The Economist

Management theory

Survival of the fittest

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

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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It is also out of date.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. 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.