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Managing the mature family enterprise for success

A healthy economic engine is important—but it's not the only factor.

BY STUART LUCAS

A FAMILY IN CONTROL of a successful, large and growing business will eventually find itself running not just a business but also a family enterprise. The vitality and longevity of a mature family enterprise depend on three equally important key value drivers: the family economic engine, including both business and financial assets; the family itself, its culture and members; and "leakages" that include both cash flow management and estate planning. To thrive for the long run, you must manage your family enterprise as a comprehensive, integrated whole.

Otherwise, over time, diffuse and fracturing ownership, estate taxes, poorly designed or executed investment strategies, and fraying and fragile personal ties will overwhelm the family's economic engine and the family itself. Achieving the goal of a thriving, multi-generational family enterprise requires a deep understanding of each of the key value drivers and the interplay among them.

The graphic on page 53 highlights the key value drivers for successful family enterprise governance.

Flourishing family enterprises require a clear and shared family purpose, a strong economic engine and effective management of leakages. Sometimes these key value drivers work in harmony, but conflicts among them regularly arise and must be resolved.

Are your family's long-term objectives defined, communicated to and absorbed by family members? Are your governance and operating structures stable? Does your family take a fully integrated approach to risk management? If your family is executing well in all three areas, you can make business decisions for the success of the business, invest more financial assets prudently for long-term appreciation, support family members to realize their individual potential and strengthen family ties. In well-managed families, success and stability in any one sphere influences and strengthens the other spheres and the whole system, creating a virtuous circle.

I've also seen families' assets destroyed by poor understanding of the math of maintaining wealth, flip-flopping priorities, undisciplined investing and personal animosity. Problems rarely arise in isolation:

- A common family purpose is not identified, adequately communicated or cultivated. In this vacuum, family members may feel obligation or guilt, value autonomy or feel a strong sense of entitlement. They may have lost a sense of positive commitment to the family. Divisive and competing self-interest and short-termism may come to dominate family decision making.
- Family members with poorly managed financial assets become dependent on dividend cash flow to support their lifestyles, putting increasing pressure on the family business to distribute cash.
- Estate planning structures work at cross-purposes with optimal investment strategies, thus creating havoc in the business and the family at generational transitions.

Poorly managed financial assets do not just intensify pressure on dividends; they can bring unanticipated liabilities to bear on your whole economic engine.

Non-family predators often seek to divide and to undermine the economic engines of underperforming, unsuspecting or factionalized families. It is too late to try to shore up the family's defenses when your prized asset is under threat.

For the virtuous circle to prevail, effective leadership and governance are necessary, within and among each of the three key value drivers. Governance structures must be aligned, values and rules of engagement must be shared and understood, and leaders must be credible and empowered.

Within each of these value drivers are levers of control that must be managed effectively.

Family purpose

The family's leadership, operating within the governance structure, is responsible for shaping, communicating and advancing the family's purpose. Family purpose is supported by three commitments:

• **Maximize the human potential of each family member.** When each individual is encouraged to flourish and be productive, your family benefits, regardless of the way in which each individual meets his or her potential.

• **Adapt and evolve the family's culture and values over time.** A stagnant family culture and value set will likely become irrelevant and be ignored.

• **Identify and invest in shared affinities.** What brings family members together with purpose or fun? What builds a sense of shared identity and purpose?

In catalyzing connections and common identity beyond your family's economic ties, a shared purpose provides the platform for stronger interpersonal relationships and more effective decision making. The strength and value of shared family purpose become particularly evident during times of transition: of leadership, of generational ownership, and during the complex transition from business-owning family to financial family.

Economic engine

Your lifestyle is fundamentally tied to the strength of your economic engine. In the wealthiest families, this link may seem tenuous—but even in these families, eventually reality bites.

The math is clear, though not widely understood. Your family's economic engine—businesses and/or financial assets—must generate annual returns of at least 10% just to cover the combined weight of taxes, fees, inflation, (modest) distributions and the "law of compounding children": the growth in the number of family members from one generation to the next. Over a generation or two, only exceptional businesses and investment portfolios generate returns at this level. The strength of your family's overall economic engine depends on the robustness of each of the following: your business, your family members' careers and the performance of your financial assets.

• **Your family business.** Businesses are typically the primary engine of wealth creation. Most family businesses start out undiversified, illiquid and subject to powerful operational, economic and competitive factors that can lead to wealth creation and, just as rapidly, wealth destruction. Mature family enterprises, in contrast, control businesses that generate stable excess cash flow—although they still entail considerable risk. Families in this situation face additional challenges. How do you maintain a family culture of entrepreneurship as the wealth grows? What should be your family's continuing operational involvement in the business? How should your operational involvement affect your governance structure? How do you diversify if you don't want to sell your business? How do the cash flow requirements of the business, financial assets and family members relate to each other?

Some families eventually choose to sell the core family business. For any number of reasons—perceived risk in the business, lack of family business leadership, animosity within the family, inadequate returns—a family may determine that the benefits of continuing to own the business are insufficient relative to the value achievable from selling. You want to maximize the probability that your family controls the disposition of your core asset, rather than having a decision forced upon you by externalities. For the optimal outcome, you want to be able to evaluate the decision to hold or sell within the context of your family enterprise as a whole. What would be your net-net result, after the sale causes you to realize what may be decades or generations of deferred capital gain on your company shares? What will you do with the cash? Where will you reinvest the proceeds not earmarked for spending? Are you prepared—organizationally, culturally and in terms of financial infrastructure—to be a financial family? The transition from a business-owning to a financial family is a radical and risky transformation of the family enterprise.

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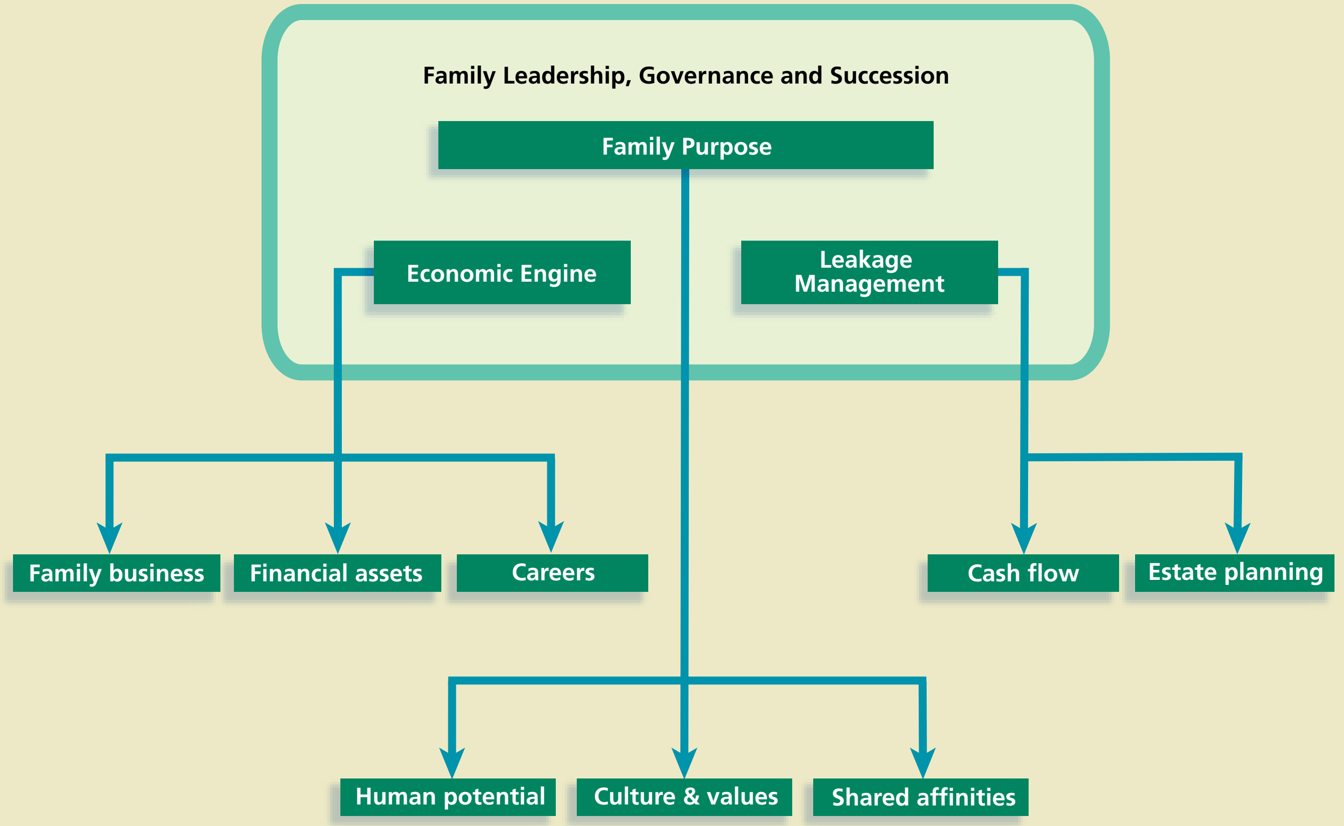
• **Careers.** Careers generate additional income and reduce your family's overall economic risk profile because they diversify family members' sources of cash flow. Careers carry a cultural benefit to your family, too. Over generations, wealthy families risk creating a culture in which family members are always valued customers but do not benefit from the discipline of having customers themselves. A culture of setting stretch goals, of prudent risk taking, of service to customers and community, and of having to make reasonable sacrifices in the pursuit of those goals is healthy. We see the potential for a virtuous circle: The less each family member depends on the family's wealth for his or her lifestyle, the more risk you can collectively afford to take, and the more likely the family enterprise will flourish for generations to come.

• **Financial assets.** Excess cash flow generated by the



The vitality and longevity of a mature family enterprise depend on three key value drivers: the family economic engine, including both business and financial assets; the family itself, its culture and members; and "leakages" that include both cash flow management and estate planning.

business can be redirected back to the core business. It also can be used to diversify in either related or unrelated businesses or into financial assets. Alternatively, it can be distributed to family members to spend or invest. Seeking to improve liquidity and to diversify their wealth, many mature family enterprises redeploy cash flow from their businesses into financial assets. If too much distributed cash flow is spent by family shareholders rather than invested, the opportunity for this important diversification disappears.

Effective management of your financial assets is crucial to the functioning of your family enterprise, especially as they become substantial asset pools in their own right. Financial assets bring your family greater economic security and relieve distribution pressure on the core business. But poorly managed financial assets do not just intensify pressure on dividends; far more dangerously, they can bring unanticipated liabilities to bear on your whole economic engine (for example, when a cousin uses shares in the family business to collateralize a risky loan).

Some families distribute excess cash flow to each family member, leaving it up to individual family members to manage their capital as they see fit. Other families make a concerted effort to commingle financial assets, develop a common investment strategy and retain highly experienced investment professionals.

Considerable benefits come from managing financial assets with scale and focus, especially if your collective assets exceed $100 million or more. First and most important, you can attract better investment talent, specifically a chief investment officer (CIO), with a single large asset pool than with a series of much smaller, independently managed pools. A CIO is a professional investor—not a client service representative or product salesperson—responsible for delivering investment performance and integrating that effort with the strategy for the entire family enterprise. Second, your single, larger pool of capital will have access to more desirable investment opportunities, which often come with higher minimum investment requirements and lower management fees. Third, commingling assets allows your family to share the administration of estate planning and investment management, simplifying tasks and lowering administrative costs. Finally, with a commingled investment strategy, family members are mutually accountable. To make the strategy work, each family member must control his or her financial affairs within guidelines that are agreed upon through the family governance process. While to some this all may feel constraining, the structure and discipline of pooled investing can significantly increase your family's economic security, including the long-term security of your core business.

Leakage management

Think of the economic engine as having leaks—dividend payments, expenses, taxes and inflation, to name a few. Leakages are an inevitable part of any family enterprise, and they are much more within the family's control than the value of a business or an investment portfolio. Year over year, leakages profoundly affect your family's wealth, but their importance to the long-term vitality of your family is often poorly understood. The larger and less well-managed your leakages are, the greater the risk to the family enterprise and the more likely it won't stand the test of time.

You can divide family leakage management into two buckets. The first is cash flow management. How much is distributed to family members and spent each year? What are family operating expenses above and beyond those of the business? How much does your family pay in taxes annually? The second area is estate planning, including governance, control, succession planning and tax minimization. How much of your family wealth will be transferred to government coffers upon the death of family members? Are estate plans structured to help protect the family's assets from unwanted outside interference?

Good leakage management can mean the difference between maintaining control of your family business and leaving the fate of your family enterprise to chance.

Building a virtuous circle

People wonder why family enterprises don't last. The math describes the challenge clearly: It is very difficult to grow and spend your wealth simultaneously. A healthy economic engine is necessary, but also insufficient, if you want to maintain your family enterprise over time.

For long-term vitality, you must manage your entire family enterprise as an integrated whole. Mature, well-managed family enterprises are stable and strong with good governance, clear family purpose, diversified assets and controlled leakages. Operating in this context, you can make prudent long-term investment decisions for your core family business, determine the most productive level of family involvement in the business, and control its destiny. Your family's financial assets, professionally managed to realize the benefits of scale and focus, are key contributors to your family's continuing economic vitality. Family members feel strong positive connection to your family enterprise and are encouraged to thrive and contribute to an evolving and relevant family culture. When you build this virtuous circle, you are stewarding your good fortune and cultivating your family's valuable business, human and financial resources. In doing so, you serve the family enterprise as a whole as well as each family member. FB

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