (see “A principled way of life and business: An interview with Emílio Odebrecht”) operates with a highly delegated decision-making structure. It works because all owners in this large group have bought into the system, and there is a high level of trust.

As if all this were not enough to think about, family members also have to manage multiple roles. The classic scenario of wearing three “hats”—family member, owner, and manager, sometimes all in the same person—is a well-known source of difficulty. For example, an aunt may struggle to step out of her role as a caring and nurturing family member and into that of the straightforward manager delivering negative feedback to her nephew. It takes a great deal of self-awareness and equanimity to manage these conflicting roles.

Exhibit 1 Critical tensions emerge in the transition from siblings to cousins.



Key issues in the transition

During the transition, it can seem as though issues are bubbling up everywhere. In our experience, however, there are four areas in which tensions emerge in their most naked, and therefore most addressable, form. Left unaddressed, these will build over time and eventually defeat even well-laid plans for ongoing success. On the other hand, companies that get ahead of the game by dealing with these issues before they become major problems improve both their competitiveness and family cohesion.

Here are the four areas where tensions must be called out and defused:

1. **Values.** The family must define and, where necessary, revitalize its values to provide cohesion.

2. **An escape valve.** The family must create ways for family members to access their wealth, and even exit the business while preserving economic value for the remaining owners.

3. **Portfolio management.** The family must find a corporate strategy that reflects its unique circumstances and needs.

4. **Talent management.** The family must strike a balance between its needs and those of the business, through a plan that aspires to meritocracy while also allowing family involvement.

Define and revitalize family values to provide cohesion

In times of change, the positive values that may date back to the founding of the enterprise can be fundamental to survival. Values are beacons that illuminate the company's direction and guide its high-level strategic decisions. Rallying shareholders and company employees around a clear set of values is a powerful force for stability. When communicated clearly, they create a link between the past, present, and future; unify owners and managers; and define the corporate culture. Values are part of the "family capital" that differentiates these businesses from other kinds; they are intrinsic to their competitive advantage.

Working to agree on a set of values involves some soul searching and can work beautifully to build cohesion when both generations are involved. In one Asian family, the next generation played a vital part in formulating the values of the family and challenging the whole family to live by them. The conglomerate had for a long time actively promoted the role of women in their workforce but had a shareholders' agreement that enabled only male members to inherit. In the family assembly, the youngest female member pointed out this discrepancy. When she had finished talking, the male cousins proposed a change in ownership succession. The men were willing to give up a substantial part of their ownership to live this core value. The senior members listened, agreed, and changed the rules on the spot. The family then proceeded to formulate an entire ownership philosophy based on unity, fairness, and the collective good.

The most compelling way to transmit family-business values is to put them to work in the business. OCS Group, a fifth-generation global facilities-management business based in the United Kingdom, is organized around the needs of its customers and is based on the founder's vision to build trust through delivery. This core value means that the frontline staff is regarded as the most important connection to the customer. In fact, CEO and family member Chris Cracknell sees his role as the servant of the staff, once remarking in a room full of window cleaners and other maintenance personnel: "I'm probably the most dispensable person in this room."

The values of transparency and two-way communication are upheld by initiatives such as "Lunch with Chris"—a chance for all employees to ask questions of Cracknell and get answers. There is also a whistle-blower number leading directly to the CEO for workers to lodge complaints.

To uphold its values, the company runs a yearly award scheme called ABCD, or Above and Beyond the Call of Duty. One year, a cleaning-staff member won by being the only person to make it to work one day—on skis, when all of Scotland was snowed in. The CEO and chairman attend this and other award ceremonies in person.[3]

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[3] *Family Business Honours: Case Studies of 2005 Winners*, JPMorgan Private Bank, Institute for Family Business, and the London Business School, 2005, london.edu. OCS Group received the 2005 Family Business Honour for excellence in family governance, social responsibility, and business success from JPMorgan Private Bank in association with the Institute for Family Business and the London Business School.

Another company, a 120-year-old fifth-generation firm, puts its emphasis on transmitting values to future shareholders at a young and receptive age. The company realized that trying to communicate with teenagers is difficult—a finding to which many parents can relate. Instead, it connects with its youngest members at an early age—five or six—when values are formed. It uses cartoons and comics to bring these youngsters into the fold, showing them what the family is all about.

Philanthropy offers another way to build cohesion through values. Business-owning families routinely engage in philanthropy because doing so is part of their values and also because they see themselves as part of the community. If this leads to strengthened business relationships, it is a welcome consequence, but it is rarely the intrinsic motivation. In the words of one Middle Eastern executive: “Our family came from nothing, so we want to help other families in the region who have nothing.” Many firms also use philanthropy as a vehicle to involve family members who do not work in the business. This is an excellent way to strengthen family ties and keep values fresh, particularly at times of generational change. Finally, philanthropy provides a platform to bring family owners and nonfamily employees together in an informal and inspiring way.

Lest values be seen only as abstract concepts, they must be made visible and put into action. This can take many forms. Third-generation members of one company in the Middle East, for example, videotaped interviews with their elders to gather stories that exemplified the family’s values. The family compiled these stories into videos and a book that celebrate the family’s values in the past, present, and future. The family shared the book and videos, along with photos and artifacts from the founder’s era, at its annual family meeting. A sixth-generation British company deploys long-term employees as “cultural ambassadors” who introduce new hires to the history and values of the company.

Create options to allow family members to access their assets

To maintain cohesion and minimize disruptive battles as the business grows more diverse, family members should always be able to access a portion of their stake—or all of it, for those who wish to exit the business. Without such a release valve, individual shareholders may become disgruntled and cause ruptures detrimental to both family relationships and business performance.

In many cases, the family does not want the shares to be sold in the market but also does not have the means to buy major blocks of shares. Therefore, the family business may have to arrange for liquidity. The place to start is with an overall philosophy of ownership. For example, a family might consider inheritance an obligation as well as a right. When family members want out, the most important issue is to protect the interests of those who stay and maintain control in the family. This principle has the practical consequence that exit comes with financial penalties. Taken to the extreme, ownership can be abolished altogether and all assets placed into trusts or foundations, with the family being the beneficiary or the guardian.

Given the seriousness with which they treat the obligation, families often decide that any sale of shares should only take place between family members and should be easy to execute. One American family business that followed this philosophy allowed sales of shares only within the family, for half of book value. Over many years, family members committed to the business used this rule to buy out—rather inexpensively—those who were less interested, keeping the company in the hands of a small, committed group. An example of a different basic principle is to make sure that family shareholders can get full economic value relatively easily and quickly. That principle results in an entirely different model, in which family members hold shares in publicly traded companies with few strings attached.

Exhibit 2 Family businesses have many options as they build a policy for members to access assets and exit the business.

Parameters	Loose control → Tight control			
Timing	**Ad hoc:** At the seller's request	**Structured buyouts:** Periodic liquidity event every few years or once a generation	**Minimum shareholding limit:** All shareholders below a certain threshold (eg, 3%) are forced to sell	**Inheritance for noneligible owners:** Forced buyback
Prioritization of buyers	**Any eligible shareholder**	**Own branch**, then **other branches**	**Own branch** only	
Funding options	**Company funds:** Equity or debt	**Redemption fund:** Liquidity pool managed by the company	**Seller credit:** Staggered payment (up to 5–10 years depending on the amount)	**Internal market:** Facilitation between sellers and buyers
Valuation methodology	**Market value:** Assessed by a 3rd party	**Preagreed valuation formula:** Multiple of key financial metric (eg, 4x earnings before interest, taxes, depreciation, and amortization)	**Book value** (or multiple of)	

Once the ownership philosophy is clear, families can then address issues of timing, buyer selection, funding, and valuation (Exhibit 2).

There are no cut-and-dried rights and wrongs about how to do this; the choices depend on the family and on business preferences, as well as local legal circumstances. However, there are some practices that make sense. First, shares are typically sold at a discount to protect the remaining shareholders. Second, to prevent mass exodus and depletion of firm funds, families set caps on how much stock can be sold at a time, and buyback payments are normally staggered.

In one business with more than 150 shareholders from seven different branches of the family, the owners created an internal market. Those who want to sell must offer their shares first to their own branch (for example, descendants of the brother of the founder), which has the right of refusal. If this branch passes, the wider family is offered a chance to buy. Failing that, a trust buys the shares; the returns on the trust's shares are used to fund a long-term incentive program for nonfamily executives.

Whatever the specific rules, it is important that these are codified and communicated in a shareholders' agreement to prevent surprises or disappointment. Even when there is an overarching philosophy to guide the process, the content can be detailed and complex. Lawyers will therefore be required. Legally implementing a full shareholder agreement typically takes at least a year.

Find a portfolio structure that accommodates family and individual needs

The classic structure of the second-generation business is for each of the interested siblings to manage a discrete portion of the business, usually divided by sector. As a portfolio-management approach, this is often good enough in the medium term. The businesses can typically be run independently, and more to the point, siblings often do not want to intervene critically in another's designated domain. Over time, however, the businesses' prospects diverge. Some siblings may have been fortunate; their portion may have been in a high-growth sector. Some siblings may prove to be excellent managers and may have lifted their business to strong performance. In both cases, some businesses do better, and some do worse, and the sibling group is prepared to live with those differences.

As the third generation enters the scene, that situation changes. Third-generation owners were not involved in the original division of the company, and their emotional ties to the businesses (and the uncles and aunts who run them) are weaker than the siblings' bonds. Moreover, they are not afraid to speak up and question why some businesses are doing so much worse than others. Cousins also have divergent needs and desires; some may want a cash flow from dividends, while others want to build something the way their fathers and grandfathers did. Cousins will often have more of a financial-investor mind-set than siblings; that leads them to look at the business portfolio largely with respect to its risk-return profile.

Another special characteristic of family businesses also emerges in the transition from the few to the many. Family shareholders are not like public-company shareholders. In many cases, they have more than 90 percent of their wealth tied up in the business; they are not diversified in the classic sense but achieve diversification (if at all) through the mix of businesses that the family pursues.

Institutional investors in public companies, on the other hand, are assumed to be diversified, and corporations design their strategies to provide shareholders with a pure (and hopefully competitively advantaged) exposure to the company's sector. Stray too far from this pure exposure and investors assign a conglomerate discount.

Put it all together, and the second-to-third-generation transition exposes the need for a new strategy. Getting there requires a fundamental change in mind-set. Creating a corporate strategy means looking not just at the pieces but at the entire puzzle. Which pieces should go? Which should stay? How should they be operated and managed? Typically, getting to a stable and rationalized portfolio of businesses entails the concentration of authority and influence in company management and in a board of directors invested with real power. The decisions they have to make can push submerged tensions to the surface, on whether to be operators or investors and whether and how to diversify. In addition, families have to focus on separating ownership from management.

Building a successful corporate strategy for the family-owned business requires a combination of top-down and bottom-up guidance. The top-down work is designed to get shareholders to agree on a set of aspirations and a definition of success. This is about the family's dream, its vision for the business, and must be articulated and then translated into such factors as risk-return expectations, liquidity targets, and sector positioning. In describing the dream, the family has to make hard choices to resolve its tensions—obviously, not a trivial task. Often, a part of the family will want to pursue growth, and another part will want to preserve capital. Both parts of the family will need to be considered in the construction of the portfolio.

The bottom-up work deals with the business's operational reality. It entails an evaluation of the current state of the business and its capacity. The assessment should include a determination of whether the business has the capital to fund reinvestment and whether it is operationally fit to enter into a new sector. At a basic level, many family businesses do not even understand all of their current holdings; obviously, it is difficult to manage a portfolio whose components are a mystery. The bottom-up analysis helps everyone in the family understand the chips they have in the game to come.

Once the aspiration and the assessments are done, the next step is to bring them together to find common ground. Throughout the process, it is important that family members—especially second-generation owners, but also those in the third generation—accept a "no boundaries" view when it comes to making choices. These choices might include selling businesses, investing in them, going into new sectors, or exiting altogether. Everything needs to be on the table.

Having reconciled the dream with reality, the final tasks of classic corporate-strategy development can begin: developing a portfolio and financial-investment plan, allocating capital, and setting performance metrics. Exhibit 3 shows the critical parameters for the construction of a portfolio and the allocation of capital. A distribution of capital across operating companies, financial investments, and real estate can help the family meet all its collective and individual needs. (Note that the family's final determination can create the need for a family-investment office, a subject that is discussed in the next section.)

Exhibit 3 The family-business portfolio can contain a range of assets to meet everyone's needs.

Value

	Where group allocates capital			
	Operating companies: Controlled	Operating companies: Noncontrolled	Financial investments (excluding real estate)	Real estate
Description	▪ Sector-focused operating companies where the group has full control	▪ Sector-focused operating companies where the group has a relevant but noncontrolling share	▪ Cash, equities, fixed income, funds, and other financial investments	▪ Income-generating properties ▪ Family real-estate assets (used by family and often managed by group) ▪ Land bank
Levers	▪ Active ownership ▪ Realization of synergies ▪ Capital allocation		▪ Stock/investment picking ▪ Capital allocation	▪ Trading (land) ▪ Development ▪ Access
Measures	▪ Income growth ▪ EVA[1] ▪ ROIC[2]	▪ Appreciation and dividend payout ▪ ROIC	▪ Return above benchmark	▪ Yield for income-generating assets ▪ Value appreciation

1 Economic value added.
2 Return on invested capital.

Strive for meritocracy while balancing family needs

Many organizations deal with nepotism. In family-owned businesses, though, the issue is more visible because the protagonists are also the owners. Nepotism is not always a bad thing. Growing up around a vocation or a business can create a powerful sense of commitment[4]; family executives have a weight in negotiations with the outside world, due to their unique symbolic and cultural significance, that others do not have. On the other hand, nepotism can go too far if the untalented and the lazy, or those who are simply not particularly driven or suited to business, are promoted above their competencies. Hiring family members is not the problem; hiring (or not firing) the wrong family members is the problem. When the number of family members who are weak managers grows within an organization, it can bring down even a strong company.

One way to address the issue is to keep family members out of management altogether (Exhibit 4). The other, more common approach is to define third-generation employment policy around criteria such as education (typically an MBA) and some outside work experience. Then family members are evaluated, promoted, and paid based on the same criteria as outsiders, usually under the authority of a career committee composed of both the second generation and human-resource professionals. The idea is to develop a coherent strategy—and then stick with it. No exceptions.

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[4] Adam Bellow, *In Praise of Nepotism*, second edition, New York: Random House, 2004.

In our experience, the second option only solves one part of the problem. Making sure only competent family members enter management is a valid concern, but the bigger question is how to attract the best talent from any source. If the business is not considered meritocratic, it will not be attractive to talented outsiders. But family members who have outside credentials might not want to be part of a system dominated by second-generation owners, and they are often in a position to build their own businesses or pursue careers elsewhere.

Other approaches can also be effective. The "up or out" method offers jobs to all competent family members; after five to eight years of service, the family council (or a specially formed family-employment committee) provides guidance to senior leaders to determine whether family members have the potential to rise to high-level executive positions. If not, they leave the group, rather than remain in middle management. Another approach (not shown in the exhibit) relies on differentiated long-term financial incentives. Those incentives go to family members who rise to leadership positions, mimicking the operation of a private-equity fund. These executives become something akin to general partners, while the other family shareholders are treated more like limited partners.

Exhibit 4 Families have adopted different models regarding members' employment.

☐ Most common

4 common models	Description
Clear separation between business and family	▪ No family members in the business
Strict selection of future top executives	▪ Only the most capable family members who have the potential to become leaders can join the business ▪ Once they join, they are groomed to become top executives
Up or out	▪ Less strict entry criteria ▪ However, the criteria to move up the hierarchy are strictly meritocratic, and those that don't meet the bar are counseled to leave
Inclusive	▪ Any family member can join the business ▪ The criteria to be promoted are meritocratic, however, family members can stay in midlevel positions if they don't meet the high-level bar

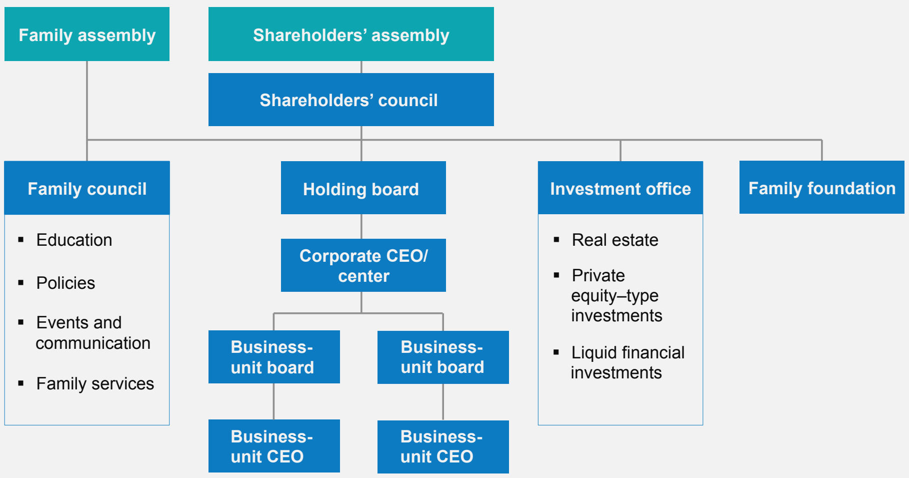
Few family businesses have built truly meritocratic cultures that are able to attract, develop, and retain the best talent, either from within or without. While total meritocracy is difficult to achieve, family businesses can build on their culture: our research shows that these businesses can be exceptionally value driven, cohesive, and appreciated by those outside the family. Experience shows that when members of the junior generation are offered autonomy and guidance, they thrive and stay. A comprehensive talent-management system—from entry through career to exit—is both more professional than the informal techniques characteristic of many family businesses and more attractive to ambitious young people.

Whatever the policy for employment, it is critical that the next generation gets exposed to it at an early age so that they can manage their expectations and have a sound basis on which to make life and career choices. Among cousins, the many will have to delegate executive decision power to a few, which requires trust. To create trust and self-awareness, the best family businesses make a sustained, long-term commitment to the development of the third generation, starting at an early age. Some organize workshops that last a couple of days every few months for those as young as 14. The goal is to build partnerships based on a common vision and values and to encourage the best talent to dedicate their professional lives to the family business.

A blueprint for governance

A comprehensive governance structure can help resolve the tensions that arise in the multigenerational family business (Exhibit 5). Pragmatically speaking, governance (which has already evolved from a one-man band, the founder) needs to include the concerns of the numerous and diverse third generation. By establishing a set of councils and boards to address critical transition issues, family businesses can address acute short-term challenges and prepare the business for subsequent generations.

Exhibit 5 Large family businesses can evolve toward a sustainable governance model.



Our discussions with scores of board members and managers suggest that most companies have some elements of this blueprint. Very few, if any, have all of them. In our view, when family firms reach a certain size and complexity—of both family and business—the adoption of a governance structure like that explained below is crucial.

Second-generation companies whose transition is on the horizon may especially want to give due consideration to a sound governance model.

Here are the core elements that are required:

Shareholders' assembly. Large family groups are typically governed by both a shareholders' assembly and a family assembly. The shareholders' assembly deals with classical legal functions. Owners are legally required to make decisions about the overall direction or vision of the company, how the ownership should be structured, large investments and sales of businesses, and dividend policy, among other issues.

Family assembly. The family assembly's purpose is to foster family unity; it typically includes spouses and the next generation. To instill family values into the next generation and raise responsible shareholders, everyone—sons, daughters, spouses, and children—has to be aligned on what this means and be an integral part of the process. Typically, the family assembly meets once a year at a weekend event with both a social and a professional agenda.

Shareholders' council. For family-business owners, a shareholders' council can be the most important link to the company because it represents the larger group of shareholders and makes fundamental decisions on its behalf. Its purpose is to regulate the relationships among family shareholders and also between shareholders and the business. The council consists of the most influential family shareholders; all sibling branches are typically represented.

As the intermediary between the family and shareholders' assemblies and the board, the shareholders' council can serve two purposes. Assemblies are about unity, first and foremost, and they will always want to align their recommendations and avoid divisive voting. The shareholders' council, which consists of representatives of all branches, takes on the hard work of exposing and overcoming these divisions. Second, as business complexity grows, the holding board has to be as meritocratic and professional as possible. Family shareholders may wish to see that the board is representative of all branches. The shareholders' council serves a vital role as a representative body of shareholders, relieving the pressure to have too many family members on the holding board.

In broad terms, the council is the guardian of the company and the family shareholder group; thus it sits at the center of the entire governance system. It does not make day-to-day operational decisions. Instead, it concentrates on long-term matters of importance to shareholders, including culture, values, risk orientation, and overall strategy, and then informs the holding board of its decisions. Its bread-and-butter issues are dividends, exit and liquidity policies, and the question of whether to stay private or whether (and how much) equity to float. It signs off on all major investments and divestitures and approves the appointment of the CEO and members of the board. The shareholders council not only decides on the role, composition, and nomination of all key governance forums but also promotes annual performance evaluations of those forums and its members.

While the decisions of the shareholders' council can be momentous, they are infrequent. The council does not meet often; once it is up and running, twice yearly is typically enough. The number of members is usually small and often reflects the number of branches in the family.

Holding board. This is the link between management and the shareholders' council. The holding board is responsible for the overall performance of the group and its CEO. On its agenda are the fundamental dimensions of the corporation, such as portfolio strategy and finance, people, and compliance matters. Because the holding board has an overview of the entire portfolio, it also allocates capital. While the shareholders' council gets the last word on major issues—the holding board often has a cap on the size of the decisions it makes—it is influential on how these are presented. For example, in one company, the holding board approves mergers, acquisitions, and divestitures below 10 percent of the company's market value. Above this level, it makes recommendations to the shareholders' council, which then decides.

A board composed only of representatives from the different family branches will often not have all the skills needed for good decision making, so it is important to bring in some external board members. External members can also be more dispassionate and assertive about dealing with issues that relatives might prefer to avoid. Board composition should reflect the diversity of the group's holdings, whether related to function, industry, or geography. The holding board typically meets four to eight times a year and is often supported by committees that specialize in areas such as finance or personnel; these prepare the board's decisions.

Family council. This group has two main tasks. First, it is an important communications bridge between the business and individual family members. It devises policies regarding family members' behavior vis-à-vis the business, such as employment, use of the family name, and conflicts of interest.

Second, the family council encourages cohesion. In one business, it sponsors a committee that puts together regular seminars about the business and organizes financial and practical support for the education of young members. Another family has a task force that is responsible for formulating policy on how family members can enter the business and manage their careers. A third organizes trips and events over the course of the year; these regular rituals bond the family both socially and, in this particular case, religiously as well.

Given the family council's mission of transferring values and traditions across generations, membership works best if it combines junior and senior members. In the beginning, it might meet every other month, then stabilize at one to four times per year depending on the size of the family and how many activities it plans. As with any group, the family council should not exceed ten members, to preserve effective decision making. In most cases, the council has five or seven members.

Investment office. This entity manages the family's assets other than the core business (cash, securities, real estate, and so on), allowing families to separate value creation (done through the holding board and the business) and wealth preservation. An investment office can also help to reduce tensions; it provides a sense of security to those distant from the business that their interests are being considered. There are many ways to structure an investment office; families can build their own, outsource to others, or go in with other families on a multifamily office (which can offer greater professionalism and better economies of scale without full overheads for running the office). Large firms are more apt to keep the office in-house, with a committee that oversees asset managers; others prefer to outsource to an independent entity.

The investment office usually provides estate planning, tax advice, and financial-reporting help to family members; it can also provide noninvestment help such as concierge services. Waycrosse, the Cargill family's investment office, has taken on many tasks that are often reserved for a family council, such as education.

Foundation. The foundation is responsible for the family's social and charitable investments. This is a complex topic that is addressed in a separate article, "Gaining strength through philanthropy: How emerging-market families can make a difference."

Once these fundamentals are in place, making the transition from generation to generation becomes a much more systemic challenge. Good governance, in effect, provides a map to the future. The journey, of course, is never easy, but having a sense of direction certainly helps.

Getting started

Kick-starting the change process is sometimes the most difficult part of the sibling-to-cousin transition. Ideally, aunts and uncles call the cousins together and say, "What has worked so well for us and makes us proud of what we have achieved will not work for you. You must go out and find your own model." When siblings are wise enough to give such a mandate, the cousin generation has a greater chance of enlisting support from the earlier generation and being successful. However, many sibling groups avoid or delay dealing with the issue, leaving it up to the cousins to organize themselves.

Often, but not always, cousins have the maturity, knowledge, and leadership to do so. Sometimes, though, the younger people in the group fear provoking conflict, or it may be that the third generation has become so large and heterogeneous that it is difficult to establish an organizational structure without provoking suspicion and resistance. Children's loyalty is often to their parents, for example, rather than to generational peers. There have been cases where highly educated and qualified cousins found the barriers to establishing governance structures so high that they actually left the business.

The first step in getting the governance process up and running is to develop a clear idea both of the status quo and of the desired destination. (This will likely look somewhat like the outline above.) That means identifying the key gaps in the existing structure, setting goals, and deciding what to do first. Only then is it time to build.

A practical way to move forward is to divide up the work into separate projects and then assign capable members to each. For example, one task force might be assigned to design shareholders' agreements that can serve well for generations to come. Another group might articulate values and educate next-generation shareholders; a third can focus on corporate strategy.

Each task force needs a mandate, a deadline, and a well-defined way to communicate with the broader family. A steering committee, ideally composed of both second- and third-generation members, will be needed to monitor the overall effort.

An inclusive process is more important than a speedy one. It is a good idea to study other families' experiences and to hold periodic meetings to evaluate work in progress. Initial development of governance structures and a business portfolio might take four to six months; full implementation will take many more months or years. It is nearly impossible to change all governance structures at the same time—better to take it step by step. Although this can stretch out implementation over several years, a more deliberate pace makes it possible to gain consensus and educate interested groups and individuals along the way. During this process, elders have to let go; younger people need to prepare themselves to assume leadership.[5]

The spirit of inclusiveness also determines the two-way direction of the process. On one side, the broader third-generation group should find consensus, then take its proposals to the second-generation leaders, who make the final decisions. In a number of successful transitions, the governance initiative came from third-generation leaders savvy enough to see the importance of the issue. In one instance, many third-generation members at a conglomerate were working in functional areas without much involvement at the corporate-shareholder level. So they formed an informal "cousins' group" to discuss business and family issues on a regular basis. At one point, the group sought to engage formally with the second-generation leaders; some of these leaders were enthusiastic, but others were disdainful. Eventually, after long and painful negotiations, the cousins' group successfully developed a governance blueprint with the second generation.

The process can also work well in the other direction. At another company, second-generation leaders collectively started a formal governance process and called in the cousins to develop a structure under their elders' guidance. Together, they lined up support to institutionalize governance and make a smooth transition.

■ ■ ■

Given the way that family businesses tend to become more complex over time, it is often up to third-generation owners to redefine the role of the family and the direction of the business. When successful, it puts the family business on a new trajectory for success. But it is almost always an emotional minefield. The healthiest companies deal with that reality—and build long-term value in the process.

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[5] The governance model we have outlined and the process to build one are adequate to resolve the tensions that plague many family firms. But it should be acknowledged that in some cases, no resolution is possible. If values are lacking or the situation is otherwise dysfunctional, there may be no point in trying to create a system to keep the business together. In such cases, it might be best to focus on selling the business or at least making it possible for unhappy cousins to exit.

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The importance of sharing success—and failure

A family leader discusses how he and his brother run a 180-year-old Philippine conglomerate.

Åsa Björnberg

The Ayala Corporation is the oldest and one of the largest conglomerates in the Philippines. Founded as an agribusiness concern in 1834 in Manila, the group has been involved in issuing the country's first paper currency, brewing its most popular beer, building its first ice plant, and opening its first ATM network. Today, Ayala's portfolio includes assets in real estate, banking, telecommunications, and water distribution.

A combination of patriarchs, matriarchs, and sons-in-law has stayed close to the business over the past seven generations and actively managed the development of the portfolio. The modern Ayala Corporation, which went public in 1976, has continued the company's tradition of seeking out new markets and new ways of doing business, albeit on a much greater scale. Individual businesses in the group have a high level of independence, but the family is still very much involved. Fernando Zobel de Ayala has been president and chief operating officer since April 2006, the same month his brother, Jaime Augusto Zobel de Ayala, succeeded their father as chairman and CEO.

In this interview with McKinsey's Åsa Björnberg, Jaime Augusto Zobel de Ayala reflects on his ownership philosophy, bringing the next generation into the family business, and how he works with his brother.

McKinsey: *You are a seventh-generation family-owned business that is essentially run by you and your brother. How did the family retain control over such a long period?*

Jaime Augusto Zobel de Ayala: We had a buyback event in the 1980s, which resulted in the share ownership becoming more concentrated. My father, great-aunt, and her husband reached an understanding to exchange shares for assets.

Following on from that event, our great-aunt, who was in the fifth generation, transferred her shares to us in the seventh generation. She and her husband had no children. As such, most of the ownership skipped past one generation, and the shares did not become as diluted as they would have in conventional generational transfers across many branches.

My brother and I are now the governing owners. We are the link between the family owners and the operating business, due to our executive-management responsibilities and our positions on various boards and committees in the business. We also have a shareholders' board where our father sits, along with other family-owner representatives.

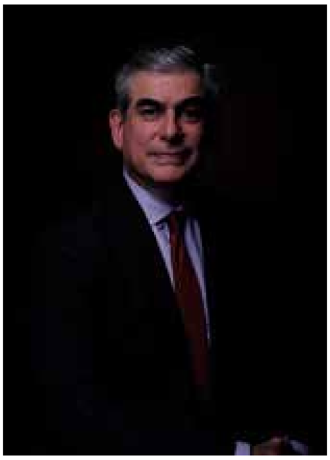
McKinsey: *How did you formulate your ownership philosophy and values?*

Jaime Augusto Zobel de Ayala: It began with informal family meetings that my father encouraged as a way to exchange views and share information. He felt we needed to have a more structured framework to exchange information, reach a common understanding on the values and principles that defined our actions, build trust, and create unity in decision making. We started by defining ourselves as a family unit, understanding our responsibilities, and reaching a common platform on the values that defined us as a family and a business. We wrote a constitution that encompasses these agreements.

One key component of this understanding is that we have a fiduciary role to add value, in a progressive way, to an institution that has been part and parcel of the economic history and growth of this country. This has been a strong part of our tradition and legacy. So, in a way, we are active and engaged caretakers. We also agreed that we have a responsibility, as defined among ourselves, to pass this heritage on to future generations. To be successful in this respect also means keeping the company dynamic, growing, relevant, and engaged in the economic future of the Philippines.

McKinsey: *One of the challenges for family-business executives is that they are owners, as well as governors, through board positions and such. How do you experience the difference between being an executive manager as opposed to a governor and owner?*

Jaime Augusto Zobel de Ayala



Vital statistics
Born in March 1959, in Manila, Philippines

Education
Received a bachelor's degree in economics from Harvard University in 1981

Received an MBA from Harvard Business School in 1987

Career highlights
Ayala Corporation
Chairman and CEO (2006–present)
President and CEO (1994–2006)

Fast facts
Named the Philippines Management Man of the Year in 2006

Won the Alumni Achievement Award from Harvard Business School in 2007

Was conferred the Presidential Medal of Merit for service to the Philippines in 2009

Jaime Augusto Zobel de Ayala: I'll be very frank: The transition from manager to owner was a challenge for Fernando and me, in the sense that we were always trained to be managers. We saw ourselves as capable professionals looking to add value as part of the executive team.

This started at a relatively young age for us. My grandfather on my mother's side was a very respected and capable civil servant, but he was not an owner. He brought up my mother and her sisters in the challenging economic environment of postwar Spain. This defined my mother's character and gave her a strong framework of values that were centered on education, discipline, hard work, and fending for oneself. It also created a strong sense of altruism in her, with a focus on the good of the community versus the importance of self. Thanks to her, my brother and I never had a sense of entitlement.

In fact, we experienced the exact opposite. Her worldview and upbringing defined the way we saw ourselves, namely as professional contributors to the business; it was never with any expectation about being owners. We were actually very happy to just be given the opportunity to grow professionally. We saw ourselves as professionals, and we educated and trained ourselves along that paradigm.

On my father's side, he grew up with a sense of the history and tradition of the family business. He also had significant international exposure in his life and education. He, in turn, helped define our commitment to preserving a family tradition but remaining attuned to global trends, education, and culture.

At a certain point, the transition to ownership did begin to happen, when my great-aunt and my father began to pass on the responsibility of ownership and governance to us. It happened rather fast. There was no real dialogue about it and how our responsibilities and roles would change. Fernando and I already had a good working relationship and a high degree of trust, and we just brought common sense to bear on defining the ownership roles between us. Over time, we found a winning combination. As we look to the future, we would like to be more deliberate in our handling of these issues for the next generation, where the complexities of a broader family group involve new challenges.

“And if we have failures, we fail jointly. Equally, our successes, in all cases, are joint successes.”

McKinsey: *When your great-aunt transferred her shares to your generation, did you discuss this transition with current and future family owners?*

Jaime Augusto Zobel de Ayala: It was important for us to anchor these new roles in a constructive way. We spent several family sessions discussing the difference between an executive role and a governance role. We discussed how family members could participate in a governance role without participating in an executive role. Essentially, we were saying that in the future, a family member did not have to be a full-time executive to have an important role on the governance side.

McKinsey: *What are your thoughts regarding the involvement of the next generation as employees in the business?*

Jaime Augusto Zobel de Ayala: We have chosen the approach of agreeing, as a family group, on matters related to leadership succession. We have used our family gatherings to agree on a framework that sets out expectations on education, leadership values, trust, stamina, resiliency, commitment, and intellectual capacity. In addition, we have encouraged engagement by, for example, opening up summer internships in the company to family members during their education. However, before they apply for any formal post-university jobs, we encourage family members to seek professional employment for at least two years outside of the family business. This allows potential next-generation members who are interested in business to prove their worth independently, in established institutions, and to build an independent sense of themselves.

McKinsey: *People use the term “roots and wings” in the family-business context, meaning letting the young generation try their wings elsewhere, but providing them with a place to return to. How do you see that?*

Jaime Augusto Zobel de Ayala: While encouraging independent intellectual and professional growth, one also has to create a structure that is conducive to family talent returning. One has to offer potential executive family members an environment where they can grow professionally and where they can put their personal passions and skills to good use. Bottom line, they have to be fulfilled as individuals whose skills are validated and recognized.

To accomplish that, there has to be a structured process to weave them back in. The moment one provides a professionally attractive structure with the added potential of possible leadership and governance, it becomes a mutually advantageous value proposition. If they have talent and they have spent some years outside the company, they already have the possibility of an independent career path. However, if they feel that the family business constricts their personal growth, it may no longer become an attractive proposition to work for the family business. We have to remain sensitive to this also.

McKinsey: *What’s it like working so closely with your younger brother, Fernando? It’s interesting, for example, that you both appear on many boards in the group.*

Jaime Augusto Zobel de Ayala: When the responsibility of ownership became a reality for us, we thought it best to define a working relationship that allowed us to share responsibilities. We have a portfolio of businesses in Ayala, so our structure is quite complex. We both built core competencies in different industries. But once the responsibility of ownership was given to us, we basically decided to divide up our lead responsibilities across different industry lines. We reached agreement relatively easily, and we continue to do it relatively easily as new opportunities and problems arise.

We currently each take a leadership role in different industries. For example, Fernando provides leadership across our real-estate holdings, and he defines the framework for strategy and board governance. I keep myself informed and provide advice as the vice chair of that industry. We often consult with each other and share advice. I also get more personally engaged when I want to learn more about an area of the industry that interests me or when a crisis needs us both to be engaged. The same takes place in the areas or industries where I provide leadership, like the telecommunication business or banking.

McKinsey: *How did you decide on who was going to lead which business?*

Jaime Augusto Zobel de Ayala: We divided it up roughly equally along lines of interest, experience, or convenience. At the holding company, I carry the title of chairman and Fernando carries the title of president, but, frankly, we make the decisions jointly there.

McKinsey: *How do you manage disagreements?*

Jaime Augusto Zobel de Ayala: We generally have governance roles together in most of our businesses, so we are jointly informed on most issues. Beyond that, we also use informal ways to keep each other informed, and we bounce decisions off each other. If we have a difference, Fernando and I discuss it privately and reach agreement. I don't think we've ever made a decision where the other person is uncomfortable with that decision without first reaching consensus. Of course, we'll challenge each other across a spectrum of ideas and settings, and I like to think that our end decision is the better for it. The same atmosphere, it is worth pointing out, also exists with our executive leadership team.

McKinsey: *What does it mean to have a sounding board in someone as close as your brother? Is there a downside?*

Jaime Augusto Zobel de Ayala: Leadership at the top, in any field, can be quite lonely and demanding, particularly when there are problems that need to be addressed. To be able to develop ideas, solve problems, and find solutions in an atmosphere of trust is very useful and effective.

The only negative, which is not that demanding, is that staff groups sometimes have to present twice, since Fernando and I have hectic travel schedules and cannot always be together. But we have worked out a good system to manage that, and communication is easier than ever with the use of technology.

And if we have failures, we fail jointly. Equally, our successes, in all cases, are joint successes.

Åsa Björnberg is a senior expert in McKinsey's London office. Copyright © 2014 McKinsey & Company. All rights reserved.

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Gaining strength through philanthropy: How emerging-market families can make a difference

Answering five questions can help families increase the impact of their giving.

Naina Dhingra,
Doug Scott, and
Lynn Taliento

Philanthropic giving has become a focused and strategic undertaking over the past few decades. One indication of this trend is that more and more families are institutionalizing their philanthropic activities in the form of trust funds or foundations. In emerging markets in particular, there is an enormous amount of activity—but not nearly as much experience as in countries where structured philanthropy has a longer history.

In our work with emerging-market philanthropists, we have noticed how philanthropy can strengthen and deepen family ties and improve the performance and health of family-owned business. And we believe that these efforts can make a major difference, particularly in their home regions.

Effective philanthropy, whether it is done by establishing a family foundation or through the family-owned business itself, requires many of the same skills as creating a business. The process entails defining the problem and then crafting an approach to address it, using professional management and fact-based decision making. Those who recognize the importance of this process are more likely to see their foundations succeed and endure. The first step is to articulate their underlying values. Only then will families be able to identify where their efforts can do the greatest good and determine which structure best suits their goals.

In this article, we discuss trends in philanthropy in emerging markets and offer five strategic questions for families looking to improve their chances of making a difference.

An emerging force

While the concept of individual philanthropy typically brings to mind billionaire Americans such as Warren Buffett and Bill Gates, the next frontier is in emerging markets. People such as Mo Ibrahim (Sudan), Hüsnü Özyeğin (Turkey), and Carlos Slim (Mexico) are becoming major players in the field. With fast and sustained economic growth in many emerging markets, there is more money to spare—and a growing commitment to share it.

There is a long history of philanthropy in emerging markets. What is changing is the extent to which it is becoming organized, often through family-owned businesses. This has its challenges. Wealthy families that historically made donations privately now want their children to understand why and how to give, but they may not know how to engage the younger generation. Other families want to give away significant sums but are conflicted about how visible to be. Some Gulf State donors believe that, for ethical reasons, philanthropy must be anonymous; in other cases, donors worry about being embarrassed if their efforts fall short. In countries with relatively few philanthropists, some families worry that public giving will only lead to more pleas for funding.

Despite these difficulties, the number of family foundations outside the traditional philanthropic centers of Europe and North America has soared as cultural mores change and families become more aware of the advantages of a structured approach to giving. Younger generations in particular are often keen to create independent family foundations; they are aware of the power of philanthropy done well and see this as a way to contribute to the family enterprise.

Family-owned businesses have established six foundations in the United Arab Emirates and three in Saudi Arabia, each with an endowment of at least $1 billion. In India, in 2012, more than 70 percent of donors had less than three years of grant-making experience. Wealthy Chinese businesspeople are also getting in the game, albeit more slowly; recently, a private company announced the formation of a $3 billion foundation, the country's largest. Almost half of Brazil's foundations were first registered after 1999.

Reasons for giving

What accounts for this charitable boomlet? For most families, philanthropy is an end in itself, a way to fulfill a sense of obligation to the society in which they earned their wealth. But there are often other considerations as well.

According to a 2011 study by INSEAD and UBS on giving in Asia, the desire to instill values, strengthen family ties, and promote knowledge and leadership are important reasons to engage in philanthropy. Some families use philanthropic platforms to develop leadership and management capabilities before the next generation takes on leadership roles in the business.

In addition, philanthropy can be a powerful tool for enhancing a company's reputation. This can be especially important in developing countries, where a business may face outsize expectations. Philanthropic efforts can also generate financial value for the family's business by improving talent attraction, morale, and retention; facilitating new-market entry; gaining knowledge of local consumer needs; and improving relations with local governments and regulators.

Finally, families may also be responding to changing expectations. In a 2008 poll, 90 percent of senior executives from developing countries agreed that consumers expect businesses to take a broader interest and role in dealing with environmental, social, and political issues.[1]

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[1] *Business's Social Contract: Capturing the Corporate Philanthropy Opportunity*, CECP, 2008, cecp.co.

In our experience, while families usually get into philanthropy for altruistic reasons, a successful philanthropic venture, either through the family-owned business or a foundation, can initiate a virtuous circle in which doing good leads to a better reputation, which helps the family-owned business, and so on. At the very least, the fact that there can be beneficial side effects to philanthropy makes the case for pursuing it more compelling.

Five strategic questions

Enthusiasm and goodwill are no substitute for careful planning and thoughtful decision making. Establishing a philanthropic venture must be done deliberately. The key to success is to invest the time up front to figure out the philanthropy's mission and operating model, as well as the role of the family. The most senior and influential family members must lead this process, with full engagement from the younger generations. Developing a strategy is an iterative process, but it's critical to get off to the right start. Regardless of the place or kind of activity being considered, families should ask and answer these five questions.

1. **Why are we doing this?**
   This sounds simple; it is not. Families might share a deep commitment to philanthropy but still not have the same goals. Younger family members may be passionate about specific causes or organizations, and older ones may be chiefly concerned with bolstering the family's long-term legacy and thus may be more risk averse. Business leaders need to keep in mind the company's reputation and relationships with key stakeholders. These differences can lead to ad hoc decision making or the creation of separate smaller funds to support individual interests.

   One European family, for instance, created different charitable entities for specific purposes or for individual family members. Although this approach satisfied numerous interests, it did not allow for the possibility of a single strategic vision around which the family could structure its long-term giving. The result was organizational disarray, with some two dozen legal entities. That fragmentation added costs and diluted the family's influence. It now faces the painful process of unwinding these entities and merging them into a more manageable whole.

   Families should therefore work to develop a shared vision by asking one another several questions: What values define us? What do we stand for? Exploring these issues helps to anchor the philanthropic mission. It also reinforces the sense of purpose and gives family members something to refer to as the foundation evolves.

2. **What do we want to achieve?**
   Philanthropists need to define the long-term objectives of their philanthropy and then set and monitor specific goals. A number of dimensions should be considered:

   - **Impact on society.** For example, is the intended impact making a measurable difference on an important issue, serving specific population groups, or supporting particular organizations? We have seen families make specific commitments to increasing the number of girls in school in their region or to reducing the burden of preventable childhood diseases.

   - **Relationships with stakeholders.** This can mean strengthening family ties, building employee and consumer involvement, or improving relationships with communities and government officials.

   - **Benefits to the business.** Such benefits could include improving the company's reputation, deepening local knowledge of consumers, or developing new growth opportunities.

Determining where the family's time, skill, and financial resources can yield the best return involves understanding the problem the foundation seeks to address, identifying those most affected, and determining what is already being done. All this should be underpinned by knowledge of the latest thinking in the field.

For the Lucie and André Chagnon Foundation, which defined its mission as preventing poverty in Québec, this meant that the founders went on a three-year "listening journey," meeting major North American foundations, philanthropic leaders, experts, and academics. Chagnon learned that there were many organizations running similar programs, but they lacked sufficient capacity to do the work well. After piloting some specific approaches, it decided to serve as a catalyst, providing fund-raising, specialist support, and networking for the nonprofits it supports.

3. What do we have to offer?

Families need to consider the full range of assets they can deploy, including money, people, business assets, and networks and reputation:

- **Financial resources.** Setting clear objectives is crucial to define the scale of resources required to achieve them. Philanthropists may also set the amount based on principle; for instance, those who sign the Giving Pledge attest that they will give away at least half of their wealth in their lifetimes. Others make an explicit link to the business. This promotes economic sustainability and emphasizes the importance of the work. Some companies dedicate a fixed percentage of profits to their foundations every year or give the foundation a percentage of shares in the business. Any of these approaches can work. What matters is being realistic about what can be achieved based on the scale of investment compared with the scale of the problem. It's important to know what has worked before—and what hasn't. Too often we have seen philanthropists with unrealistic expectations of what can be achieved without sufficient investment or partnerships.

- **People.** There should be explicit discussions about the goals and expectations for family members with respect to roles, time commitments, and governance. Many emerging-market philanthropists govern their philanthropic efforts informally; this may work well initially but becomes challenging over time, particularly when the next generation gets involved. Professional staff is essential both for impact and for effective family engagement; these experts can act as neutral parties focused solely on achieving the mission. They can also bring credibility when interacting with stakeholders and partners. In establishing a foundation, one wealthy Indian family determined that the overall governance would involve family members but be led by an outside CEO with management experience and expertise in the program areas. This enabled the foundation to quickly gain a level of professionalization and sophistication, particularly in how it interacts with its stakeholders.

- **Business assets.** The products, services, and capabilities of the family business can play a distinctive role. For example, there are cosmetic companies that provide financial-literacy services to women in their sales forces, banks that provide scholarships to families based on their credit history, and healthcare companies that send their nurses to work in clinics. Providing opportunities to involve employees can strengthen loyalty while enhancing the company's culture and reputation.

- **Networks and reputation.** These can be even more valuable than money. Using reputation to influence public opinion can be invaluable on issues where success requires a real change in public behavior, such as driving safely or not littering. We all appreciate the power that famous people can have on the public, such as the efforts of Indian celebrities, including Bollywood stars, to stop open defecation. Top business leaders in emerging markets also have star power and may be more credible than celebrities in some instances; the fact is, however, that they rarely use it to shape opinion. In India, one wealthy philanthropist used his convening power to bring together major corporations to get involved with maternal-health efforts and influenced the government to spend more in that area.

4. **How should we deploy resources to do the most good?**
Finding the right partners can be a struggle. Many business leaders worry that ineffective or fraudulent organizations will waste funding, especially in countries where civil society is less developed. Families can also fall into the trap of making decisions based on who they know or where their friends give, rather than on an objective assessment of who is most likely to deliver. Just like a business discussion about entering a new market, there should be an objective, well-informed analysis of the problem and what can be done about it. What does the data say? Who are the other players? What do they do well? What is missing? What could be our distinctive contribution? These assessments are tough to make in most emerging markets because there is limited public data on civil-society organizations and their impact.

In some cases, then, philanthropists might consider alternative approaches to testing. For example, a family foundation in Saudi Arabia that sought to provide opportunities for economic improvement for low-income Saudis conducted extensive focus groups and in-depth interviews with the target population. Because there was limited data and few organizations in the space, the foundation was able to identify potential new solutions to the problem.

5. **What is the right vehicle to organize philanthropic giving?**
It is often difficult to separate personal, family, and corporate philanthropy, in part due to the legal and regulatory considerations around setting up foundations and charitable trusts in emerging markets. Philanthropic giving is usually the province of the family business itself at first, but younger generations often push to create an independent family foundation. In Brazil, corporate foundations and corporate social responsibility have become a driving force in the growth of philanthropy. In India, we see a growing trend to establish separate family foundations among the very wealthy, where examples include the Azim Premji Foundation, the Bharti Foundation, and the Shiv Nadar Foundation.

The choice of vehicle will depend on local regulatory considerations, the desired linkage to the family-owned business, and the family's long-term objectives. Regardless of the choice, clear governance is critical to determine the role of different family members in decision making and to foster ongoing discussions about strategy and oversight to ensure the desired objectives are being met.

■ ■ ■

Families in emerging markets are becoming powerful instruments of social change through philanthropy. Like the causes they serve, however, these efforts cannot be static. There must be a clear mission, strategy, and operating model for the philanthropy that strengthens the family and the business while achieving the stated goals. The process of deeply exploring values, objectives, and assets takes significant time and energy up front, but it pays off well into the future. The best operations regularly refine their mission and strategy in order to adapt and evolve apace with the environment in which they operate.

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A principled way of life and business: An interview with Emílio Odebrecht

Principles and values have helped this Brazilian family-owned conglomerate thrive.

Ana Karina Dias

The Odebrecht Group is a private Brazilian conglomerate. It concentrates on engineering, construction, petrochemicals, utilities, oil and gas, real estate, agribusiness, environmental resources, waste management, and infrastructure; it also has several investment funds. In recent years, Odebrecht has expanded rapidly. In 2013, revenues were more than $41 billion. The group has operations in 23 countries, including in Africa, the Americas, Asia, the Caribbean, Europe, and the Middle East.

Norberto Odebrecht, an engineer, founded the company 70 years ago in Salvador, Brazil. He led the company for almost 50 years, transferring leadership to his son, Emílio, in 1991. Soon after, Odebrecht became the first Brazilian company to win a public bid in the United States. In 1998, Emílio became chairman and CEO. In 2002, Emílio left the executive leadership of the group but retained his position as chairman. Pedro Novis, a nonfamily executive, became CEO to help ease the transition to the next generation. In 2008, Emílio's son, Marcelo Odebrecht, became CEO of the group.

In this interview with McKinsey's Ana Karina Dias, Emílio Odebrecht reflects on the family's leadership philosophy and how the company builds human capital.

McKinsey: *Can you describe Odebrecht's principles and how these were formulated?*

Emílio Odebrecht: The whole system was built on my father's philosophy. This set of values was forged from the very first days of the construction company that became the kernel of the organization. In the beginning, when the seed regional company was transferred from my grandfather to my father, there was large debt associated with the contracts. But there was also a superbly well-trained, integrated, and committed team of workers, upon whom he built the business. An alliance for higher productivity, supported by incentives and merit recognition, enabled them to go forward and take us to where we are today.

The organization has eight deeply ingrained core principles, conceived from an explicit culture and forged in practice: trust in people, service spirit, client satisfaction, value creation, decentralization with planned delegation, a partnership mind-set, self-development of people, and reinvestment of returns in the business for continued work opportunities. Reinvestment is key for those who are with us now, for those who will join us in the future, and for promoting community development through new jobs.

Odebrecht Entrepreneurial Technology

Odebrecht Entrepreneurial Technology provides the ethical, moral, and conceptual fundamentals for the performance of group members. It is a philosophy of life centered on education and labor, one that acknowledges human beings' strengths.

Putting the principles into action is a process that relies on the confidence shared by leaders and the individuals that follow them. Each partner-entrepreneur is responsible for carrying out his or her action program. This is done autonomously but with a common strategic direction and coherence of action and thought.

These cultural and ethical principles should never become a straitjacket that hinders the initiatives, creativity, and style of those who put them into practice. On the contrary, their aim is to boost individual capacity and allow everyone to make a personal mark on the facts and acts of the entrepreneurial life. There are eight principles:

- trust in people and in their capacity and desire to evolve
- service spirit, with competence and passion, to offer innovative solutions able to break through established patterns
- client satisfaction, focused on providing them services with an emphasis on quality, productivity, and community and environmental awareness
- return to the shareholders of the capital that was invested, adding value to their assets
- decentralized performance grounded in full and planned delegation so that the partner-entrepreneurs can perform their action programs with autonomy and responsibility
- partnership among the members who plan and perform the work and share in the results
- people's self-development, especially regarding education through work, which fosters the organization's development
- reinvestment of results to create new labor opportunities and ensure sustainability

These principles, part of what we call “Odebrecht Entrepreneurial Technology,” stimulate the willingness to serve, the desire and ability to evolve, and the aspiration to overcome challenges to achieve results. They also foster a process of planned delegation based on trust and partnership between leaders and mentees. (For more, see sidebar, “Odebrecht Entrepreneurial Technology.”)

McKinsey: *How does Odebrecht’s ownership system work?*

Emílio Odebrecht: The fundamental idea is to have clear and independent identities for the family and for the business, protecting each of them from issues regarding the other. For the family, five responsibilities are important: preserving values, retaining control, ensuring unity, appointing a single person as the main executive of the family and the business holdings, and facilitating renewal and succession planning.

A representative of the family, along with his substitute, is in charge of acting on behalf of the full family to represent its interests. The representative also fosters the intangible values—the Entrepreneurial Technology—in the businesses; this is the legacy of my father.

Five companies, one for each of the siblings, hold equal shares in the family holding that detains the company holding. This holding owns Odebrecht SA, which in turn controls the different Odebrecht companies.

We don’t have a formalized policy for dividends, which allows payouts to be reviewed periodically according to the results and funding needs of the businesses, enabling their growth. The CEO submits proposed dividends to the board. In recent years, the family owners created a family holding liquidity fund should someone want to leave (by selling proportionally to the remaining shareholders). After bonuses are awarded, some results go to this fund, and the rest are distributed as dividends.

Our shareholders are not spendthrifts. The shares in the family holding are not tradable. And the family representative is empowered to act as the sole interface between the family and the businesses. As the representative, I have the roles of chairman of the family holding and chairman of Odebrecht SA, and I am delegated by the other family members to make decisions in the name of the whole family.

McKinsey: *How do you engage other leaders in the organization to buy into your philosophy?*

Emílio Odebrecht: We think what makes us different is our ability to really translate our philosophy into actual behavior and concrete results, not just theory. We believe that a leader should be one who educates as a personal conviction. Our priority and focus is in identifying and training leaders who teach.

To translate values into behavior, and behaviors into achievements, we reinforce our trust in the spirit of service—and I mean trust in the fullest meaning of the word. All our partners feel part of Odebrecht, regardless of whether they have the family name. We want people to start from the lower ranks, get to know themselves, and continue to grow. The most senior group of 100-plus executives, whom we consider partner-entrepreneurs, has significant participation in the business. But each person is responsible for values in the qualitative and quantitative sense. You create trust when you measure results, not when you measure activity.

The people model of Odebrecht was forged internally. We develop people primarily within the group, expecting them to continue the constant development and integration of the next generation. The whole process is extremely dynamic: from the service centers to the business units, all partner-entrepreneurs are responsible for simultaneously satisfying clients and shareholders. Good people are never idle. We give them opportunities, trusting that they will do the right thing and requiring leaders to practice the “pedagogy of the presence.”

“Our system of principles, Odebrecht Entrepreneurial Technology, is practiced by the family. It’s a method of living.”

As growth is both a need and a reality, the only limitation of such a system is the constant need for more people to lead the challenge. As we continue to grow quickly, leaders will always be in short supply. The bottleneck lies in preparing more people to take on leadership roles.

McKinsey: *How does your governance model reinforce this culture?*

Emílio Odebrecht: This system of trust and interdependence imposes responsibilities on every component of the organization. For example, we don’t need a demanding capital-allocation process: each business unit must be financially viable on its own.

The companies of the organization have independent CEOs who work with their boards to develop action plans. Odebrecht’s CEO and representatives of the main corporate functions—such as people, finance, and legal—also sit on each board to provide visibility and alignment for all businesses.

The focus of our executives is then to satisfy clients and to fulfill the business’s action plan. Having a clear plan is essential so that executives can practice what needs to be done. We prize discipline, not bureaucracy.

McKinsey: *How does Odebrecht go about attracting and developing entrepreneurial leaders?*

Emílio Odebrecht: Attracting and developing capable leaders is central to our organization. For us, the main role of the board is to preserve our core values and culture. And the values challenge is greater among executives. Strengthening the culture is critical, since in past years we have had to integrate thousands of new people.

Today there are some 180,000 members in the group, of whom more than 11,000 are considered to be in a strategic position for today and for the future of the organization. All of them feel and act like owners of the company, as we believe in the philosophy of freedom and accountability. We do not value position; we value responsibility. Client needs are at the top of our hierarchy.

Emílio Odebrecht

Vital statistics
Born in Salvador, Brazil, in 1945

Education
Earned a degree in civil engineering from Universidade Federal da Bahia

Career highlights
Odebrecht Group (1966–present)

Chairman of the board (1998–present)

CEO (1991–2002)

Executive vice president (1981–91)

Fast facts
Awarded the Global Family Business Award by the International Institute for Management Development in 2010

When a partner-entrepreneur takes responsibility, his or her leader becomes a supporting point to overdeliver results. Executives are aware that their compensation follows from performance, and the incentives in place stimulate a long-term view. Strategic executives benefit from a program that provides incentive for share purchases, so that their variable compensation is aligned with the returns of shareholders. These shares are not freely negotiable, becoming available to newer executives as they are returned after retirement.

There is a strong "education through work" mechanism, and we also evaluate leaders critically on their skills and success in developing the next generation. Part of all profit goes into bonus pools, and after dividends are distributed, the rest gets reinvested. As a consequence, the top leaders—our partner-entrepreneurs—often get a much higher share of the profit than shareholders. Odebrecht's success does not belong only to the family.

McKinsey: *Normally, the transition from the founder to the next generation is a challenge. How was the succession from the first to the second generation for you? What is the model for future transitions?*

Emílio Odebrecht: My father's role, as the founder, was essential. In a succession model like ours, it is important to have full transparency, to have the founder create space for a successor while he is alive, and to build a fair process to distribute equity.

Everyone in the organization understands that successors are not chosen but emerge from a proven track record of top performance. The ones who are ready and show themselves to be leaders take over—the family and the executives respect these people. We also believe that family governance should be designed to survive two generations ahead, with the next generation making whatever adjustments are necessary.

I succeeded my father, Norberto, as chairman of the family holding in a smooth transition: we shared the same values and aimed at the best for the organization, so this process of trust and interaction was natural. While leading the company through the emerging-markets crisis in the early 2000s demanded a lot of me, this resulted in many benefits. We reviewed our structure and put in place financial key performance indicators, which help us manage and stress test at the holding level.

The transition to my son Marcelo involved placing Pedro Novis in the role for six to eight years. Pedro was the CEO while Marcelo was being groomed. The succession process is designed to work independently of the number of family members, so the chairman is responsible for this appointment. In the future, my son, who is the group CEO today, shall succeed me as chairman of Odebrecht.

McKinsey: *How do you conduct share transitions and involve the next generation of the family in the business?*

Emílio Odebrecht: The underlying concept is that your shares are not your property—you are the guardian of the shares for the next generation. Young people do not live off the dividends; they only have access to them when they are 40 to 50 years old, as these are donated for life with usufruct (the legal right to use something belonging to another) by the oldest shareholders.

We also follow the principle that economic rights are equally distributed within the family, whereas political rights are not—they're delegated to the chairman. This is a formal arrangement, and that's how it has to be; people grow up knowing this is so. Being the successor depends on the individual, not on who his or her parents are.

Everyone in the family knows he or she can work for the company, with no additional stimulus or constraints. For those wishing to do so, there is a rigorous model —admission, appraisal, and exit processes are equally strict. In their work, they are expected to behave as executives, not as shareholders. Direct-reporting relationships between relatives are forbidden. And family members leave the company when things don't work out as well as when they joined.

McKinsey: *How do you foster Odebrecht values among family members?*

Emílio Odebrecht: Our system of principles, Odebrecht Entrepreneurial Technology, is practiced by the family. It's a method of living.

We make a deliberate effort to invest in the conceptual and philosophical alignment of our values. We now have about 60 family members, of four generations, so interacting constantly is an important part of ensuring cohesiveness. My father started a program to promote interaction by gathering members of all generations.

I hold monthly meetings with representatives from each branch of the family for communication, and all cousins over the age of 12 participate in a year-end event that consists of business presentations. Most of us live close by, and many of the second-generation members are in the same building. Cousins also have a lot of interaction. Every year, the family gets together. We gather on an island, and together we organize many of our daily activities, such as breakfast. Relatives of the same generation share the same house, strengthening ties. The family visits during this period reinforce our unity. Having four generations fishing together induces reflection, and eating what we produce emphasizes the value of hard work. Fireside chats are also an important component of transmitting knowledge and keeping a virtuous cycle: discipline creates respect, respect creates trust, and trust ensures peace.

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October 2014
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Printed in the United States of America.