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Joining the family business: An emerging opportunity for investors

Family-owned businesses are a large and growing force, especially in emerging markets. Those who would invest in these companies must first understand them.

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Almost all of today's biggest companies came into being through the work of a founder and family. Over time, in developed markets, ownership tends to become dispersed. Less than one-third of the companies in the S&P 500, for example, are still controlled by founding families. The picture is quite different in emerging economies. Approximately 60 percent of their private-sector companies with revenues of \$1 billion or more were owned by their founders or families in 2010. And there are good reasons to suspect that proportion will only increase. As brisk growth propels emerging regions and their family-owned businesses forward, our analysis suggests that an additional 4,000 of them could hit \$1 billion in sales in the years from 2010 to 2025 (Exhibit 1). If that's how things shake out, such companies will represent nearly 40 percent

of the world's large enterprises in 2025, up from roughly 15 percent in 2010. Developing an understanding of them, therefore, is fast becoming a crucial long-term priority for would-be investors. What follows is a brief guide to their attractions—and some complicating factors.

Why past may not be prologue

The starting point for many family-controlled local companies is a demonstrable, even dominant, "home field" advantage; they have a deep understanding of their countries and industries, as well as considerable influence on regulators and domestic policy. They derive this from years of personal relationships with stakeholders across the value chain. Many have proved resilient through times of economic crisis.¹

The very fact that they are family businesses may be advantageous in emerging economies. Where the conventions of commercial law and corporate identity are less developed, doing business on behalf of a family can signal greater accountability—the family’s reputation is at stake—and a stronger commitment to a “through-cycle view” of their businesses. Indeed, we have observed circumstances where a personal commitment from the owner of a family business was as powerful as a signed contract.

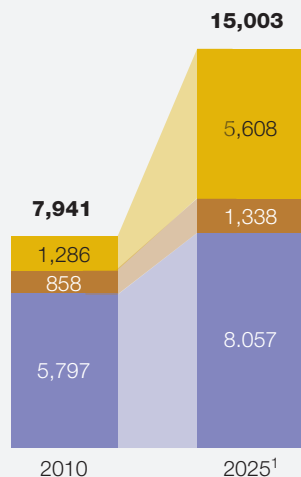
They can also work fast. As one executive at such a company told us, “All the world is trying to make managers think like owners. If we put in one of the owners to manage, we don’t need to solve this

problem.” An owner–manager can move much more rapidly than an executive hired from outside. The friction costs of delayed decisions from passing them up a chain of command or putting them in front of an uncooperative board, as well as many of the principal–agent challenges that confront non-family-controlled companies, are neutralized. Family-owned businesses can therefore place big bets quickly, though, of course, there’s no guarantee that the bets will pay off. Still, owner–managers are largely relieved of the quarter-to-quarter, short-term benchmarks that can define—and distort—performance in Western public companies, so they’re freer to make the hard choices necessary to create long-term value.

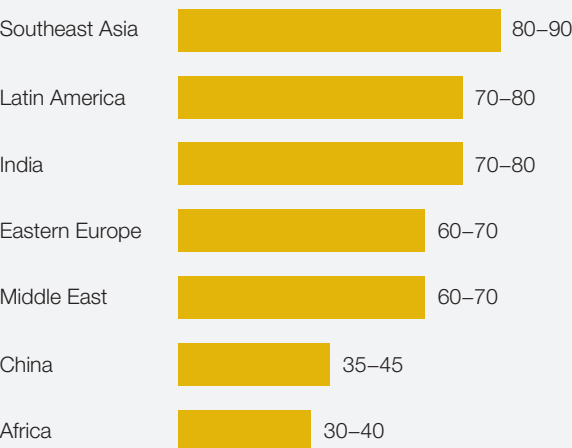
Exhibit 1 A growing number of family-owned businesses in emerging markets could hit \$1 billion in sales from 2010 to 2025.

■ Emerging-market family-owned businesses ■ Other emerging-market companies ■ All developed-market companies

Companies with ≥\$1 billion in revenue,
number of companies



Share of large companies that are family owned,² %



¹ Projection based on city GDP forecasts.

² As of 2013 or closest available year, captured at headquarters location.

Source: Bloomberg; company websites; *EXAME* magazine’s 2013 Melhores & Maiores list; *Jeune Afrique*’s Top 500 African Companies; Kisvalue; Mexico’s Secretariat of Finance and Public Credit; PRIME news agency’s rating of Russian family-owned businesses; Prowess; Zawya; McKinsey Global Institute analysis

Indeed, the owners' long time horizons and sense of mission often suffuse the whole organization. A McKinsey survey of businesses owned by families and founders showed that 90 percent of board members and top managers—family members or not—said that family values were present in the organization, and fully 70 percent said these values were part of the business's day-to-day operations.

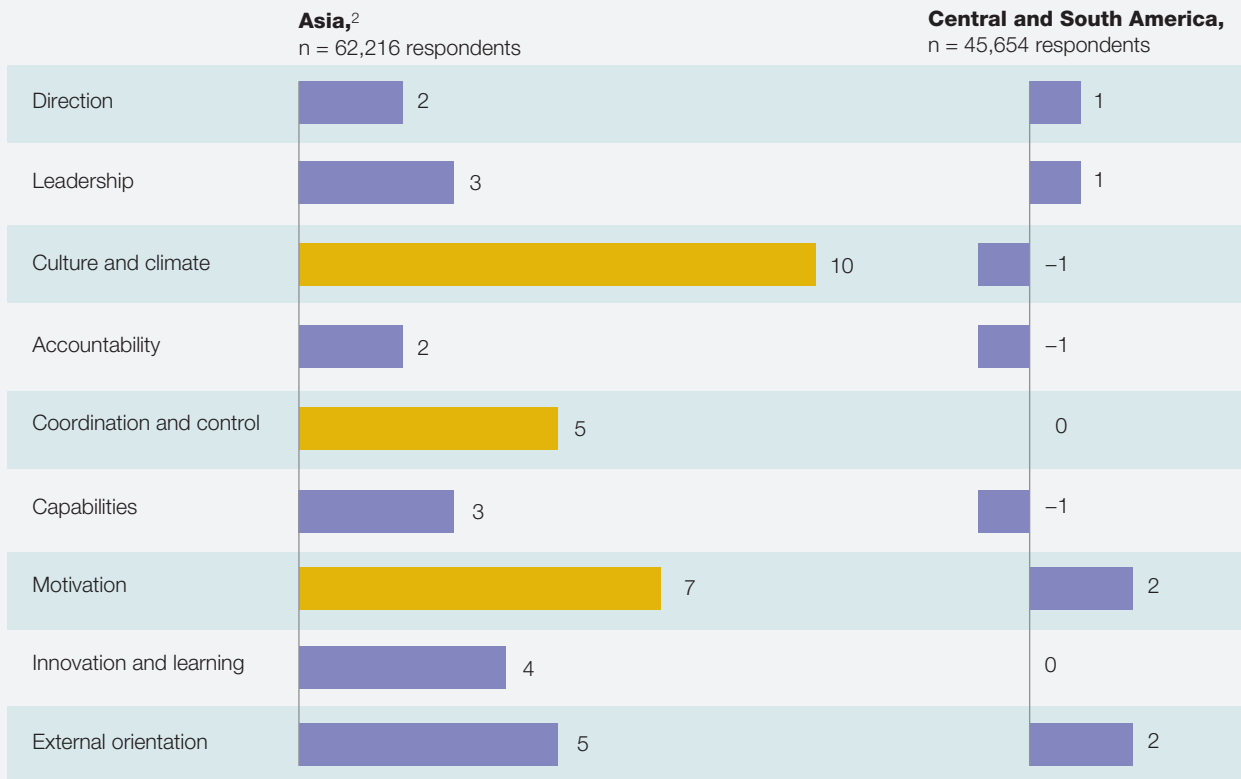
In McKinsey's long-running study of organizational health,² businesses owned by families and founders in emerging markets—some 60 leading companies in Asia, Central America, and South America, with more than 100,000 survey respondents—had health outcomes better than or comparable to those of other companies in the same markets (Exhibit 2). Moreover, in Asia these companies are stronger than

Exhibit 2 Family-owned businesses in emerging markets have organizational-health outcomes better than or comparable to those of non-family-owned businesses in those same markets.

Gap between Organizational Health Index scores of family-owned businesses vs those of non-family-owned

Statistical significance¹

■ Stronger ■ Comparable



¹ Difference statistically significant at 95% confidence level.

² Emerging markets only.

Source: McKinsey analysis

their non-family-owned counterparts on several specific management practices, including shared vision, strategic clarity, employee involvement, and creativity and entrepreneurship.

For all these reasons, family businesses are attractive to investors. In a world where free-flowing capital seeks out success, the emerging markets' strong-performing publicly traded family businesses will likely be rewarded. In India recently, nearly 70 percent of private investment has gone into family businesses. Market-leading ones can expect to be sought out by potential investors and venture partners alike, for success is a magnet. Even weaker family-owned businesses can lure investment. Some have ownership models that are inflexible and lack transparency, drawing the attention of activist investors who see value in better governance, more disciplined capital structuring, and getting out of so-called hobby businesses that support family members.

Playing by the family rules

That said, investors need to tread carefully. The resilience of family-owned businesses in emerging markets contains a paradox for investors. Many private-equity firms and institutional investors approach these markets in search of rapid growth, yet the family-owned businesses they're considering partnering with are balancing the importance of liquidity against an extremely long view. Founders and families hold their shares for decades, even centuries. "For us," the chairman of such a business explained, "short term is 5 years, and medium term is 20 years—that is, one generation." Some investors have similarly long horizons. But others find that mismatched time horizons can create tensions that undermine strategic partnerships. Exacerbating matters is the volatility of many emerging markets. Many deal partners and portfolio managers have barely experienced a full business cycle, so they struggle to understand

and quantify risk, to form a through-cycle view of the opportunities, and thus to partner meaningfully with their peers in family-owned businesses.

The conglomerate nature of many family-owned companies makes for a good fit with investors with similarly diversified interests. As our colleagues have noted, the largest conglomerates in China, India, and South Korea are entering new businesses (often in unrelated industries) at a startling pace, adding an average of one new-business entry every 18 months.³ Almost 70 percent of these diversifying conglomerates are family or founder owned. In large part, they aspire to play the portfolio game, reallocating capital more frequently by taking advantage of access to talent and capital, as well as allocating family assets across different industries. This is an appropriate strategy for preserving wealth over the long term—and one that, our research finds, is paying dividends for conglomerates in the BRIC countries.⁴

However, investors must be prepared for the unexpected. Family-owned companies making moves into or out of seemingly unrelated industries can show up as competitors, partners, asset purchasers, or sellers, with varying degrees of success.⁵ And families' expectations of investors can be high. In a recent survey of family-controlled portfolio companies of private-equity firms in India, most gave high marks to their investors for improving board efficiency and providing valued strategic input. But they had several unmet expectations, including access to new customers, new opportunities sourced from external networks, and expertise to support operational improvements. The survey also found that while investors support strong governance and strategic guidance from the vantage of a board seat, family owners often blur lines between governing and operational roles, placing value on developing new opportunities and capacity.

The big question for investors in family businesses is, of course, succession. Fewer than 30 percent of family- and founder-owned businesses around the world survive to the third generation as family-owned businesses,⁶ and it's an open question whether those in emerging markets will fare any better. History suggests they won't. While statistics are scarce, a comparison of the top 20 family-owned businesses in a given emerging market 20 years ago with today's leaders shows great discrepancies. Nonetheless, there is some reason for optimism: the factors behind successful transitions are reasonably well known, and much can be learned from companies that failed the test. (Today's family-owned businesses in emerging markets are more likely than ever to engage in careful succession planning.) Still, the basic challenges—such as family feuds, nepotism, and the gradual loss of entrepreneurship when leadership passes on to new generations—will surely bring down many family-owned companies in emerging markets, as they have elsewhere.

The time when power transfers from one generation to the next is also a window for investment. As succession unfolds, the family must deal with the central question: Is the family the best owner or manager of a company, or is it in business to support the family? In essence, family first or business first? Potential partners, investors, and competitors should seek to understand a company's family tree, ownership models, and current succession processes before drawing conclusions about sustainability.

Finally, people who watch emerging markets should keep a weather eye on the role of regulation. Many governments in these countries struggle to strike a balance between, on the one hand, extending support to family-owned businesses that are, at times, synonymous with excess or entrenched

privilege and, on the other, fostering development via entrepreneurship to promote job creation.⁷ Would-be investors ignore at their peril both the potential of family-owned businesses and the policy interventions to reshape the nature of competition in these markets quickly and dramatically. ■

¹ For example, across Asia, businesses owned by families or founders have increased their share of total market capitalization since 2008, while state-owned enterprises have ceded share over the same period. For more, see "Avoiding the dinosaur trap," *Economist*, May 31, 2014, economist.com.

² McKinsey Organizational Health Index (a McKinsey Solution), mckinseysolutions.com.

³ See Martin Hirt, Sven Smit, and Wonsik Yoo, "Understanding Asia's conglomerates," *McKinsey Quarterly*, February 2013, mckinsey.com.

⁴ Brazil, Russia, India, and China.

⁵ To be sure, many founder- and family-owned businesses struggle in these circumstances. For example, one of India's largest such conglomerates has a long tail of value-destroying companies in sectors where more focused players have delivered higher returns. Ultimately, the fundamentals—coherence in strategy, strong decision making, and the ability to realize synergies—still apply.

⁶ See Christian Caspar, Ana Karina Dias, and Heinz-Peter Elstrodt, "The five attributes of enduring family businesses," *McKinsey Quarterly*, January 2010, mckinsey.com.

⁷ See "The new age of crony capitalism," *Economist*, March 15, 2014, economist.com.

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