The Economist

Making it work

The family way

Distinctive problems call for tailor-made solutions

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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.