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SPECIAL REPORT
FAMILY COMPANIES
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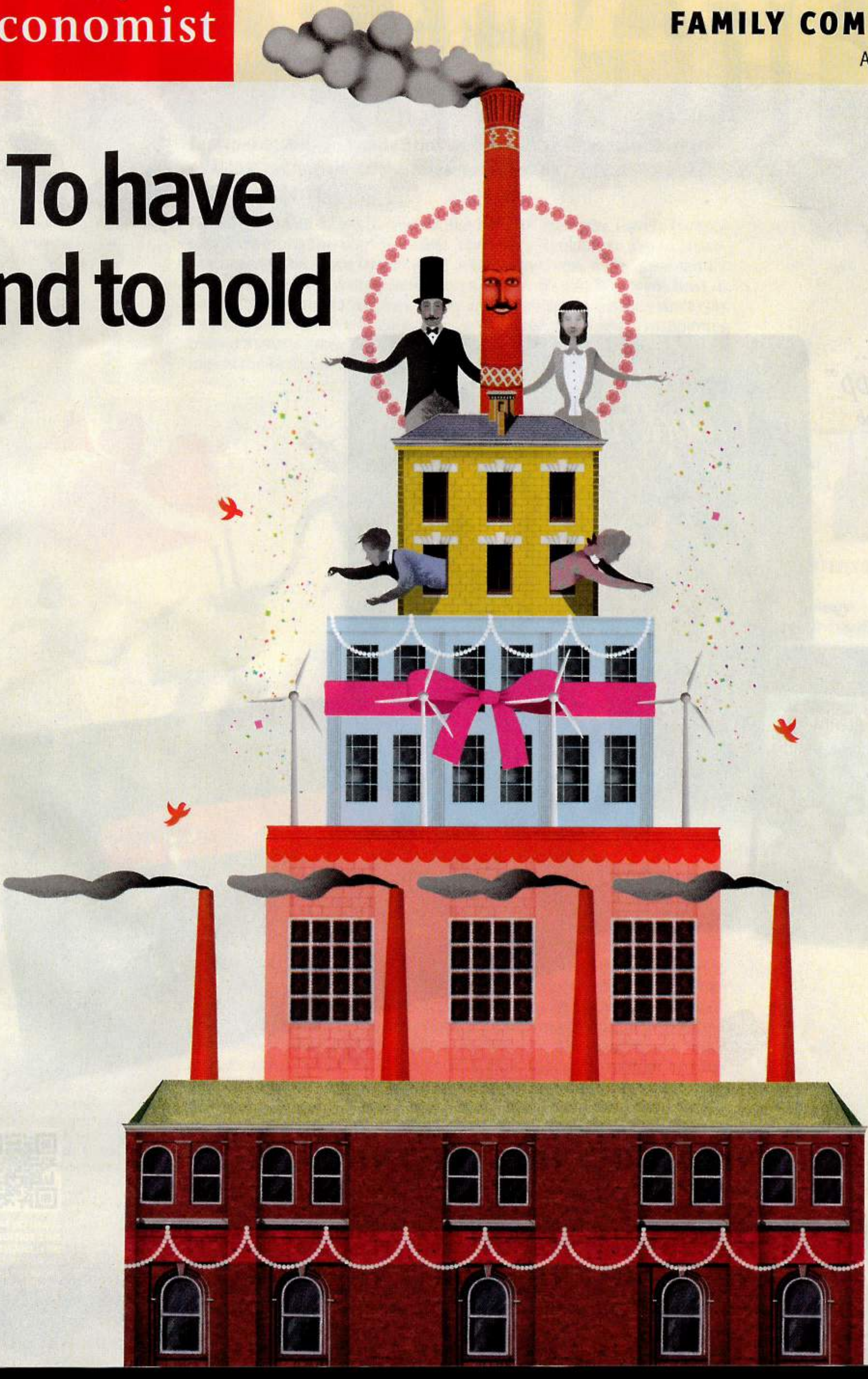
To have and to hold



To have and to hold

Far from declining, family firms will remain an important feature of global capitalism for the foreseeable future, argues Adrian Wooldridge

FAMILIES HAVE ALWAYS been at the heart of business. Family companies are among the world's oldest. The Hoshi Ryokan, an inn in Japan, has been in the same family since 718. Kongo Gumi, a Japanese family construction firm, was founded even earlier, in 578, but went bust in 2006. The Antinori family has been producing wine in Tuscany since 1385 and the Berettas have been making guns since 1526. Family companies played a starring role in the development of capitalism: think of the Barings or the Rothschilds in banking or the Fords and Benzes in carmaking.

Family companies are ideally suited to the early stages of capitalism. They provided two of the most important ingredients of growth, trust and loyalty, in a world where banking and legal institutions were often rudimentary and poor communications made far-flung activities hard to control. It was easier to raise money from kinsmen than from strangers. And it was safer to send a relative than a hired hand to expand the business abroad.

Business enterprises also provided patriarchs with a way of transmitting wealth and status to future generations. "The banker's calling is hereditary," said Walter Bagehot, a distinguished 19th-century editor of this newspaper. "The credit of the bank descends from father to son; this inherited wealth brings inherited refinement." Family dynamics sometimes dictated business strategies: the Rothschild bank helped to globalise finance when Mayer Amschel Rothschild, the dynasty's founder, sent his five sons to set up banks in different countries.

Serious thinkers have given surprisingly little thought to the family dynamics behind the early stages of capitalism. Novelists are a better guide to this subject than classical economists. In "Dombey and Son" Charles Dickens describes how Dombey wants to pass his business on to his son but is frustrated by a scheming manager. Thomas Mann's "Buddenbrooks" is about the children of a great business founder turning their backs on the bourgeois virtues that built the family's fortunes.

Business gurus have also given family firms short shrift. Alfred Chandler, the doyen of business historians, regarded family companies as relics of an earlier era that found it hard to muster the capital and talent needed to compete. The real engines of modern capitalism were public companies, owned by diverse shareholders and run by professional managers. Peter Drucker, the doyen of management theorists, reckoned that the drivers of these great engines were professional "knowledge workers", not business patriarchs and their families.

Chandler was right that public companies made enormous advances in the late 19th and early 20th centuries as capital-intensive businesses turned to public markets for funds. But he was wrong in his prediction ▸▸

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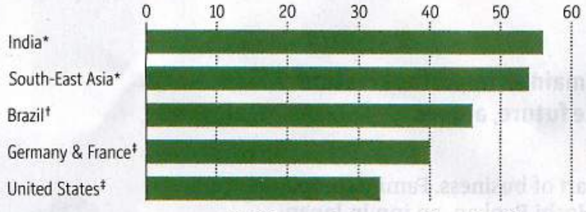
An audio interview with the author is at Economist.com/audiovideo/specialreports

Family matters 1

Family businesses as % of top companies, latest available



Source: Boston Consulting Group

*Top 200 companies by revenue †Companies with revenues over $500m ‡Companies with revenues over $1bn

that they would push family companies to the margins of the modern economy. Even in the Anglo-Saxon world, where public companies gained the most ground, families held on to some of the most prominent businesses, such as Walmart, the world's largest retailer, and Ford, one of the largest car companies. In continental Europe public companies remained the exception.

Thirty-eight years after Chandler published his paean of praise for the public company, "The Visible Hand", family companies still provide many of the necessities of life. You can get your news from the *New York Times* and the *Wall Street Journal*; your car from Ford or Fiat; your smartphone from Samsung or LG; and your groceries from Walmart or Aldi. In a scholarly book, "Dynasties", the late David Landes of Harvard University demonstrated that you could write a respectable history of capitalism through the lens of family histories. You could write an equally respectable survey of the state of modern capitalism by telling the story of a dozen family firms.

Family businesses make up more than 90% of the world's companies. Many of them are small corner shops. This special report will focus on the larger companies that shape the global economy and develop world-changing products and ideas. The point is to show that family businesses can flourish in the most sophisticated areas of the modern economy.

Defining these larger family companies is tricky. If you restrict the term to companies that are both owned and managed by family members, you will end up with remarkably few. If you expand it to include companies that are run by the founders, you will take in tech giants such as Google and Facebook, which few people would see as family firms. The Boston Consulting Group has produced a reasonable definition made up of two elements: a family must own a significant share of the company concerned and be able to influence important decisions, particularly the choice of chairman or CEO; and there must have either been a transition from one generation to the next, or, in the case of a founder-owned firm, plans for such a transition. On that definition, BCG calculates, family companies represent 33% of American companies and 40% of French and German companies with revenues of more than $1 billion a year. In Asia and Brazil they are even more prevalent (see chart 1).

Powerful families are also adept at using pyramid-style business holdings to keep a controlling number of shares in other companies. Randall Morck, of the University of Alberta, points out that the Wallenberg family controls companies that represent up to half the market capitalisation of the Swedish stockmarket, including global giants such as Ericsson. The Agnelli family controls 10.4% of the Italian stockmarket. In Hong Kong the top 15 families control assets worth 84% of GDP, in Malaysia 76%, in Singapore 48% and in the Philippines 47%.

The majority of the world's most successful medium-sized companies are also family firms. Hermann Simon, chairman of Simon-Kucher & Partners, a consultancy, calculates that they account for two-thirds of Germany's mighty *Mittelstand*, including world leaders in doors (Dorma), balancing machines (Schenck) and industrial mixers (Ekato). Italy has a large number of family-owned global champions in taste-conscious niches: Ferrari in cars, Versace in fashion, Ferrero Rocher in chocolates.

The most striking thing about family companies is arguably not their average quality but their variance: they have more than their share of pariahs as well as paragons. Portugal's Espírito Santo was one such pariah: massive debts turned the family-owned financial conglomerate into one of Europe's largest corporate failures, obliging the government to save the family from the consequences of its own greed and folly.

The best thing about family companies is their sense of ownership. That helps them get round two of the most troubling defects of modern capitalism: the focus on short-term results and the so-called agency problem (the potential conflict of interest between owners and managers). On their own admission the CEOs of public companies find it hard to think about the long term because they have to focus on "hitting the numbers" every quarter, and the length of their job tenure has fallen steeply over the past decade. Family owners regard their shares as long-term investments and keep a close eye on management even if they do not run the company.

Clogs to clogs

The worst thing about family companies is succession. This is difficult in all organisations, but especially so in family firms because it involves the biological as well as the institutional sort and throws in a mass of emotions. Family businesses that restrict their choice of heirs to their children can be left with dunces. Moreover, wealth corrupts, a principle so well-established that many languages have a phrase for it. In English it is "clogs to clogs in three generations"; in Italian "from stables to stars to stables"; in Japanese "the third generation ruins the house"; and in Chinese "wealth does not survive three generations". According to the Family Business Institute, an American consultancy, only 30% of family businesses survive into the second generation and 12% into the third. A mere 3% make it into the fourth and beyond.

Family companies' sense of ownership gets round two of the most troubling defects of modern capitalism: short-termism and the so-called agency problem

More broadly, family businesses often suffer from human quirks. Alfred Sloan, the founder of General Motors, argued that the aim of professional management was to produce "an objective organisation" as distinct from "the type that gets lost in the subjectivity of personalities". That was much in evidence at his great rival, the Ford Motor Company, where Henry Ford's idiosyncratic behaviour almost ruined the business. But that "subjectivity of personalities" can also enable family bosses to make brilliant decisions which elude professional managers.

This special report will argue that family companies are likely to remain a significant feature of global capitalism for the foreseeable future, thanks to a combination of two factors. Family companies in general are getting better at managing themselves: they are learning how to minimise their weaknesses while capitalising on their strengths. At the same time the centre of the modern economy is shifting to parts of the world—most notably Asia—where family companies remain dominant. ▸▸

McKinsey, a consultancy, calculates that by 2025 an extra 4,000 founder- or family-owned companies could hit sales of $1 billion. If this proves correct, family firms in emerging markets might then make up nearly 40% of the world's large companies, compared with 15% in 2010. McKinsey's habit of conflating founder-owned firms and family firms is less problematic in Asia than it is globally because founder-owned firms there are more likely to become true family firms. The consultancy is right, too, about the direction of change: the world's most dynamic region also happens to be the friendliest to family businesses.

To understand family companies better, business analysts will need to pay more attention to their internal dynamics. These firms are not just immature public companies, nor are they just highly successful startups. Some of their distinctive behaviour is explained by their "familyness" in the same way that public companies' behaviour is explained by their "publicness". Investors will need to look more closely at things like succession planning and whether family members are getting on well together. Academic theorists reflecting on the reasons why firms exist will need to add one more: their role as a mechanism for the transmission of property to future generations.

Since family companies are not just surviving but flourishing, many assumptions about the nature of modernity will have to be rethought. Classical sociologists and classical economists both predicted that family businesses would retreat as societies became more rational and bureaucratic. Families themselves would become nothing more than "havens in a heartless world", as Christopher Lasch, a historian, put it. But that orthodoxy is crumbling in the face of growing evidence that family dynasties can do well in even the most sophisticated modern societies. ■

United by diversity

The four main types of family business

FAMILY COMPANIES COME in many guises. In a paper published last year Soumodip Sarkar, of the University of Evora, and two colleagues identified 200 different definitions. Some people use the term as a synonym for a small company, for others it means a closely held company. This special report will define family companies as those with families as either owners or managers or a combination of the two. They must involve more than one family member, and there has to be a succession, or a planned succession, from one generation to another. In a new book, "The Family Business Map", Morten Bennedsen, of INSEAD, and Joseph Fan, of the Chinese University of Hong Kong, explain that this basic model comes in four main flavours.

In a classical family company the family exercises both ownership and control, as exemplified by members of the Hénokiens Association, an international club of 44 family businesses that combine family ownership and management and are at least 200 years old. They include 14 Italian companies, 12 French, five Japanese, four German, three Swiss, one British and one Austrian. The British have gone one better with a Tercentenarian Club of companies, owned and controlled by the same family for over 300 years.

As firms get bigger, this combination of ownership and control becomes harder to maintain, but a few manage to hold on to both. Lakshmi Mittal, scion of an Indian steel dynasty, owns 41% of the shares of Arcelor Mittal, the world's largest steelmaker, and acts as both chairman and CEO. Charles and David Koch between them own 84% of the shares of Koch Industries, a company with revenues of $115 billion. Charles Koch is the CEO and David his loyal lieutenant.

In the second model, the family owns a controlling stake in the company but hands over the running of it to professional managers. The Walton family owns around half of Walmart but does not run it on a day-to-day basis. Passive ownership can be risky for families. The Cadburys retreated from direct management of their chocolate empire and progressively diluted their family control, so when Kraft, a giant American food company, made a hostile bid for the company in 2010, all they could do was protest.

Some families seize their patrimony back from professional managers. Li & Fung, a Hong Kong-based trading group, saw the family's control slip away after the company was listed on the Hong Kong stockmarket in 1974. But in the mid-1980s William and Victor Fung reasserted family control by borrowing to buy out other owners and then relisting the company on the stockmarket in 1992.

Third, and more surprising, in some family companies the family retains very little ownership but continues to play a managerial role. This model is fairly common in Japan. The Toyodas and Suzukis have only small shareholdings in the companies that bear their names, but Suzukis have managed the company for generations. Toyota appointed Akio Toyoda CEO and president in 2009 when the company had been forced to recall 4.2m cars after a safety scare. The eight families that in 1917 founded Kikkoman, a soy-sauce company, own just 20% of it now, but the post of CEO continues to rotate among them.

In a fourth type of family firm the family turns itself into a venture-capital fund to give its younger members a start in life. The Mulliez family owns one of France's leading retail groups, Auchan, and younger members have used family money to found many other companies, including Decathlon (sports), Pizza Pai and Flunch (catering), Leroy Merlin (do-it-yourself) and Boulanger (electrical appliances). These businesses are all owned by a holding company, Cimovam, that employs 366,000 people.

Many family companies are hybrids, alternating between giving managerial roles to family members and bringing in hired guns. Barings flip-flopped between family and non-family CEOs before the bank went under in 1995. Since Henry Ford died in 1947, three members of his family have been CEOs.

The prevalence of the hybrid form argues against the idea that families tend to move from being owner-managers to passive shareholders. That seems to have been the dominant model in the Anglo-Saxon world, but not elsewhere. Julian Franks of the London Business School and his colleagues studied more than 30,000 firms across Europe and found that older firms in France, Germany and Italy are in fact more likely to be family-controlled than younger ones.

The upsides

Old-fashioned virtues

Patience, distinctiveness, thrift and trust still count

EVERYTHING ABOUT BERRY BROS. & RUDD'S showroom in St James's Street, London, suggests tradition. The walls are panelled in dark oak. Leather-bound volumes record "the weights of customers of this establishment" from 1765 onwards, sitting alongside a set of weights from a time when the shop sold coffee rather than alcohol. Simon Berry represents the 7th generation of Berrys to run the company, and he looks the part. Sitting in a small office with a roaring fire (gas, alas) and an old-fashioned rotary-dial phone, he talks about the company's Cutty Sark brand of whisky being blended on the table in front of him.

But Mr Berry is not just resting on the company's laurels. He is working hard to expand his family patrimony, particularly in China, where wine-drinking is booming, but also in America. He has a state-of-the-art cellar for 2m bottles in Basingstoke, near London, and another 6.3m bottles at other sites. The neatly dressed shop assistants tap away on computers kept discreetly out of sight. They have all been sent on acting courses to polish their customer service. His father, Mr Berry recalls, liked to say, "it's only money." Today family firms come with a harder edge.

Ask the boss of any family business what makes his company different, and he will mention his long-term perspective. That helps him resist the temptation to make a quick buck and allows him to think in terms of decades rather than quarters. Mr Berry jokes that once you have survived the South Sea Bubble—a financial crisis in 1720 that caused the British economy to shrink by a quarter—you can see the 2008 recession in perspective.

Keep it steady

More systematic inquiry bears this out. The Boston Consulting Group compared a list of 149 medium-sized to large publicly traded but family-controlled businesses with a group of non-family companies from the same countries and industries and found that family companies performed more consistently than non-family ones. They did not make as much money as other sorts in good times but did better when the going got rough. John Coates and Reiner Kraakman, of Harvard Law School, who studied the tenure of CEOs in the Standard & Poor's 500 in 1992-2004, found that those who held more than 1% of the stock (which includes family firms) were at the helm for an average of 13.4 years, compared with 5.5 years for other companies. Hermann Simon, the consultant, calculated that the CEO of a German *Mittelstand* company sticks around for an average of 20 years, sometimes considerably longer. Horst Brandstätter, the boss of Playmobil, a German toy company, lasted 54 years. He once gave one of his designers a ten-year deadline to come up with a new product. Hans Riegel, the boss of Haribo, a confectioner that invented gummy bear sweets, was in post for 63 years.

This strategic patience has proved particularly useful in two quite different businesses: newspapers and luxury goods. Two of the world's best newspapers are owned by families: the *New York Times* by the Sulzbergers and the *Wall Street Journal* by the Murdochs, who bought it from another family, the Bancrofts. (The Pearson family owns the *Financial Times*, which has a 50% share in *The Economist*.) Family companies have been much more willing than widely held companies to make the sort of long-term investment required to ensure first-rate journalism.

The world's largest luxury brand, LVMH, is a successful family company, owned by Bernard Arnault, that has bought up other family companies such as Bulgari and Fendi. Hermès, another family company, demonstrates the virtues of patience. In the difficult 1970s it refused to compromise on quality, insisting that all its products be made from the finest materials. That left it well-positioned for the subsequent luxury boom.

One of the best examples of the power of long-termism comes from a surprising industry: outdoor advertising. Jean-Charles Decaux, the eponymous CEO of Decaux, explains that family ownership gave his company the scope for the "patient innovation" that turned it into the biggest in his industry. It introduced a series of innovative ideas such as the "freemium model", providing cities with street furniture such as bus stops in return for the right to rent out advertising space on them. The company also pioneered the free-bicycle model that has changed urban transport across the world. The founder, Jean-Claude Decaux, harnessed sibling rivalry to push global expansion, much as Mayer Rothschild did in his day: he put each of his three sons in charge of his own region so they could show their entrepreneurial clout. "The first generation invented the company," says Mr Decaux. "The second generation took it global."

Such long-term thinking is turning into more of an advantage as public companies become increasingly focused on the ▸▸

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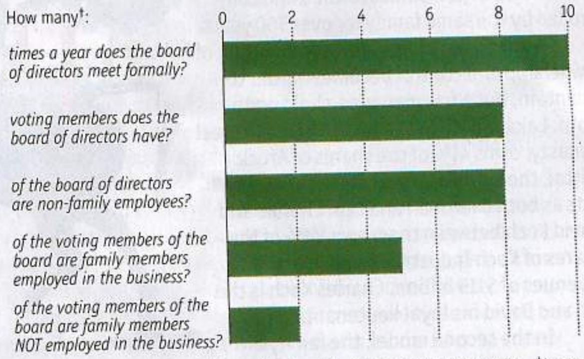
House rules

Governance of family-controlled companies*



Source: EY *Covering 2,400 of the world's largest family businesses in 21 countries †Average

▸ short term. Not only has the average tenure of a CEO in a public company declined from ten years in 2000 to about eight today, the average period for which owners hold the stock has also fallen with the rise of electronic trading. A growing number of CEOs praise the private-equity model, which provides a longer time horizon, but even that does not stretch beyond five to seven years. Family ownership provides companies with a perspective that is almost impossible to replicate in either public or private capital markets.

Family companies are also particularly careful with money, even though many of them operate in luxury niches that depend on extravagance. Some of the most successful ones are bywords for frugality. Mars has famously modest headquarters in McLean, Virginia, and Walmart asks middle managers to economise by sharing rooms when they travel.

Once again research confirms these impressions. BCG notes that the family firms it studied are better than other companies at keeping their costs under control because their owners keep a much closer eye on them. As a result, they had to make fewer lay-offs during the 2008 financial crisis.

Another strength of family companies is their powerful internal culture. Whereas public companies have become increasingly bland, many family companies are islands of distinctiveness. They have their own way of doing things, often derived from their founders' strong convictions. When Heinz-Peter Elstrodt and his colleagues at McKinsey examined 114 family firms and 1,200 other large companies for their "organisational health", they found that family firms scored significantly higher on things like worker motivation and leadership, though they lagged slightly on innovation.

The personal touch

These internal cultures give family companies three interconnected advantages that are increasingly valuable in a world where so much is commoditised. The first is a stable base of employees. Holger Mueller and Thomas Philippon, of New York University's Stern Business School, suggest that family companies tend to have better labour relations than other firms. They keep their workers for longer and can call on deeper reserves of loyalty. John Davis, of Harvard Business School, says that many family companies are like tribes: they want to recruit loyalists who will be around for a long time rather than high-flyers who want to burnish their CVs.

The second advantage of family companies' strong internal culture is a distinctive set of stories that they can tell their customers. These stories are sometimes about their age: Molson likes to boast that the family has been brewing beer "since before there was a country called Canada". Sometimes they are about the quirky personality of the founder: Ingvar Kamprad, the founder of IKEA, a giant Swedish furniture retailer, habitually flew economy class despite his wealth. And family companies are increasingly using their ownership as a selling point in its own right.

His father, Mr Berry recalls, liked to say, "it's only money." Today family firms come with a harder edge

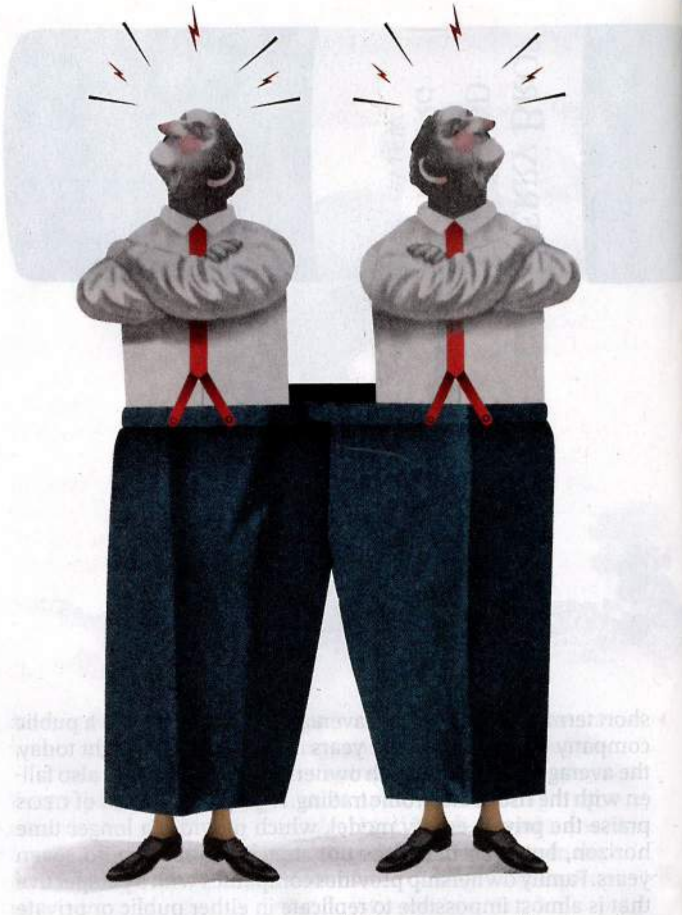
The third plus is trust, which is particularly important at a time when capitalism is in danger of losing its legitimacy. Edelman, an American public-relations firm, publishes an annual "Trust Barometer" which shows that across the world people trust family businesses more than other kinds of companies. (Edelman, as it happens, is a family company, started by Dan Edelman in 1952, currently run by Richard Edelman and now bringing on the third generation.)

Fans of family companies like to point to another advantage: value-based leadership. To be fair, not every family company has it. But there is something to this idea. A striking number of the world's great family companies were created by members of religious minorities who embraced a strict ethos. These minorities put particular emphasis on both business and the family because they were excluded from public-sector jobs and because they had to look out for themselves. The Jews are just one example. In Britain the Quakers are another. The Cadburys and the Rowntrees created chocolate companies to try to wean the British off alcohol, and the Barclays started banks to fund their co-religionists. In India the main example are the Parsees. The Tatas and the Godrejs prided themselves on running companies that offered other Parsees honest work. In America the Mormons have created many highly successful family companies, such as Marriott (hotels) and Huntsman (energy).

Lastly, family businesses offer scope for unlikely successions. They have led the way in promoting women, who sometimes take over when a husband or father has died. On August 3rd 1963 Katharine Graham heard an ear-splitting noise from a downstairs bathroom. Her husband, with whom she had just had lunch, had shot himself. Mrs Graham had no business experience: she had been happy for her tycoon father, Eugene Meyer, to leave his media business to his son-in-law rather than to his daughter. Her husband's suicide left her with little choice but to step in. She became the first female CEO of a *Fortune* 500 company in 1972 and proved to be one of the 20th century's greatest newspaper proprietors. Under her iron reign the *Washington Post* brought down President Nixon with its investigation into the Watergate break-in and challenged the *New York Times* for the title of America's most illustrious newspaper.

Likewise, Maria-Elisabeth Schaeffler succeeded her husband in 1996 as CEO of INA-Schaeffler, the world's second-largest manufacturer of ball and roller bearings, and turned out to be much better at the job. Family companies have also sometimes made bets on relatively inexperienced people. Hartmut Jenner became CEO of Karcher, the world's market leader in high-pressure cleaning equipment, at the age of 34, and Robert Friedmann took control of Würth, a $10.7 billion conglomerate, at 38.

The best family companies can draw on a wide range of assets, from patient capital to social trust to brilliant widows, none of which can be easily replicated by widely held public companies. But each of these assets also has the potential to turn into a terrifying liability. ■



The downsides

All too human

How families can cause trouble for their firms

TWO OF THE most successful television soap operas were about family businesses. "Dallas" told the story of J.R. Ewing's struggles with his brothers, half-brothers and in-laws for control of Ewing Oil. "Dynasty" was a saga about another oil dynasty, the Carringtons, who "lived and sinned in a 48-room Denver mansion". The producers understood that money and family together make the perfect stuff of drama.

Koch Industries, an oil, gas and commodities conglomerate based in Wichita, Kansas, makes "Dallas" look sedate by comparison. It has been a cockpit for family quarrels that have eaten up millions of dollars in legal bills and sometimes threatened to tear the company apart. It has also become toxic in some quarters because Charles and David Koch helped raise an estimated $400m in a bid to stop Barack Obama's re-election in 2012 and fund organisations that promote libertarianism and climate-change scepticism. The firm was founded by Fred Koch, who had a genius for inventing ways of getting more petrol out of each gallon of oil. Fred's second son, Charles, eventually succeeded his father as the firm's CEO. David, a younger brother, acts as a loyal lieutenant. But this succession created huge tensions with two other brothers, Fred junior, the eldest, and in particular Bill, David's twin. Bill and Fred started bringing legal cases against "Prince Charles" and his sidekick. Lawyers sued and countersued. For nearly two decades the two Koch factions exchanged hardly a word that was not mediated by a lawyer. The brothers were finally reconciled in 2001, at least officially.

Such quarrels are nothing unusual among the world's biggest family businesses. Sumner Redstone, the majority shareholder of a clutch of media companies, CBS, Viacom and National Amusements, has a long history of feuding with his children, Brent and Shari, over succession. The Porsche and Piëch families, which control Porsche and Volkswagen respectively, have been fighting for decades even though they are related.

Some family companies thrive despite such quarrels. Koch Industries is a highly successful company with over 100,000 employees and an annual turnover of around $115 billion. Two of the world's leading shoe companies, Adidas and Puma, were founded by warring brothers, Adolf and Rudolf Dassler, who set up rival factories in their German home town of Herzogenaurach. But family quarrels also destroy or break up many family companies.

Follow the leader

Internal family rivalries often come to a head over the question of succession. Many family patriarchs are larger-than-life figures who are unwilling to make way for their successors. Haldor Topsoe remained an active chairman of his company until close to his death at almost 100. Arnold Maersk McKinney Moeller retired as boss of Maersk, the world's largest container shipping company, at 80, but continued to cast a long shadow over the company until he died in 2012, aged 98.

Family companies are more likely than other businesses to be thrown off balance by an unexpected death. Researchers who studied more than 5,000 family companies worldwide to see how vulnerable they were to health shocks among family members found that the unexpected death of a CEO could reduce performance by up to 30% and the death of a spouse or child by 10%. Even the hospitalisation of a family owner had an impact.

The biggest problem for family companies is the distinct possibility that the children or grandchildren of business founders may not match the founder for either brains or character. Warren Buffett, a veteran investor, once compared family succession to "choosing the 2020 Olympic team by picking the eldest sons of the gold-medal winners in the 2000 Olympics". A family grandee says that the biggest barrier to keeping the family show on the road is the "growing sloth of family members". And CEOS who bear the family name are far more difficult to sack than hired hands, even if they turn out to be useless. Francisco Perez-Gonzalez, of Stanford Business School, compared the returns of America's 500 largest firms in the three years before and after succession and found that returns of firms with non-family CEOS were about two percentage points higher than of those with relatives in the top job. Morten Bennedsen, of France's INSEAD business school, and Kasper Nielsen, of Copenhagen business school, conducted a study of succession in more than 5,300 private firms in Denmark and also found that relatives significantly underperformed outsiders.

Although family companies on the whole are trusted more than other firms, that advantage can quickly dissipate. Business founders will enjoy that trust no matter how rich they become, but their successors will lose some of it no matter how much they improve their companies. Billy Vanderbilt more than doubled his father's fortune in the seven years after "the Commodore's" death, but has since become a mere footnote in history.

The best family companies work hard to prevent this erosion of trust over time by holding themselves to higher standards than the rest. They force heirs to earn their entrepreneurial spurs, perhaps by conquering new regions or entering new industries. But these efforts fail as often as they succeed: the more mature a family company becomes, the more suspicion it faces.

Family companies also often suffer from a surfeit of bodies. If the family multiplies rapidly, ownership bcomes more and more diluted. The Mulliez family, for example, has grown to 780 ▸▸

members, 600 of whom have ownership stakes in the family investment company. The Wendel family has more than 1,000 family members involved in Wendel Participations, the holding company that owns almost 40% of Wendel. Such dilution creates numerous problems. How do you decide who runs the company and who is just a passive shareholder? How do you ensure family harmony when different members have different levels of ownership and different degrees of control? Family members who are mere shareholders are likely to press for higher dividends, whereas those who remain in management will want reinvestment and growth. The bigger the family, the bigger the potential for conflict.

The Pritzker business empire, which included the Hyatt hotel chain, was broken up by the logic of numbers. The family patriarch left the empire to 11 cousins who all wanted very different things from their inheritance. The Pritzkers remain a powerful family; they include America's current commerce secretary, Penny, as well as numerous billionaires. But their business clout has been scattered to the winds.

A handful of families have the opposite problem: too few children. This seems to be particularly common in one of the world's most business-minded ethnic communities, the Parsees. Their number has fallen by about a tenth in each decade since the 1950s, and only about 61,000 of them are now left in India, three-quarters of them in Mumbai. They closed their maternity hospital in that city a decade ago. Nobody knows why they have so few children: some people point to their preference for late marriage, others say the reason may be genetic. But there is no doubt that it has a marked impact on business. The Tata family's repeated failure to produce offspring helps explain the structure and ownership of India's biggest company. When it ran out of direct heirs in the 1930s, the family handed control of the company to a trust. And because Ratan Tata, the chairman of Tata Group until 2012, has no children, the company's CEO is now called Mistry rather than Tata. ■

Making it work

The family way

Distinctive problems call for tailor-made solutions

JAPANESE BUSINESSES HAVE come up with a logical solution to the problem of disappointing heirs: find better ones. The easiest way to do this is to persuade your daughter to marry a talented man. ("You can't choose your sons," goes a Japanese adage, "but you can choose your sons-in-law.") Another way is to adopt a star employee as a son. For best effect these two techniques can be combined: adopted sons can be persuaded to marry their stepsisters. A study of leading Japanese companies since the second world war found that about 10% of "family successions" in business families involved a son-in-law or an adopted son. Kajima Construction has been run by non-blood heirs for three generations. Suzuki Motors, too, has had a run of non-blood heirs. Osamu Suzuki, who was himself adopted into the family, chose his son-in-law as his successor, though the proposed heir then died. The use of adoption not only allows business families to draft in talent from outside. It also puts competitive pressures on biological heirs by raising the possibility that they will be moved aside.

The Japanese solution is unlikely to travel. But across the world family companies have been producing distinctive solutions to their distinctive problems, and they are getting better at it. That is partly because they have a growing body of family-company lore to draw upon. One grandee of a storied Western company active in the East says that China's new billionaires are constantly asking him about the secrets of his company's longevity. Partly, too, it is because the management-theory industry is at last beginning to take family companies seriously.

The secret of the pyramids

The biggest challenge for family companies is how to preserve family control while competing with public companies that can draw on public capital markets. One solution is to stick to a tiny global niche; many *Mittelstand* companies credit their success with refusing to compete "where the elephants play". A second strategy is to form a close relationship with a local bank. This was once popular with Quaker families in Britain and is still the norm in much of continental Europe. But the most successful technique is to structure your company so that you can separate the right to a return (income) from the right to a say in how the company is run (control).

The most popular way to do this is by pyramiding. Yoshisuke Aikawa, the founder of the Nissan group in pre-war Japan, saw pyramids as the ideal solution to what he called "the capitalist quandary". If a capitalist uses only his own or his family's money, his scale of operations will be too small. If he taps into public equity markets, he risks losing control. Pyramids provide him with the best of both worlds—secure control and unlimited access to public capital. The family controls the company that sits at the top of the pyramid, which has a controlling stake (say 51%) in the company at the next level, and so on down the pyramid. This system allows families to maintain the maximum amount of power for their investment (and, as they see it, gives passive investors the maximum amount of profit from the managerial abilities of talented families). Sweden's Wallenberg family and Italy's Agnelli family both control large swathes of their country's economies through pyramid structures.

A second technique is to issue dual-class shares, with the upper class carrying superior voting rights. This is widely practised in the media world. The most enthusiastic pyramiders also use dual-class shares: the Wallenbergs provide 40% of the capital for their investment vehicle, Investor, but control 80% of the votes. There are lots of variations on this two-class option: voting caps on non-family shareholders; cross-shareholdings giving families holdings in each other's companies; golden shares that carry specific rights, such as blocking the sale of the company; and staggered boards that cannot be changed when the majority shareholding changes hands.

A third way of separating income from control is to put the ownership of the company into a trust or a foundation. Many of the world's biggest companies, including the *New York Times*, Walmart and Ford, are owned by family trusts. Many of the most successful business families in Germany and northern Europe have handed their companies to foundations in order to manage their tax bills, including Bertelsmann, Heineken, Carlsberg, Robert Bosch, Novo Nordisk and Maersk. Trusts and foundations not only allow families to keep control of a company indefinitely, they let them exercise self-discipline: seats on the foundations can be reserved for the most talented and hardest-working members of the family.

Critics say these techniques offend against the principles of good corporate governance. Powerful families can use pyramids to transfer money between companies under their control and employ dual-class shares to disenfranchise other investors. Two decades ago the tide seemed to have turned against these devices. But founders of tech companies are keen on them, claiming that they provide protection against short-termism. The decision by Alibaba, a huge Chinese e-commerce company, to list on the New York Stock Exchange (which allows dual-class shares) rather than the Hong Kong one (which does not) has created strong pressure to reverse the bans.

Another big challenge for family companies is how to professionalise their management without losing their family roots. Ideally, this is done by training family members to become accomplished professionals. Brown-Forman, a maker of spirits such as Jack Daniel's and Southern Comfort, ascribes its success over the past 140 years to a policy of "planned nepotism". Many family companies throw a dauphin in at the deep end and see if he can swim. John Elkann, the chairman of Fiat (and a member of *The Economist*'s board), worked incognito at a number of different family-related businesses before stepping up to the top job. All members of the Mulliez family who want to have a career in one of its companies or get involved in its venture fund have to undergo a strict apprenticeship. The De Kuyper family, which makes spirits, has an independent supervisory board responsible for selecting family members who want to work in the company. They must have gained a university degree and held a job in an unrelated firm for five years.

Some families choose outside managers to run the day-to-day operations of their companies but keep a careful eye on them from the boardroom. The Freudenberg Group, a classic German *Mittelstand* company, has been run by Freudenbergs for eight generations and has deep roots in its home town of Weinheim. But the Freudenbergs have retreated into a supervisory role and chosen an American-Iranian, Mohsen Sohi, to mastermind the rapid globalisation of their company.

Estée Lauder, a large cosmetics firm, has chosen a middle way. The company is enveloped in family tradition: much of the 41st floor of the General Motors Building in New York where it has its headquarters is given over to the eponymous founder's perfectly preserved office and a reproduction of her sitting room in her Palm Beach house. But in 2009 William Lauder decided to step down as CEO and bring in Fabrizio Freda, a senior executive at Procter & Gamble. At the time the company was badly adrift, and William found the job exhausting. "Being CEO of a company is a sentence," he likes to say. "Being CEO of a family company is a life sentence because your largest shareholders have your home phone number and don't hesitate to phone any time of day or night." Mr Freda's professionalism has worked wonders: the share price has increased by about 145% since he took over and its market capitalisation has soared from $6.5 billion to $30.8 billion. But William Lauder remains closely engaged: he and Mr Freda have offices opposite each other, and in a joint interview with your correspondent they often finished each other's sentences.

Keeping the peace

The most important skill for any family business is managing the family itself. Professional managers have to succeed at only one thing: managing the company they work for. Family managers have to succeed at managing both their companies and their families. The second is a precondition for the first.

Sensible families approach both tasks with the same rigour. They draw up family constitutions to work out the division of power and responsibilities. They appoint family offices to run the family's affairs. They hold regular family councils and retreats, create private websites and publish family histories to foster a sense of collective pride.

Sweden's Bonnier family, which focuses on publishing and media, is ruled by a general assembly of 76 family members, some of whom are responsible for a holding company (which presides over the family's businesses) and others for a foundation (which runs the family mansion as well as several subsidiary foundations). The family holds regular get-togethers to induct younger Bonniers into its traditions and reinforce mutual bonds. Germany's Haniel family, too, works hard to encourage its 650 family members to behave as responsible owners and organises many events to enable them to meet.

Michele Ferrero, Ferrero Rocher's long-time boss, who died

The most important skill for any family business is managing the family itself

earlier this year at the age of 89, was in some ways the archetypical family businessman of the post-war generation. He only ever gave a single interview to the press and refused to ask consultants or bankers for advice, convinced that he knew his business better than anyone else. It is impossible to argue with the success of his chocolate business, yet most leaders of today's family firms belong to a very different world. They need to use new techniques to survive in a world of technological disruption and globalisation.

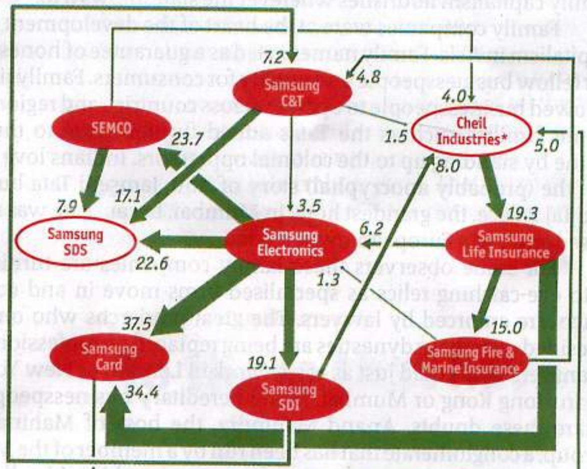
Family companies have become increasingly willing to use public-relations companies and law firms. They are also more prepared to draw on professional advice from consultancies and business schools. McKinsey and BCG are currently competing to produce cutting-edge research on family businesses. Switzerland's IMD business school focuses heavily on family companies, and Harvard Business School puts on a popular executive-education course especially for them.

Wealthy families increasingly look at themselves as collective enterprises with different branches, including family philanthropy as well as core businesses. They are also becoming more businesslike in running their private affairs. The richest among them have traditionally employed family offices to look after their personal finances, staffed by wealth managers, accountants, lawyers and assistants. Today a new breed of multi-family offices is extending this service much lower down the wealth scale. These offices are increasingly extending their influence into new areas. Britain's Salamanca Group started out providing security for wealthy clients from the Middle East; now it offers families advice on everything from how to get their children into the best British public schools or managing their property portfolios to protecting their family businesses from cyber-crime. ■

A spider's web

Corporate structure of Samsung Group, simplified version, September 2014

Listed · Unlisted · 0.0 % stake



Source: CLSA

*Formerly Samsung Everland

Asia

Asian values

In the world's most dynamic region, family companies occupy the commanding heights of capitalism

THE BUSINESS CAPITAL of the Philippines is a part of Manila called Makati. But it might be called Ayala, after the country's most powerful company, which seems to dominate it. Ayala's 35-storey headquarters stands in the heart of Makati, in Ayala Triangle just off Ayala Avenue. Its tenants include the Philippines Stock Exchange as well as a roster of the world's big banks. The local museum is called the Ayala Museum (and houses a stunning collection of pre-colonial gold). Even the headquarters of the Bank of the Philippine Islands (BPI), which challenges the Ayala Tower for dominance of the skyline, is not really a rival: BPI is the financial arm of the vast Ayala empire.

Ayala has six divisions: property (Ayala Land), banking, mobile phones, utilities, call-centres and electronics. But this list understates the company's ambitions. Ayala Land is in the business of turning plots of Philippine land into parcels of the American dream (and lifting their market value sky-high).

The Ayala empire has been run by the Ayala-Zóbel dynasty for the past 181 years. The family started out in agriculture, then diversified into everything from construction to phones. The Zóbels have professionalised and focused the company in recent years. The six main businesses have been listed on the stock exchange and put in the hands of professional CEOs, but the family remains at the heart of the firm. Two brothers from its sixth generation, Jamie Augusto and Fernando, run the holding company that sets the strategy. Three children from the eighth generation are working their way up the corporate hierarchy.

Jamie Augusto has a glowing vision of the company as the driver of his country's modernisation. It has always taken a leading role in this, from building infrastructure to supporting corporate philanthropy; the Ayala Foundation is one of the country's largest. But in recent years it has increasingly focused on the mass market in an effort at "nation-building". Jamie Augusto, an alumnus of Harvard Business School, says this change of direction has been influenced by eminent management gurus. C.K. Prahalad urged companies to look for the "fortune at the bottom of the pyramid" and Michael Porter advised them to embrace "shared value". But it would be just as accurate to credit the influence of Globe, the family's communications business: you cannot build a mobile-phone empire without considering the poor.

It is hard to know what to make of this vision of the family company as nation-builder. On the one hand Ayala is an unelected body with an interest in keeping new businesses out of the market. On the other, it is an efficient organisation that has had to compete with other conglomerates, some of them run by overseas Chinese, notably Henry Sy's SM Group. Whatever their faults, these conglomerates do a better job of providing services than does the Philippine state, with its noxious mixture of incompetence and rent-seeking.

Ayala Land provides Makati with much of its public infrastructure in the form of walkways and parks. In 1997, when Ayala took over Manila Water, the taps in the utility's headquarters did not work. Today it offers a reliable water supply to more than 8m customers. The company is good at long-term thinking and co-ordinating activities across a broad range of industries. In one of Ayala Land's projects, Nuvali, it is building not just houses but also schools and churches for the people who work in the company's factories and call-centres.

The commanding heights of the world's fastest-growing region, Asia, are dominated by great business families. At first glance companies such as Samsung and Hutchison Whampoa ▸▸

may look like regular public companies, but closer examination quickly reveals a family dynasty and a family saga. The partial exception to this rule is China, where state-owned enterprises (SOEs) still dominate. But even there the country's own brand of family capitalism flourishes wherever the state allows it to.

Family companies were at the heart of the development of capitalism in Asia. Family names acted as a guarantee of honesty for fellow businesspeople and quality for consumers. Family ties allowed businesspeople to operate across countries and regions. Some families such as the Tatas added further lustre to their name by standing up to the colonial oppressors. Indians love to tell the (probably apocryphal) story of how Jamsetji Tata built the Taj Palace, the grandest hotel in Mumbai, because he was refused entry to a European-owned hotel.

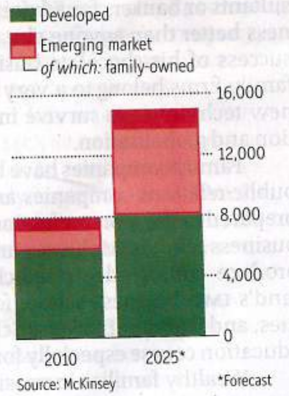
For some observers these family companies are turning into eye-catching relics as specialised firms move in and contracts are enforced by lawyers. The great patriarchs who once presided over these dynasties are being replaced by professional managers who could just as easily work in London or New York as in Hong Kong or Mumbai. Many hereditary businesspeople share these doubts. Anand Mahindra, the boss of Mahindra Group, a conglomerate that has been run by a member of the Mahindra family for three generations, is uncomfortable with talk of family capitalism. Family companies are mostly stuffed with family members "99% of whom should not be there", he says.

But the numbers tell a different story. Asian countries are far more family-oriented than Western ones, and well over half the largest business groups in South-East Asia and India are controlled by families. Family companies continue to draw on time-honoured advantages such as their good names and deep connections, and continue to reinforce their positions through judicious marriages.

Family companies can also draw on new advantages, such as modern management techniques and their connections with Western companies. The local princes and princesses are almost invariably educated at famous Western business schools (to which they make generous donations) and then polished in well-known Western companies such as McKinsey and J.P. Morgan.

Vikram Bhalla, of the Boston Consulting Group, points to an even more important competitive advantage of Asian family businesses: their entrepreneurial zeal. They are more likely than public companies to make big bets and take big risks, and better than lone entrepreneurs at making things happen because they can mobilise far more resources. Being able to take a long-term view and co-ordinate activities across a wide range of sectors allows them to shape entire industries.

The future is rosy
Companies with over $1bn revenue



Which is yours?

Mr Bhalla divides Asian family companies into five main categories. The first is family-driven conglomerates, formed as the company repeatedly expands into new areas to provide jobs for the children. Boys tend to get "hard" industries such as construction whereas girls are given "soft" sectors such as hotels. The second is splitters, the opposite of the first: the family undergoes a strategic split to avoid (or disentangle) family conflicts. This can work smoothly, but is more often messy. The Birla family has repeatedly divided its empire amid furious arguments. The third group is institution-builders: the family hands over the day-to-day management of its businesses to professional CEOs and consolidates family power in holding companies. Anand Mahindra rules his group from his holding company. He likens himself to a "private-equity player" who chooses where to invest in the "Mahindra federation".

The fourth category is joint families, in which several family members manage a company together. The main example of this is Asian Paints, which is flourishing under the joint control of three brothers. The fifth is serial entrepreneurs. Here the business platform is the family rather than the company: it moves from one industry to another but continues to use its name and connections to power its business dealings. The Piramals are a good example. Having started life in textiles, they shifted to pharmaceuticals, then used the profits from a judicious sale of their generic-drugs business to America's Abbott Laboratories to go into big data and financial services.

But even such typologies risk understating the role of families in Asian business. Most of them are far more deferential to their patriarchs than their equivalents in the West, even in the face of dubious business decisions. They are also far more all-enveloping, even if they seem completely Westernised. Ajay Piramal, chairman of the Piramal Group, is a habitué of Davos; his wife, Swati, a doctor, is a member of Harvard University's Board of Overseers; his two children were educated at "all the brand-name universities and business schools". But the entire Piramal clan, numbering 40 in all, lives together as a huge extended family, discussing business and family affairs over every meal. "We go to Harvard," says Mrs Piramal, "but we also wear saris."

Perhaps the best place to learn the secrets of Asian capitalism is not the business sections of the newspapers but the gossip pages of glossy magazines. The stories of family feuds and scheming mistresses that can be found there are far more likely to change the balance of corporate power than the latest hostile takeover. As in family businesses the world over, the most important dramas are to do with succession. Many of the great patriarchs who created modern Asian capitalism have been useless at succession planning. They hold on to power until they have one foot in the grave. Talking about succession, they reckon, "is almost like putting a curse on someone", in the words of Yupana Wiwattanakantang, of the National University of Singapore Business School. Sir Run Run Shaw, the chairman of Television Broadcasting Limited, waited until he was 103 to announce his retirement, handing his position to his 79-year-old wife. Joseph Fan of the Chinese University of Hong Kong studied succession in 250 family firms in Hong Kong, Taiwan and Singapore and found that on average the firms lost 60% of their value in the period spanning five years before succession and three years afterwards. Many lost a great deal more.

Again, feuds are commonplace. One of the highest-profile ones was the bitter dispute between Mukesh and Anil Ambani over their conglomerate, Reliance, after their father, Dhirubhai, died without leaving a will. Mukesh has proved the more talented of the two, celebrating his relative success by building a 27-storey house in Mumbai for his family.

The tale of the Kwok family is even more colourful. Kwok Tak-Seng built up his company, Sun Hung Kai, to become the second-largest business group in Hong Kong and then left it to his wife and three sons, Walter, Raymond and Thomas. This quartet got on well until Walter was kidnapped and held in a wooden cage for a few days until a ransom was paid. The aftershocks of the kidnapping tore the family apart. Walter accused his brothers of quibbling over the size of the ransom, the rest of the family tried to oust him from his role as chairman of the family trust, and the fight continued for years.

Asian family politics are further complicated by Chinese patriarchs' tendency to have several families. Stanley Ho's gambling empire has repeatedly been convulsed by fights over inheritance between different branches of his family (he has had four wives). Given that the company once accounted for 40% of the Macau economy, these quarrels have aroused keen local interest. And since Wang Yung-ching's death in 2008, his Formosa Plastics group has been rocked by rows among the nine offspring he had with his three wives.

Fixing family capitalism

As the patriarchs who built Asian capitalism after the second world war retire or die, Asia is seeing one of the biggest transfers of wealth in history. Some families are learning how to prepare their companies for a different age, preserving a measure of family power while also modernising their patrimonies.

The retiring generation has given its children two things that they need to succeed in this new world: personal wealth and a privileged education. But they are also wired into the old world of "Asian values". Victor Chu, the boss of First Eastern Investment Group, is one of the rising generation of middlemen-cum-dealmakers. He earned his reputation in Japan by founding Peach Aviation, a low-cost carrier. ("He may not have his own plane but he does have his own airline," quips a friend.) But his real talent lies in connections: he spends his life introducing Western companies to the East and vice versa.

The best example of a successful transition is Asia's richest man, Li Ka-shing. When he put together his property and trading empire, Cheung Kong, political and family connections were vital. He had a genius for establishing monopolies through licences and building businesses with astonishing speed. But he has been preparing his empire for a different world for decades. He chose the cleverer of his two sons, Victor, to succeed him and set up his other son, Richard, in a different business to head off any quarrels. He has consolidated his empire into a more formal structure, with Hutchison Whampoa at its heart, and is moving its centre of gravity from Hong Kong to the global stage.

The Zóbels of Ayala fame also look likely to be around for generations to come. They have made use of all the tools of sensible family government and are training up the next generation of Zóbels in the family business. In a society given to flashiness, they come over as relatively modest. That helps at a time when the gap between the new business aristocracy and the poor is opening ever wider. ■

Perpetuating inequality

To those that have

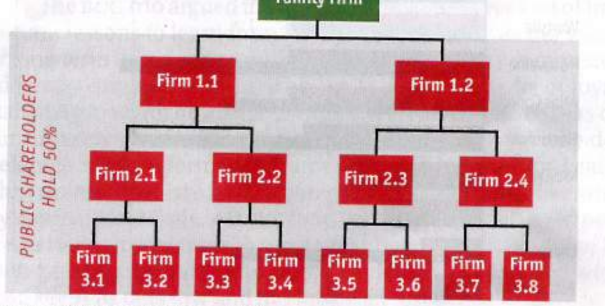
The dark side of family capitalism

FOR MOST PEOPLE the chance to fly business class, let alone first, is a rare pleasure. But Heather Cho was not enjoying herself. As the Korean Airlines flight taxied onto the runway at New York's John F. Kennedy International Airport last December, she was fuming over her macadamia nuts, which had been served in a paper bag rather than on a plate. She used her position as one of the airline's senior executives, not to mention the owner's daughter, to demand an apology, and ordered the plane to return to the terminal so the offending steward could be taken off the plane. The "nut rage" incident, and the message it conveyed about the gap between the rich and powerful and the rest, started an agonised debate in South Korea.

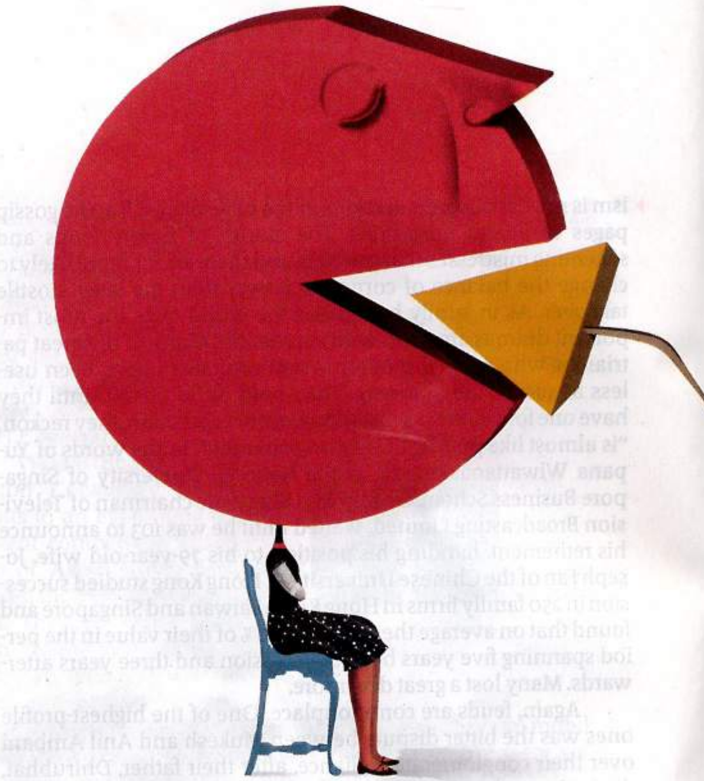
Even by Asian standards, South Korean capitalism is unusually family-focused. About 20 families run the huge conglomerates or *chaebol* that make up 60% of the country's stockmarket value and most of its exports. The leading one alone, Samsung, accounts for 25% of South Korea's exports, putting enormous power in the hands of its ruling family, the Lees. Most South Koreans revere the *chaebol*. They powered the "miracle on the Han river" which transformed a war-torn backwater into a comfort- ▸▸

The power of dilution 5

Schematic pyramid structure, illustrating control mechanism



Source: La Porta, Lopez-de-Silanes and Shleifer



able middle-income country. That reverence extends to the great patriarchs who turned the *chaebol* into mighty industrial machines. But doubts are creeping in.

South Korea puts great emphasis on upward mobility and social solidarity, yet the country is increasingly ruled by a collection of old families whose members marry each other and inherit all the best jobs. The concentration of wealth produces a range of other problems. Political cronyism is rife. Corporate governance is shoddy, with *chaebol* families exercising power through convoluted ownership structures. The chairmen of Samsung, Hyundai Motor, SK and Hanwha have all been convicted of crimes, and three of them have spent time behind bars.

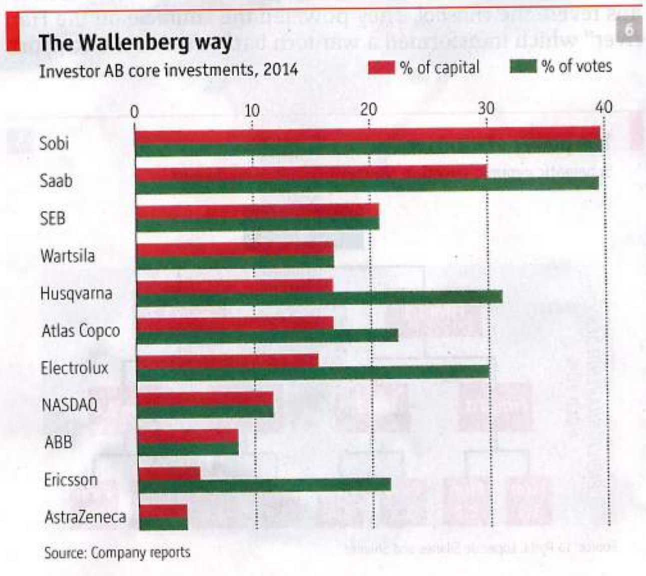
Worse than you think

South Korea's concern about inequality taps into a worldwide debate about the increasingly unequal distribution of wealth, to which Thomas Piketty's book, "Capital in the Twenty-First Century", published in 2013, made a notable contribution. Mr Piketty, a French economist, does not devote much space to family companies: his argument is that inequality is growing rapidly because the returns on capital are higher than the rate of economic growth. But the extent to which families are able to perpetuate and leverage their wealth suggests that the problem may be even worse than Mr Piketty thinks.

Bill Gates, the world's richest man, has countered Mr Piketty's thesis by arguing that wealth dissolves over time: families either lose their money through incompetence or give it away to charities. But families are getting better at breaking the clogs-to-clogs cycle. They are not only learning how to manage family companies and family fortunes better; scions of family fortunes are also increasingly marrying intelligent partners who can help them run their companies. A growing number of them are determined to work for their living. The industrious rich could prove far more of a threat to equality of opportunity than the idle rich.

The desire to preserve wealth lies behind one of the biggest problems with family companies, poor corporate governance and lack of transparency. Families set up convoluted structures to prevent outsiders from gaining control. The most extreme example of this is South Korea, but in Europe, too, many families use foundations or investment vehicles to keep control.

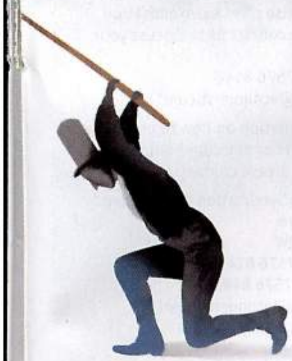
Business families have developed ways of exercising corporate power, such as control pyramids and dual-class shareholdings, that go far beyond their formal ownership. Randall Morck, the academic, finds that in large parts of the world pyramidical business groups allow "mere handfuls of wealthy families" to control entire economies (see chart 5, previous page, for a schematic view of how this works). This problem is particularly marked in developing countries, but is also common in much of the rich world, except in the Anglo-Saxon sphere. In Sweden, which is widely regarded as one of the world's most egalitarian countries, one family, the Wallenbergs, controls a big chunk of the Stockholm Stock Exchange, thanks to a family-run investment fund and a complicated system of privileged shares and pyramid holdings (see chart 6). Mr Morck also calculates that the top ten families control 34% of Portugal's market capitalisation and 29% of France's and Switzerland's.



Pyramids may have had an economic justification during the early stages of capitalism, but that has largely gone as institutional voids have been filled. America launched a vigorous war on pyramid structures during the New Deal, and by 1937 American companies were as widely held as they are today. Britain fought an anti-pyramid campaign in the late 1960s, with equally rapid results. Now Israel is stopping the oligarchs who control most of its domestic economy from using pyramid holdings, on the grounds that they reduce competition and raise domestic prices. Countries such as India and Brazil would do well to study Israel's example—and even Sweden might have a rethink.

Business families have also proved adept at consolidating their positions through political marriages. Paul Desmarais junior, one of Canada's richest people, whose family trust owns Power Corporation, among other companies, is related by marriage to Jean Chrétien, a former prime minister. Jessica Sebaoun-Darty, an heiress of a vending-machine empire, is married to Jean Sarkozy, a son of a former French president. The Lees, who own Samsung, are connected by marriage to four other *chaebol* (LG, Hyundai, Kolon and Poosan) and many leading politicians, including a former South Korean prime minister. The Toyoda family network includes two former prime ministers and seven big Japanese business empires.

Other successful techniques include going into politics yourself (like the Rockefellers or the Kennedys), funding political campaigns and cultivating friendships with politicians. Such political connections are pervasive in Latin America where, thanks ▸▸



to weak property rights and a long history of political interference, even the most virtuous companies have to keep in with politicians. In Colombia, two of the richest families, Sarmiento (banking) and Santo Domingo (beer) own the two main newspapers. Carlos Slim was said to be the main funder of Andrés Manuel López Obrador, the populist leader of the Mexican left. JBS, a giant Brazilian meat company that has expanded with the help of funds from the national development bank, BNDES, was the biggest donor in the Brazilian election last year.

The problem of poor corporate governance is particularly severe in the Gulf region, where some $1 trillion of family-business assets are due to be handed over to the next generation within five to ten years. Families can involve several wives and many children. The boundary between the firm and the family is often ill-defined and the courts, particularly in Saudi Arabia, are not well equipped to deal with complicated inheritance disputes.

The region is making an effort to improve the governance of family companies. Badr Jafar, the managing director of the Crescent Group, has set up the Pearl Initiative, which pushes for good practices such as the establishment of family councils. SABIS, a Lebanese education company, has established clear rules for succession planning and hiring new family members. The Zamil Group, a Saudi conglomerate, has set up an internal leadership programme open to both family and non-family. The Abdullatif Alissa Group, another Saudi conglomerate, has removed all family members from management positions, limiting their role to sitting on the board. But for every example of good planning there are dozens of botched successions. ■

Management theory

Survival of the fittest

The success of family companies turns much of modern business teaching on its head

THE MODERN THEORY of the firm is the theory of the public company: obsessed with questions such as transaction costs but blind to questions of transmitting wealth to future generations. In numerical terms, this emphasis on the public company is clearly a mistake. Its triumph is limited to the Anglo-Saxon world. The economies of most of the rest of the world—developed as well as emerging—continue to be dominated by family-focused businesses that control a wide range of companies, not just individual firms.

It is also out of date. Talk of the triumph of the Anglo-American public company might have made sense in the post-war era when the British empire still had a glow and the American Century was in full swing (though family companies continued to flourish in both countries). It makes far less sense in an increasingly integrated Europe and in rapidly emerging markets. The world's fastest-growing region, Asia, is dominated by powerful business houses run by families. Though some of these could no doubt benefit from more focus, a significant number are Schumpeterian entrepreneurs destined for success, thanks to a rare combination of risk-taking and long-termism.

This special report has argued that family companies are much more than just half-formed public companies. They are a category of companies in their own right. They have unique advantages in the form of long-term thinking and concentrated ownership. They have unique disadvantages in the form of succession problems and family feuds. And they have unique ways of dealing with these problems. Given the sheer number of family companies of all sizes, and their economic importance, they deserve a lot more attention, in particular from three groups of people: business analysts, professional managers and theorists of the firm.

Putting the family back into capitalism

Business analysts would do well to add some new tools to standbys such as company prospectuses and analysts' reports. They might read more novels—say Jane Austen's "Pride and Prejudice" for its observations on the marriage market and Thomas Mann's "Buddenbrooks" for its insights into the fading of the entrepreneurial spirit across the generations. They should also follow the gossip columns. A set of bad numbers can be turned around. A bad marriage can doom a business empire.

They should certainly keep an eye on problems of succession. A huge transfer of corporate wealth and power is currently taking place in two parts of the world—Asia and the Middle East—which have little experience of such things. The fate of two of the world's biggest companies, Samsung and Hutchison Whampoa, is being shaped by family succession. So is that of thousands of other companies which operate out of the glare of publicity. BCG's Vikram Bhalla has a shrewd piece of advice for investors: invest in a family-run company four or five years after a new CEO has taken over, because he will have settled in and may well have a clear run for the next decade or so.

Business analysts like to argue that conglomerates will become less prevalent as markets develop, but conglomerates are also driven by families' desire to provide opportunities for their offspring. Business analysts point to the logic of the market to explain mergers and acquisitions, but an equally powerful reason may be family affinity. LVMH has managed to buy a number of family-owned luxury companies because they are much happier selling to another family firm than to an anonymous public company. Estée Lauder is pursuing a similar strategy in buying up family-owned beauty companies.

In November 2012 the *Harvard Business Review*, the management profession's bible, published an article entitled "What You Can Learn from Family Business". For decades the profession had looked down on family businesses as amateur and slapdash. Now three leading BCG consultants, Nicolas Kachaner, George Stalk and Alain Bloch, were changing tack.

The BCG trio argued that public companies have a lot of important lessons to learn from family companies, from the value of long-term thinking to the virtues of frugality. They commended family companies on their ability to develop a cadre of loyal staff; they may not be able to compete with investment banks or consultancies in hiring top talent, but they make up for it by developing high-performance teams that stick together for years. They pointed to a list of public companies that act rather like family companies. Nestlé, a Swiss food company, slightly underperforms its big competitors in good times but outperforms them in bad. Essilor, a global leader in optical lenses, is obsessed with cost, keeps its debt low and has little staff turnover. ▸▸

But the three authors missed one important competitive advantage that family companies enjoy: their ability to differentiate themselves by telling compelling stories about themselves. New wine merchants may be able to best Berry Bros. & Rudd on creating global distribution channels, but they will never be able to match its stories about selling wine to Pitt the Younger and Lord Byron. The more companies compete to sell "meaning" as well as mere products, the better family companies will do.

The nature of the firm

The most intriguing challenge posed by the enduring success of the family company is to one of the building blocks of modern economics: the theory of the firm. The modern theory of the firm is based on the assumption that public companies represent the end of corporate history. In "The Modern Corporation and Private Property", published in 1932, Adolph Berle and Gardiner Means argued that public companies were rapidly replacing family companies as the mainstay of modern capitalism. But these public companies contain within them a potential conflict of interest, between the widely dispersed shareholders who own them and the professional managers who run them on a day-to-day basis. In "The Nature of the Firm", Ronald Coase argued that firms make sense only if the cost of doing things within them is less than the cost of contracting those things out.

Most subsequent writing on the firm has been a commentary on these two seminal texts. Michael Jensen elaborated Berle's and Means's insight about the conflict between owners and managers into modern agency theory: company owners (or principals) have to develop elaborate methods to prevent company managers (or agents) from losing them money, either through laziness or through empire-building. Mr Jensen argued that the best way to solve the agency problem was to get managers to think more like owners by giving them share options.

The prevalence of family companies in so much of the world suggests that theorists of the firm need to think more in terms of groups of firms rather than just individual firms. Berle and Means and Coase were guilty of Anglo-Saxon parochialism in focusing on free-standing firms. Above all, the theorists need to pay as much attention to ownership and inheritance as they do to conflicts between principals and agents or to agency costs.

Put companies and families together, and you have a uniquely potent combination

Family companies demonstrate the importance of inheritance as the families create and improve the firms in order to pass them on to their children. They also demonstrate the importance of ownership. Families often think more clearly than professional managers because they own their companies rather than merely renting them.

However, inheritance and ownership bring with them a whole collection of problems that are every bit as tricky as agency and transaction costs. Heirs frequently quarrel about their inheritance, and some owners behave less responsibly than others.

All the great prophets of modernity, not just economists, shared the belief that families would be marginalised as society progressed. Ferdinand Tönnies argued that modernity means shifting from tightly knit villages ruled by personal ties (*Gemeinschaft*) to loosely knit societies ruled by impersonal ties (*Gesellschaft*). Max Weber described modernity as the triumph of rule-based decision-making: jobs are allocated on the basis of merit rather than family connections.

In fact, family connections have proved remarkably durable. The American presidential election next year is likely to be fought between two political dynasties, the Clintons and the Bushes. Family dynasties can be found in every part of the modern economy, from crime to academia, from sport to entertainment. Even rapping is becoming a family business. Far from being marginalised by the march of progress, the ability to pass skills to your children is as important as ever. And far from disappearing with the passage of time, the desire to help your children endures.

The company is one of the most powerful instruments ever produced by human beings; it allows investors and workers to pool their resources to serve the needs of strangers to mutual benefit. Successful countries such as America have many millions of companies. Failed countries like North Korea have none. Yet the family is even more powerful and universal: it allows parents to pass not just their genes and their property but also their culture and their aspirations on to their children. Put companies and families together, and you have a uniquely potent combination. Families with names like Rothschild and Baring played a starring role in creating modern capitalism. Families with names like Godrej and Lee will play a starring role in re-creating it in a more global age. ■

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