Family fortunes

Michael O'Sullivan and Ariel Sergio Goekmen consider the role of family businesses in the post credit crisis economy

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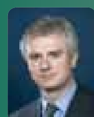
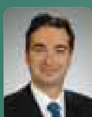

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Family businesses are back in fashion. As the credit crisis uncovers the downside of the leveraged corporate business model, the attractions of the relatively sensible family business framework are growing. Across continental Europe, as well as in the UK and the US, we believe that the characteristics of the family business model offer other companies, but also policy makers, a good reference point as they look to pick up the pieces from the credit crisis.

The past year has witnessed the fall of some European companies with either too much balance sheet leverage, or as is increasingly the case, too much operating leverage. More pain can be expected as the unwinding of high debt levels continues and as the economic contraction deepens.

Well-positioned

While family businesses are by no means immune to the credit crunch, they are arguably better positioned to deal with some of the threats and opportunities that have arisen. We suspect that the family business model will start to appear an increasingly wise one through the course of this downturn and anecdotal evidence suggests that family businesses are now picking up relatively cheap assets and managerial talent as other types of corporation cut back. There are a number of reasons for this.

Broadly speaking, family influenced businesses tend to be less leveraged, more conservative in their investment decisions and generally have a longer-term focus on investment and innovation (for example long-lasting family 'empires' like Sweden's Wallenbergs have often entered recession periods cash rich and have been able to take a more opportunistic stance as recovery arrived, and indeed, as competitors have faltered). During the previous (dot.com) bubble, certain family influenced businesses notably followed long-term objectives rather than short-term fashion, as evidenced by Bouygues refusing to run for UMTS licenses and Peugeot declining to develop a B2B internet lead strategy in 2000.

In general, though there are exceptions, family businesses can be predominantly found in more traditional economic sectors – industrial engineering rather than financial engineering for example, therefore limiting the impact of tight credit on their business. Indeed, the literature on family businesses is replete with case studies that note the devotion of family businesses to cash flow, rather than sales or earnings growth as a governing performance metric, making family influenced businesses less dependent on outside financing.

Family run, owned or influenced businesses make up over 30 per cent of the major Western stock markets (the UK being the exception) and more importantly, on average they comprise over 60 per cent of small and medium-sized firms in the private sector in countries like Germany, Italy and Sweden. As such, they are a vital, though very often unheralded part of the European economy and a focal point for entrepreneurship, and their relative stability allows them to function as a base for innovation.

In this respect the family business model can be seen an important indicator of the health and potential future direction of activity across Europe.

Challenges

In the shorter-term they are not unscathed by the credit crisis. The deep cyclical downturn in the European economy, and in many cases the dysfunction in banking, credit and other financial markets has led several viable family businesses to turn into very weak or sometimes insolvent ones in a short space of time.

While family businesses can access alternative sources of capital, such family savings, a relatively high number of family firms across Europe have been deprived of short-term funding, and suffered higher medium-term financing costs because of the disorder in markets. If this persists, then alternative funding mechanisms need to be put in place, such as the circumvention of the commercial paper market by central banks, and above all, well-managed small business loan and loan guarantee schemes at affordable pricing close to Libor rates.

Second, while market and political attention remains focused the shorter-term economic damage that is resulting from the credit crisis, how economies evolve in the next ten years is arguably more important than what happens in the next ten months. Here, in terms of reform and long-term economic growth, the family business model is also worth studying.

Aligning goals

As a model on which broad reforms could be based there are a number of points worth highlighting. Although family businesses are not without their own, often colourful, governance problems, they are a useful illustration of the benefits of aligning executive and shareholder goals through common ownership, and of the kind of stability that can follow from this. In the recent past, the compensation packages of executives in some publicly quoted companies have not been adequately structured such that long-term goals are aligned. This is different in family owned firms, where management and shareholders' interests are generally more aligned. Notably, after the dot.com crisis, as the example of Bertelsmann shows, family owners re-asserted control from over-ambitious executives.

From an oversight point of view, the family members who are involved in businesses over a number of generations tend to intimately know and understand their companies, especially when they have 'risen through the ranks'. In this way, the labour market or rather internal human capital and organisational goals are aligned.

Long-term growth

As regards long-term economic growth, once markets and economies begin to stabilise governments are likely to search out sources of long-term economic growth. 'Intangible' factors such as a stable business climate, education, innovation and entrepreneurship are some of the key drivers of long-term growth. In the past 20 years, countries that have tended to do well on these scores, like Sweden and Switzerland, have prospered. Unsurprisingly, family businesses are important cogs in the economic machinery of these countries, and in particular, contribute to economic stability, retain knowledge and expertise within the organisation better than other more fluid organisations. They have a record in fostering innovation and in countries like France, for example, tend to spend more on training and development than publicly quoted ones.

In terms of economic stimulus, recessions are periods of creation as well as destruction, and this particular recession is likely to lead to radical changes in some industry structures. We know from research that the number of family/entrepreneur owned businesses increased significantly in the major economies after the end of the three previous recessions as new businesses were created, often in new niche areas. Family businesses also play an important role in the dynamics of regional economies and as an economic conduit for ethnic minorities (for example, the fastest growing segment within UK family businesses is ethnic minority family businesses) two often-neglected areas when it comes to economic policy making.

Supporting family businesses

The challenge for policy makers here is to find ways to support the family business model through broader tax breaks for innovation, incentives to hire outside expertise and reducing the bureaucracy and taxation-related barriers to family-based ownership stakes. In addition, a number of institutional innovations are worth considering, such as the encouragement of family-business-specific arbitration mechanisms, and support for types of long- and short-term financing structures specifically for family influenced businesses. While the short-term attractions of raising taxes (such as inheritance taxes) are rising as government finances dwindle, a more long-term strategy is to keep family businesses intact as a focus of entrepreneurship and job creation. Some measures that will help family/entrepreneur-run businesses have already been announced, such as the accelerated reimbursement of tax credit to corporations in France.

Looking ahead

It is already becoming clear that the structure of the world economy post credit crisis will be a lot different to what we have been used to over the past 15 years. Long-term earnings growth will be lower, as will risk appetite, and in general there is likely to be a return toward a world of lower financial leverage, more industrial innovation and, we hope, sound finance. These are conditions that family businesses are used to, and are arguably more likely to survive in, given their traditional ability to refocus on core businesses, use of lower debt levels and more conservative risk taking.

From a strategic point of view, the relationship between the state and markets is going to dramatically change, especially in the Anglo-Saxon countries. Family businesses have traditionally played a very important role in linking and also buffering these two entities, and often in periods of great economic change – from economic upheavals in modern French history, to political change in Italy or the post World War II period in Japan, and more recently the economic modernisation of India and China – family businesses have shown themselves to be adaptive. In many countries they have performed a very useful role in feeding back economic trends to policy makers and in transmitting policy change to the wider economy.

Family businesses also capture the likely ethos of the post-credit crisis world – the collective over the individual, long-term over short-term decision making, low leverage over financial engineering, and stability over volatility.

As Europe's politicians grapple with the economic and financial effects of the credit crisis, and begin to consider what the post credit crisis world might look like, they could do worse than look toward the crucial role that family businesses have played through Europe's economic history, the stability and survivability of family businesses, and start to make them the focus of clusters of expertise and poles of excellence upon which Europe's economy can be improved.