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GOVERNANCE FOR FAMILY BUSINESSES

SUSTAINING THE "MAGIC" FOR GENERATIONS TO COME

By Camille Egloff and Vikram Bhalla

WHAT EXPLAINS THE PHENOMENAL early success enjoyed by many family-owned businesses? This success often defies rational explanation and instead can seem like a feat of magic as the family combines ambitious vision, entrepreneurship, and decisiveness with a bit of luck to ignite the growth of a thriving business. And they often accomplish this without the robust governance, organization, and processes that support day-to-day management and long-term planning for a larger modern corporation.

What happens next may be less inspiring, however. Family businesses can risk losing their early momentum when confronted by the challenges of managing a growing company in a complex and demanding environment. Most family businesses face a defining moment when they need to create a more robust management backbone to sustain their success. This defining moment can occur at a time of strong growth, international expansion, or generational transition, or at the handover of leadership to nonfamily management or the entrance of external investors. BCG's experience shows that a fivefold to tenfold increase in revenues often signals the need for change. At such a moment, the family must recognize that it needs to rethink its approach to running the business in order to enable the next stage of growth.

To illustrate the challenges, consider a composite example of a family-owned business that we will call FamilyCo. The founder personally managed all aspects of this business, from making rapid decisions on multimillion-dollar investments and closing commercial deals to deciding on employees' salary increases and Christmas presents for their children. As FamilyCo grew into a leading global player, however, even the founder's formidable capabilities could not alone meet the challenge of managing the organization's increasingly large and complex operations in a fast-paced and fiercely competitive market. The company faced an urgent need to distribute the founder's authority among strongly empowered management teams.

Such a transformation is easier said than done. To address this type of situation while maintaining the speed and effectiveness of decision making, leaders of a family business must embrace what may seem like a counterintuitive idea: the best way to sustain the magic is to formalize it. A mature family business needs agile governance and clear management structures that are supported by a simple yet robust platform of processes and systems.

Revealing the Secrets Behind the Magic

The first step to formalizing the magic is to understand what lies behind it. Although the success factors that constitute the magic are present in varying degrees at different companies, family-owned businesses typically benefit from certain key elements.

A Clear Vision. A clear vision for the company's purpose and mission lies at the heart of every successful family business. The leader uses this vision as the starting point for the business's strategy—which is often not formally articulated—and lives and breathes it while overseeing every step and minute detail of the business's development.

Long-Term Perspective. Because most family-owned businesses are private companies, they do not need to worry about impressing investors with short-term performance figures. Their long-term perspective is measured in generations, not months or years. This positions them to make bold bets in deciding whether to grow their existing business lines or expand into new ventures.

Firm Management Grip and Rapid Decision Making. Family members maintain a firm grip when managing the business and are empowered to make decisions that promote the company's long-term interests. Because they are unencumbered by organizational layers and bureaucratic processes, family businesses maintain the agility to react swiftly and effectively to changing conditions.

Entrepreneurial Spirit and Core Skills. A founder's entrepreneurial spirit provides the basis for the culture of a successful family business. Employees—whether family members or other professionals—work directly with the founder and are motivated to build the business by performing at a high level. Beyond this, the family always possesses a specific core skill—for example, relating to product development, commercial excellence, or brand building—that has propelled its success.

Loyalty. Over time, many family businesses form bonds with their employees that go beyond the usual employer-employee relationship. Examples of this informal "social contract" include covering extraordinary expenses related to illness or providing loans to help with children's education or buying a home. Moreover, employees often can pursue personalized career paths and share in the company's success, which further motivates them to stay for the long term. The family business, in turn, benefits from its loyal employees' experience and dedication.

Potential Downsides Can Impede Growth

Although the magic can drive early success, these distinctive aspects of family business management can also impede longer-term growth. If leaders do not articulate a long-term strategy as the basis for formalized investment planning, even the company's top managers may not clearly understand the family's major business objectives. Leaders who maintain a firm management grip are forced to invest time making day-to-day operational decisions, which limits or delays their availability to make the most important, complex, or strategic decisions. Moreover, leaders' failure to delegate can stifle the entrepreneurial spirit among their family members and employees. And, if the family business fosters a culture in which all employees consider their jobs secure, its best employees may have no incentive to perform at their highest level—especially if compensation is not differentiated on the basis of performance.

Formalizing the Magic

Family businesses can avoid these potential downsides and embed the magic into their organization and operations by putting in place the right structure and mechanisms to further grow the business. Four elements are essential to position a company to thrive for generations to come.

Board of Directors and Family Governance Bodies. The essential governance body from a business perspective is the board of directors, including committees responsible for investment and strategy, audit, and compensation. The board works closely with management teams to determine the portfolio of businesses, major investments in the core businesses, and new ventures to pursue. The board is composed of family and nonfamily members selected on the basis of their ownership share, independence, expertise in specific industries or functions, or a combination of these. To preserve the magic that helped drive the business's early success, all members need to maintain a long-term perspective.

To enable a smooth transition to board governance, a family business needs a well-designed transition plan and a clear demarcation of responsibilities between the board and the business units. FamilyCo initially established its board with only a few members and scheduled frequent meetings so that the board could maintain strong oversight of operations. Over time, the company increased the number of members to bring external views to the table and decreased the frequency of meetings to ease the oversight of management teams. To empower business leaders and give them room to maneuver, the company carefully delineated the division of responsibilities between the board and management teams. It also clearly spelled out when the board chairman, the business's founder, could veto decisions. Family businesses can often benefit from an independent perspective in determining this type of detailed demarcation of responsibilities.

Mature family businesses also have three other governance bodies that focus on maintaining family cohesion:

- The *family council* determines the shareholding structure, prerequisites for family members to be involved in the business, and guiding principles of the business strategy. It also manages conflicts among family members, such as those relating to leadership succession.

- The *family assembly* is a larger body in which all family members with shares can participate. It elects the members of the family council. Although it has no decision rights on business topics, it provides a venue for the family to build consensus on major issues, including continuity and succession.

- The *family foundation* manages philanthropic activities. It determines the causes to support, the investment objectives and scope of activities, and how family members will be involved in decision making.

Robust Management Platform. Sustaining the magic requires a robust management platform for the family business that supports its strategy and entrepreneurial spirit and allows it to emphasize its core skills—without imposing the complexity of overly bureaucratic processes. A management platform includes an organization structure that sets out clear roles and responsibilities, as well as a highly capable leadership team that consists of established and rising talents from within and outside the family. The platform is reinforced by a backbone of strong fundamental processes—such as for investment prioritization, developing budgets, and assessing performance—and is supported by tools such as adaptable and scalable IT systems.

The management platform should provide the decision rights and financial controls that give family members confidence to delegate authority to a management team, while also enabling the business to maintain its speed and agility. Lengthy and frustrating decision-making processes are among the main reasons that family businesses lose their magic as they mature. To avoid being weighed down by bureaucracy, the company needs to delegate authority for decisions to the appropriate governance body or organization level and design efficient decision-making processes. Providing the right checks and balances is essential for effective delegation. The board needs full transparency into business decisions, and management must have the freedom to carry out its delegated responsibilities.

FamilyCo implemented a management platform led by a new management team and established clearly defined organization structures and roles. The company's leaders used the platform to effectively communicate a long-term vision to the entire organization and design interactions to enhance collaboration and fact-based discussions. Recognizing the need to persuade long-time managers that they would benefit from the new platform, the company launched it in the context of business-as-usual activities, such as running the annual planning process, implementing a set of improvement initiatives, and instilling a new performance-based human resources culture. This allowed managers to see tangible evidence of how the platform could improve business processes—for example, by clarifying the distinct boundaries within which the managers could make certain types of decisions without needing to obtain top management's sign-off on each decision item.

Performance Management System. A strong performance management system is essential for ensuring that the management platform drives the desired results. Family businesses need a system for delegating responsibilities and managing performance that establishes clear accountabilities, objectives, targets, and incentives. The system should facilitate decision making by executives while allowing the family to manage the business at arm's length if it has chosen to do so. The system should also establish appropriate rewards for the company's professional talent, giving particular emphasis to encouraging high performance in the core skills underlying the business's success. In today's era of greater mobility, top performers expect to be rewarded in the form of bonuses or promotions—family businesses can no longer count on their social contract with employees to form an inseparable bond.

The performance management system can evolve over time to foster the right behavior. During the first year, companies can apply it to the business planning process by linking improvement initiatives to specific targets. After people have gained confidence in the value of the performance metrics and understand how they can improve results, companies can use the system to determine which employees will receive performance-based bonuses.

FamilyCo began its implementation of a performance management system by introducing a corporate scorecard that allowed the founder to manage the business at arm's length. For the first time, he was able to obtain a transparent view of business performance without having to be personally engaged on a daily basis. The scorecard also empowered business managers and their teams by setting out specific goals and targets.

Competitive-Advantage Initiatives. Family businesses need to continue building competitive advantage while managing the transition toward a more structured management platform. Maintaining business momentum requires running the transition in conjunction with programs designed to improve revenues or profit margins, rather than as a separate initiative pursued in isolation from daily business activities.

To direct the organization's energy to common projects, FamilyCo launched its transition to formal management structures in conjunction with competitive-advantage initiatives relating to strategic growth and operational excellence.

Assessing the Starting Point

Although governance should seek to formalize the magic of a family-owned business, it must also be adaptable. Simplicity and flexibility are essential so that governance mechanisms can be easily embraced by the organization and evolve with the family and business as their needs change. The ultimate objective is to enable smooth transitions to higher levels of maturity without sacrificing the action-oriented mindset that allowed the family and its employees to turn a small operation into a thriving business.

The following questions are examples of issues a family-owned business should consider in assessing how well its existing governance mechanisms support its strategy and culture:

- Do we understand the true sources of the family business's competitive advantage—such as the core skills that will drive growth—and how to preserve these in the future?

- Have we defined and articulated a clear long-term strategy to provide the basis for designing a management platform that is sufficiently scalable and robust to meet future challenges?

- Is the division of responsibilities between the board of directors and management teams clearly delineated to balance board oversight and executive maneuverability?

- Do board members and executives have the right information, support, and training to make bold bets for the long term, as well as to make decisions promptly in response to opportunities and threats?

- Have we created processes and tools that enable robust operations without imposing burdensome complexity and sweeping changes on the organization?

- Has the company formalized its process for rewarding nonfamily professionals for their loyalty and applying the entrepreneurial spirit and core skills required to propel the business's continuing success?

For many family-owned businesses, the answers to questions like these will point to opportunities to understand and formalize the magic that has been the secret of their success. The governance mechanisms established through this effort can provide the foundation for a successful business and cohesive family that endure for generations.

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