The Wendel
International Centre
for Family Enterprise

The Global Private
Equity Initiative

THE INSTITUTIONALIZATION OF FAMILY FIRMS

Europe

JANUARY 2020

This report would have not been possible without the engagement of the 121 families who participated in our survey and the many more that we interviewed. Equally valuable was the expertise of all the private equity professionals who shared their experiences of investing in Europe and helped frame our research questions.

We would like to thank Clayton, Dubilier & Rice (CD&R) - our long-term partner in this global research series. In particular, we are grateful to Tom Franco, Partner at CD&R, for his guidance.

The team at INSEAD's Wendel International Centre for Family Enterprise (WICFE) provided invaluable access to their network and shared their expertise for this report. A special thanks to Sonia Tatar, Executive Director of WICFE, and Morten Bennedsen, the André and Rosalie Hoffmann Chaired Professor of Family Enterprise and Academic Director of WICFE.

Finally, a thank you to Indira Pant for editing the final document.

This report was produced by the team at INSEAD's Global Private Equity Initiative (GPEI), which included Alexandra von Stauffenberg, Associate Director, and Claudia Zeisberger, Senior Affiliate Professor of Entrepreneurship and Family Enterprise and the Academic Director of GPEI.

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121 **Family Firms** **7** **Leading PE Firms**

INSEAD opened its doors 60 years ago to offer a place in Europe where people could study together and discuss solutions to the challenges of building sustainable businesses. From the start the school offered an international perspective in its curriculum and research and was built on the belief that business can be a force for good. Until today, this mission continues to align well with the long-term vision of family businesses and their desire to engage with the communities they interact with. Understanding how family businesses have continued to adapt over generations to the fast-changing business realities on the ground and sharing their lessons with those entrepreneurs and families at the beginning of this journey, will continue to drive our research agenda in the coming years.

Claudia Zeisberger
Senior Affiliate Professor of Entrepreneurship & Family Enterprise
Academic Director, Global Private Equity Initiative

Family firms are the dominant organizational structure in the world today. It is therefore important to engage in understanding the challenges family firms face across the world and how governance structures can mitigate these challenges. INSEAD has, over three studies, focused on the role of private equity in institutionalizing the family business model; the geographical focus in this third study is Europe. A fascinating research topic, this report definitely adds to our understanding of how family firms can create long term value for owners and societies.

Morten Bennedsen
The André and Rosalie Hoffmann Chaired Professor of Family Enterprise
Professor of Economics and Political Science INSEAD
Academic Director, Wendel International Centre for Family Enterprise
Niels Bohr Professor, University of Copenhagen

Family businesses form the backbone of the European economy and will continue to be a source of valuable and productive partnerships with private capital investors. Now in the third phase of its academic analysis of family owned businesses globally, INSEAD represents an important voice in the examination of the broader strategic and succession challenges and opportunities facing family-owned businesses. INSEAD's valuable perspective provides a foundation for a much deeper dialogue about how family-owned businesses can create sustainable, long-term value.

Thomas C. Franco
Partner
Clayton, Dubilier & Rice

Overview: *How can Family Firms Ensure Long-term Value Creation?*

Companies that are owned and controlled by families are the cornerstone of global economic activity, accounting for two thirds of all businesses, 70-90 percent of annual global GDP, and 50-80 percent of jobs in most countries.[1] As incubators of an entrepreneurial culture, family businesses act as catalysts of widespread growth. Their commitment to sustainability and social responsibility results in stable and long-term relationships with principle stakeholders. The values and priorities of family business leaders are transmitted to subsequent generations, which strengthens their business and the stakeholder communities that they support. Given the profound impact of family firms at a local and regional level, it is crucial to understand the factors that impact their financial health and longevity.

All businesses that survive the initial high-risk stage of an organization's life cycle, must institutionalize operations to thrive in the next development stage. They typically introduce and embed formal policies and procedures that strengthen commitment to their mission and values, preserve their competitive advantage and facilitate long-term growth. Are family firms adequately institutionalized? In 2017, INSEAD initiated a research project to examine the institutionalization experience of family firms around the world across six key attributes: family ownership and succession, intangible family assets, corporate governance and leadership, growth capabilities, organizational design, and access to capital.

In 2017, INSEAD published its first report: The Institutionalization of Family Firms – From Asia-Pacific to the Middle East which measured the level of institutionalization in 123 family firms in Asia-Pacific and the Middle East. A group of leading private equity (PE) firms, who are experienced investors in family-owned firms, shared their perspectives on the development paths of these businesses. Short case studies provided a glimpse of the specific challenges and opportunities faced by a cross-section of family firms in the region. Published in 2019, the Phase 2 report: The Institutionalization of Family Firms – Latin America draws on the inputs of 131 family firms and select PE experts from Latin America.

In Phase 3 of this research series the geographical focus shifts to Europe where family firms represent 70-80 percent of all business enterprises and account for 40-50 percent of employment.[2] INSEAD surveyed 121 family businesses and interviewed select leading PE firms to understand how institutionalization can help a family firm achieve sustainable growth. As in the previous two reports, we include an analysis of our survey results and select case studies to enable family firms in the region to benchmark themselves against their peers and learn from their experiences. The report also examines the nature of the family firm-PE firm partnership and identifies best practices that support sustainable value-creation.

Why Institutionalization is Key to the Survival of Family Firms

In family businesses, ownership and decision-making authority is concentrated in the hands of key family members. Such firms frequently have a recognizable brand that is derived from the family's name and heritage, their political and business connections, and the values of the founder – none of which are easily transferrable to an external owner.[3] Family owners strive to retain control of their businesses and take a long-term view on their reputation and their relationships with key stakeholders. Their driving imperative is to build a business that can survive over multiple generations.[4]

As organizations mature, they frequently face crises relating to leadership, autonomy and control.[5] Being relatively poorly institutionalized, most founder-led family businesses are particularly vulnerable to these survival threats. Almost two-thirds either shut down or are sold by the founder, and less than 15% survive long enough to be handed over to a third-generation family member.[6] Without adequate institutionalization, family businesses are most likely to face the following risks:

Inadequate succession planning: Family businesses frequently fail because the subject of succession planning is rarely addressed directly and openly; in some instances, this taboo topic is avoided altogether[7]. The succession challenge is compounded when the incumbent family leader and potential successors have differing priorities, values and visions[8]. Occasionally, the chosen successor lacks the necessary expertise because the available pool of family members is small. The resulting risk of perceived nepotism can pose a significant threat to a meritocratic culture. Without an institutionalized succession planning process, firm performance almost always declines when the new leader takes over; this decline is the steepest when the founder steps down[9,10].

Talent shortage: Increasingly, family businesses are constrained by a shortage of high-quality talent because career growth opportunities for non-family members are perceived to be limited. In addition, compensation in family firms frequently lags market rates with the largest pay deficits occurring in first-generation businesses[11]. The talent challenge faced by family firms is aggravated by inadequate resources to retain existing skilled and experienced personnel.

Weak leadership and governance lapses: A survey of 1,000 corporate directors found that non-family businesses outperformed family businesses on every measure of board effectiveness – with the largest skill deficit in the areas of talent management and technology[12]. First-generation family firms rarely have a board of directors; a few have notional boards that "rubber stamp" the family leaders' decisions. Subsequent generations "often see their board positions as a birthright that allows them to protect their interests in the company, rather than as a responsibility—based on one's qualifications—to guide the firm and protect all shareholders"[13]. This mindset can significantly erode corporate governance standards in family firms, exposing them to the risk of mismanagement.

Decision-making deficiencies: In most first-generation businesses, decision-making is slow and complex because the founder is involved at every stage of the process. As subsequent generations enter the business, decision-making slows down further and becomes more contentious. The presence of external minority shareholders has little mitigating impact as the family often retains voting rights[14]. In such circumstances there is a risk of suboptimal firm performance, particularly if the family prioritizes its own vision and interests over an efficient allocation of resources[15].

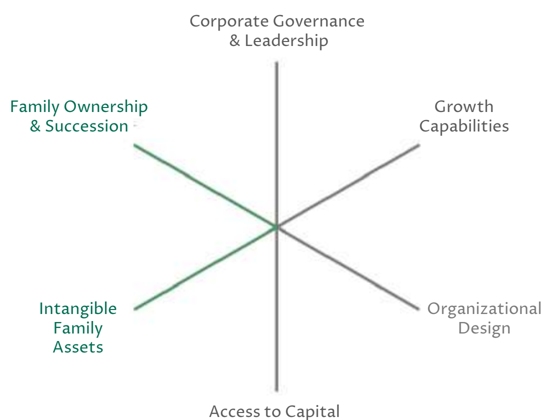
Family firms are a vital pillar of corporate economic activity all over the world. As they evolve, their continuity is threatened by weaknesses in leadership, governance, talent management and decision-making. By institutionalizing operations family businesses can leverage their strong brands, values and long-term focus to overcome these treats and thrive over generations. The following survey analyzes the institutionalization experience of European family firms.

Attributes of Institutionalization

We define Institutionalization as the degree to which process driven decision-making and core family values are incorporated into a firm's governance and day-to-day operations.

Our research framework evaluates the degree of institutionalization in family firms across six attributes. These attributes include four standard measures of institutionalization (Business Attributes) as well as two characteristics unique to a family firm (Family Attributes).

Exhibit 1: *Survey Framework: The Attributes of Institutionalization*



Family Attributes: ***Measure the sophistication of engagement between the family and the business, and the family's unique strengths.***

Business Attributes – Measure the strength of a family firm's operating model and its ability to sustain competitive advantage.

1. Family Ownership & Succession: Assesses how the family engages with the firm as owners and leaders, and whether the family is aligned regarding the future of the firm.

2. Intangible Family Assets: Assesses the importance and strength of family values, connections and heritage in the day-to-day operations of the family firm.

3. Corporate Governance & Leadership: Assesses the composition and capabilities of the bodies and individuals that drive decision-making at the family firm.

4. Growth Capabilities: Assesses the family firm's ability to identify and execute organic and inorganic growth strategies in the firm's specific geopolitical context.

5. Organizational Design: Assesses the existence and effectiveness of the systems and formal policies used to govern the day-to-day operating activity of the business.

6. Access to Capital: Assesses the family firm's ability to raise debt and equity capital to fund current and future business operations.

63%
OF ASCENDANTS HAVE A
PROFESSIONAL BOARD
82%
OF CHAMPIONS HAVE A
PROFESSIONAL BOARD

The Survey

To assess the degree of institutionalization in family firms in Europe, we asked 121 family firms to participate in a survey that investigated six key attributes of institutionalization.

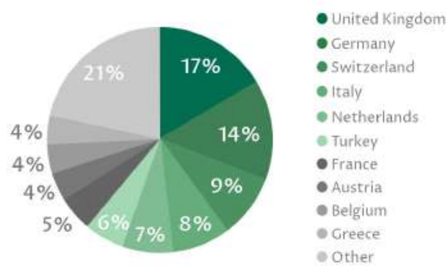
The dataset reveals two distinct groups: 'Ascendants' (1st or 2nd generation family firms) and 'Champions' (firms in the 3rd or 4th generation or older). We identify specific areas where Ascendants can institutionalize their operations more effectively thereby unlocking growth.

Special thank you to the following organization for their support & access to their network:

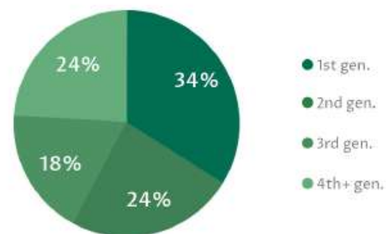
YPO Global Family Business Network

121 Family Participants

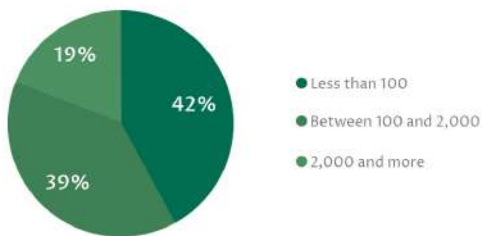
Region



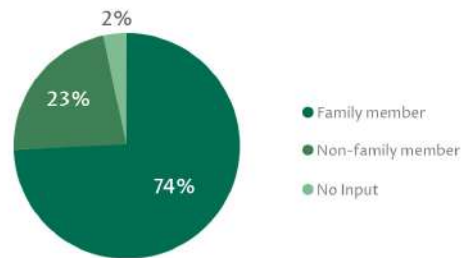
Generation



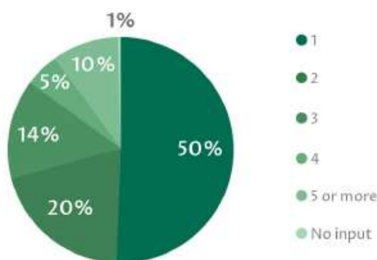
Number of Employees



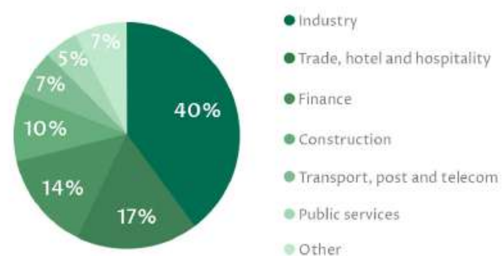
Company CEO



Number of Industries



Industry / Sector



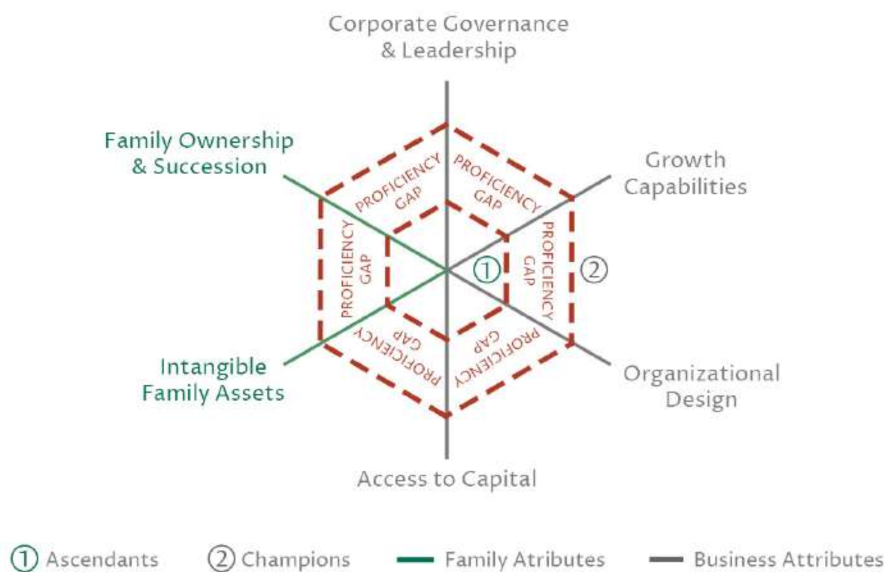
23 Countries • 1st to 13th Generation • 1 to 100,000+ Employees

Survey Framework

The survey framework measures the degree of institutionalization in family firms across the six defined family and business attributes: family ownership and succession, intangible family assets, corporate governance and leadership, growth capabilities, organizational design, and access to capital.

We invited 121 family firms to participate in the survey, which contained multiple questions relating to each of these attributes[i]. From the survey output, a total institutionalization score is calculated for each participant as the sum of its normalized attribute scores with higher scores signifying higher levels of institutionalization[ii]. Exhibit 2 depicts a firm's institutionalization "web" based on its score for each attribute; it provides a visual representation of areas of strength and weakness within the firm.

Exhibit 2: *Survey Framework: Family Firm Archetypes*



We identify two archetypes of family firm —the "Ascendants" and the "Champions". Based on our hypotheses we define them as follows:

1. Ascendants: Family firms with low levels of institutionalization which constrain their ability to capitalize on opportunities, leading to suboptimal performance. Such firms can improve specific family and business attributes in order to unlock their full potential.

2. Champions: Family firms with a high level of institutionalization that are able to efficiently capitalize on their opportunity sets and, in doing so, achieve higher performance.

This firm-level data allows us to make overarching observations for the whole dataset as well as analyze the scores of individual participants vis-a-vis their peers.

[i] This analysis is based on responses from 117 families; 4 survey responses were either from the same family firm or incomplete.

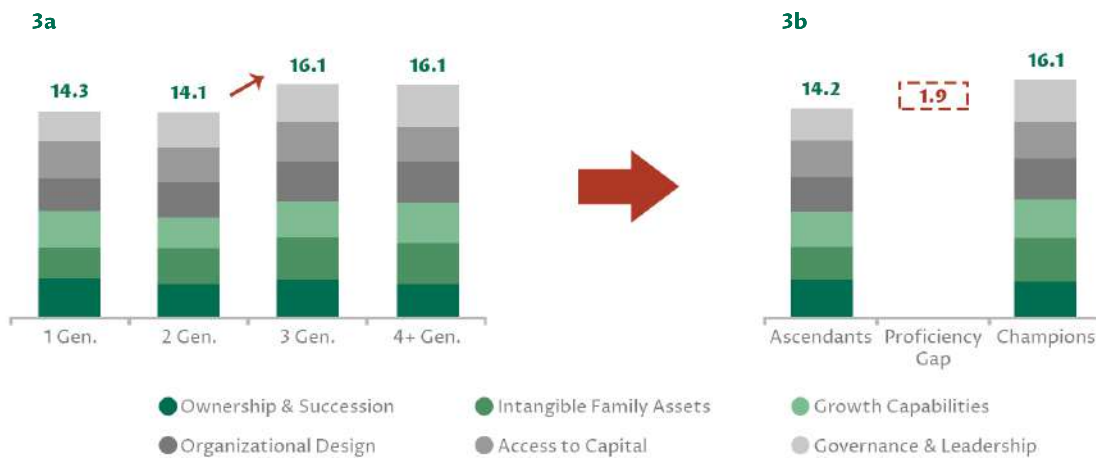
[ii] The score for each attribute was calculated as follows: We assigned points (from 0 to 5) to every question relevant to the attribute, added the points together, standardized the total points (z-scale), and added 2.5.

Survey Findings: Bridging the Gap

Exhibits 3a and 3b present the average institutionalization score of our European survey participants segregated by generation. The different color segments represent the contribution of each of the six attributes measured in our survey to the total institutionalization score.

Following the same analytical approach of the previous phases of this research series[iii], we compare the total institutionalization scores across generations (Exhibit 3a). We then identify the two generations between which institutionalization scores register the sharpest increase, and label this increase as the "proficiency gap". Exhibit 3b presents the average institutionalization scores of two distinct groups of family firms: "Ascendants" (family firms in generations prior to the proficiency gap) and "Champions" (family firms in the generations that follow the proficiency gap).

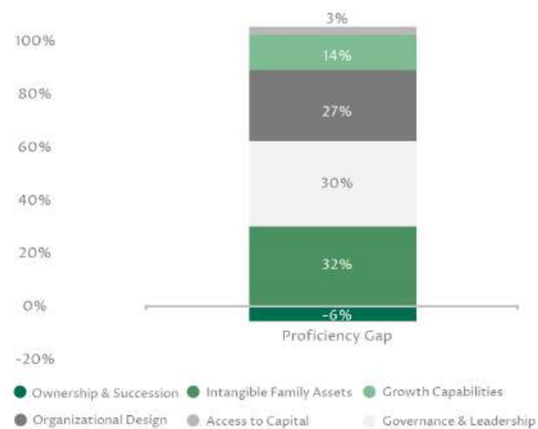
Exhibit 3a & 3b: *Level of Institutionalization by Generation*



The graph reveals that the most significant increase in institutionalization score, i.e. the proficiency gap is between firms led by 2nd generation family members and those in their 3rd generation and beyond. Therefore, we categorize "Ascendants" as firms led by 1st or 2nd generation family members and "Champions" as family firms that are 3rd generation or older.

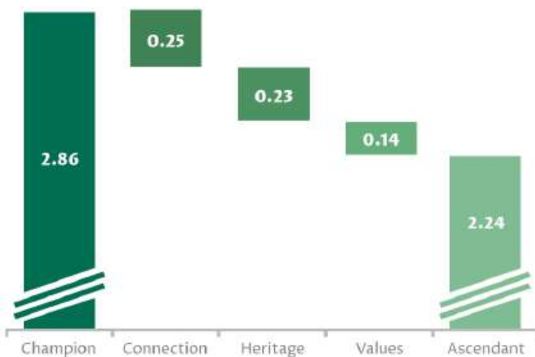
The following section analyzes the proficiency gap between Ascendants and Champions. We examine how each of our six attributes and their input factors contribute to the proficiency gap based on the share of their contribution – from highest to lowest (Exhibit 3c).

Exhibit 3c: *Composition of the Proficiency Gap*

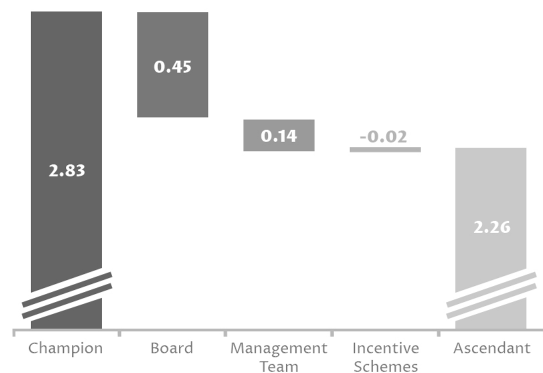


[iii] Phase 1: Asia & the Middle East; Phase 2: Latin America

Intangible Family Assets



Corporate Governance & Leadership



The average "Intangible Family Assets" score of Ascendants deviated the most from that of Champions, accounting for 32% of the total proficiency gap (0.62/1.94).

Champions outperformed Ascendants on every component of this attribute. In particular, they had deeper connections with other business families. They also had stronger relationships with central and local government officials, their customers and suppliers.

Champions also had greater "Heritage" - a special skill, recipe or business strategy that had been kept within the family and sustained the business; more Champions had their family name in their products. Champions were more likely than Ascendants to benefit from the good reputation and rich history they inherited from previous generations. In fact, a Champion's heritage formed a crucial element of its business strategy.

A Champion CEO was more likely to share the family's values than an Ascendant CEO. Champions also scored higher on the extent to which ethical values and mutual core values governed their activities.

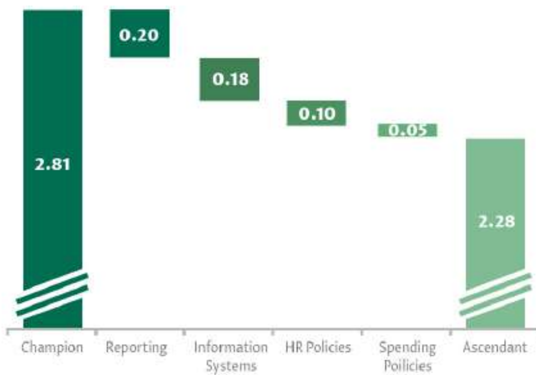
"Corporate Governance & Leadership" issues were almost as significant as "Intangible Family Assets", accounting for 30% of the proficiency gap (0.57/1.94).

The principle reason for the proficiency gap was that 82% of Champions had a board of directors compared to only 63% of the Ascendants. Among firms that had a board, a higher percentage of Champions had independent directors and appropriate sub-committees.

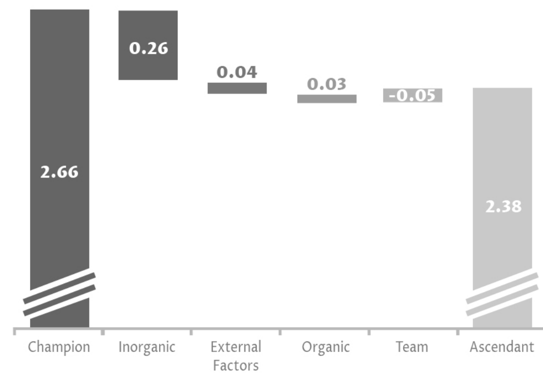
With more Champions being led by a CEO who was not a family member (39% of Champions vs 10% for Ascendants), their management teams were more professionalized than those of Ascendants. However, Ascendants had a slightly higher diversity score for their management teams.

Ascendants and Champions had comparable scores for their incentive schemes. Around a third of both groups had an employee stock ownership plan (ESOP) for non-family managers.

Organizational Design



Growth Capabilities



At 27% (0.53/1.94) of the total score differential, the deviation in "Organizational Design" scores formed the third largest component of the proficiency gap.

This was largely because of differences in key operating processes. More Champions had a formal budgeting and reporting process, used responsibility and accountability charts and monitored performance using KPIs and balanced scorecards. Champions also prepared and reported operational KPIs and P&L metrics more frequently.

Information systems were generally more robust in Champions than Ascendants; significantly more Champions had a supply chain & vendor management system (59% of Champions vs 31% of Ascendants) and a human resource management system (65% of Champions vs 37% of Ascendants). The differential was almost as great for manufacturing or service management systems (57% of Champions vs 35% of Ascendants). Champions also outperformed Ascendants, albeit to a smaller extent, with respect to financial resource management systems (71% of Champions vs 60% of Ascendants) as well as customer relationship management (CRM) systems (69% of Champions vs 54% of Ascendants). Only 6% of Champions vs 15% of Ascendants used none of the above systems.

Champions had more developed HR policies related to hiring, incentivizing, training, evaluating and terminating employees. In fact, 32% of Ascendants (vs 16% of Champions) had no HR policies in place at all.

Ascendants also lagged Champions in terms of spending policies. With pre-approved spending authority that was better dispersed, some Champions were more efficient and effective in decision-making than Ascendants.

Differences in "Growth Capabilities" scores accounted for 14% of the proficiency gap (0.28/1.94).

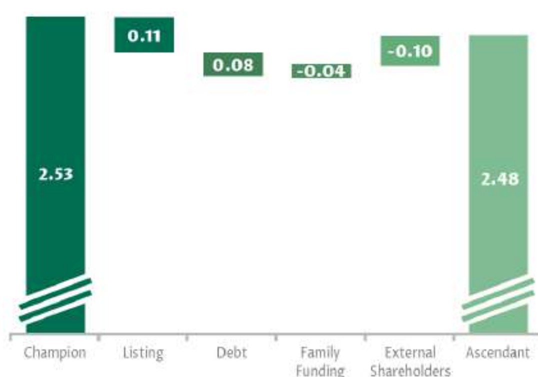
Champions registered significantly higher inorganic growth than Ascendants; 63% of Champions had executed M&A transactions, while the comparable figure for Ascendants was only 21%. Furthermore, 55% of Champions had entered into equity alliances (e.g. joint ventures, minority equity investments) vs 31% of Ascendants.

Ascendants were marginally more vulnerable to the external environment, including changes in macroeconomic policies, governmental regulation and corruption in government circles.

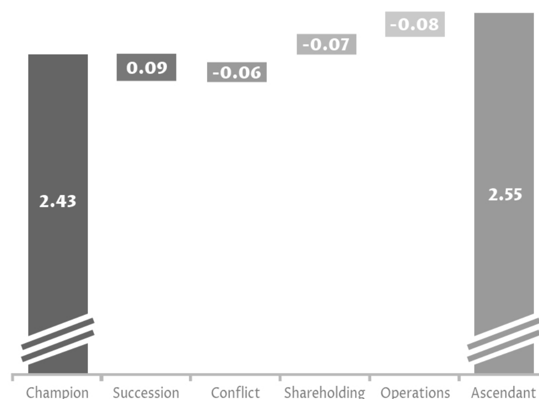
Champions had slightly more robust organic growth activity, primarily because of higher levels of innovation at the business unit level. However, Ascendants had a higher percentage of total sales generated by new products or services introduced in the past two years, thereby reducing the score differential. Also, Ascendants scored slightly better in terms of their ability to scale their existing businesses.

Surprisingly, Ascendants were slightly more likely to have in-house business development resources or specialized M&A teams than Champions.

Access to Capital



Family Ownership & Succession



The Champions' ability to access capital accounted for only 3% of the proficiency gap (0.05/1.94).

The number of Champions with public market listings exceeded that of Ascendants: 14% of Champions were publicly listed vs. 3% of Ascendants.

Champions also had slightly larger debt capacity than Ascendants because of greater access to debt-financing instruments such as unsecured bank loans, mezzanine loans or corporate bonds. This differential would have been greater but for the higher percentage of debt that Champions carried on their balance sheets in comparison with the Ascendants.

In terms of family funding, the families of both Champions and Ascendants were equally willing to invest more equity in the business. However, Ascendants scored better, because the average Ascendant firm paid out a marginally smaller percentage of company profit to its shareholders than Champions.

Moreover, Ascendants were more likely to have raised equity capital from external investors, including private equity funds, strategic investors and high net worth individuals in the past.

Reversing the pattern observed for the previous attributes, Ascendants slightly outperformed Champions on factors related to "Family Ownership & Succession". The differential in their scores accounted for -6% of the proficiency gap (-0.11/1.94).

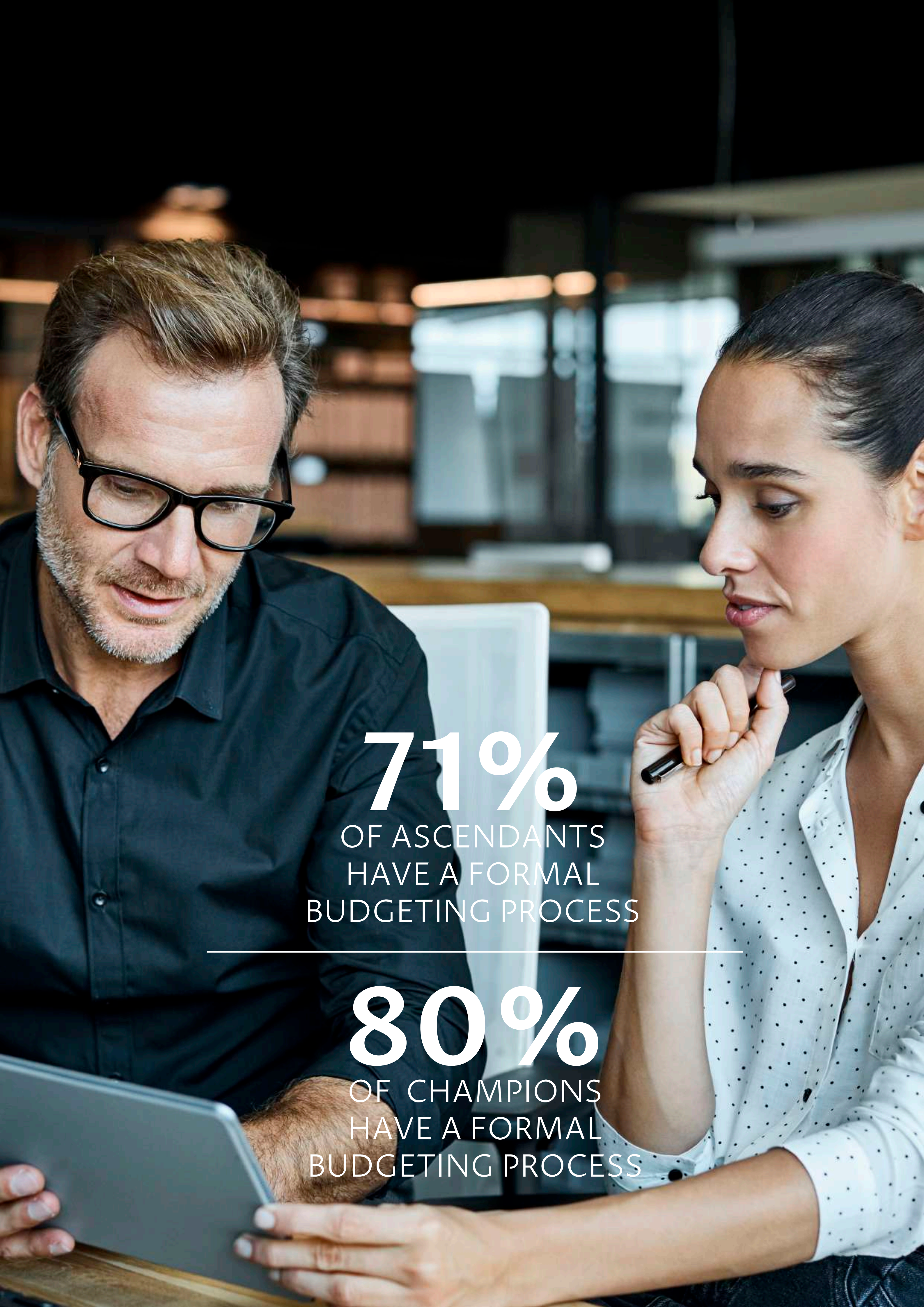
"Succession" was the only sub-factor where Champions had higher scores than Ascendants because they were more likely to have a succession plan. A third of all Champions had a written succession plan in place vs only 13% of Ascendants. In fact, 44% of Ascendants had not even started discussing the subject of succession; the comparable figure for Champions was 14%. However, the Champions' succession score was pulled down a little because they were marginally more likely to have disagreements relating to succession planning.

Surprisingly, the conflict-resolution mechanisms in Ascendants were slightly more well-developed than in Champions.

Champions were more likely to adopt an indirect shareholding model; for example, ownership via a trust, foundation or family holding company: 53% of Champions employed these vs. 31% of Ascendants. However, Champions had more family shareholders than Ascendants, which significantly reduced their "Shareholding" score. As with succession planning issues, there were slightly more disagreements in Champion families regarding the firm's future shareholding structure.

Operational issues were also a little more challenging for Champions than Ascendants. More Champions experienced disagreements relating to business strategy, day-to-day operations, organizational structure or task division between family and non-family members. Champions were also more likely to encounter sensitivities related to employing family members.

Our analysis of the proficiency gap between Champions and Ascendants in Europe indicates that Champions significantly outperformed Ascendants with regards to "Intangible Family Assets", "Corporate Governance & Leadership", "Organizational Design" and "Growth Capabilities". Surprisingly, Champions fared only marginally better than Ascendants with respect to "Access to Capital". Champions even underperformed Ascendants in terms of "Family Ownership & Succession", underlining how important this attribute is along the institutionalization journey.

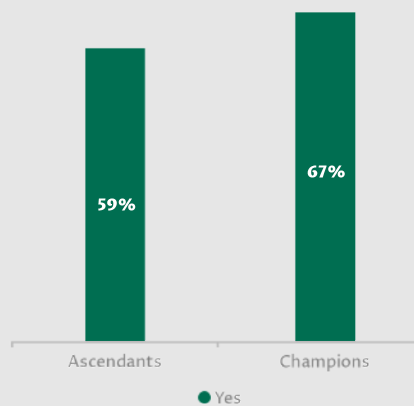

71%
OF ASCENDANTS
HAVE A FORMAL
BUDGETING PROCESS
80%
OF CHAMPIONS
HAVE A FORMAL
BUDGETING PROCESS

Importance of Environmental, Social and Governance (ESG) factors for Champions vs. Ascendants

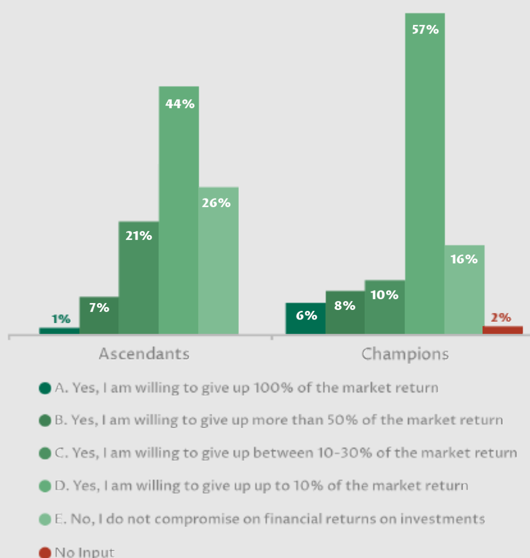
Increasingly investors incorporate ESG factors when evaluating the long-term success of a company. Hence, we included three questions to assess the significance of these factors to the family firms we surveyed.

While the results were mixed, overall awareness of ESG factors was slightly greater among Champions than Ascendants. Champions were more likely to take into account non-financial factors when making operational and investment decisions (67% for Champions vs. 59% for Ascendants). They were also more willing to give up higher rates of market return in order to create impact (14% of Champions vs. 9% of Ascendants were willing to cede more than 50% of market return). However, fewer Champions were willing to cede more modest rates of between 10-30% of market return (10% of Champions vs. 21% of Ascendants). The results were also mixed for lower rates of return: 57% of Champions vs. 44% of Ascendants were willing to give up less than 10% of the market return while 26% of Ascendants vs 16% of Champions would not compromise on financial returns at all. Lastly, slightly fewer Ascendants reported significant increases in their activities as ESG investors over the previous three years (21% of Ascendants vs. 27% of Champions). In fact, 40% of Ascendants vs. 35% of Champions reported no increase in ESG investments at all over the same three-year period.

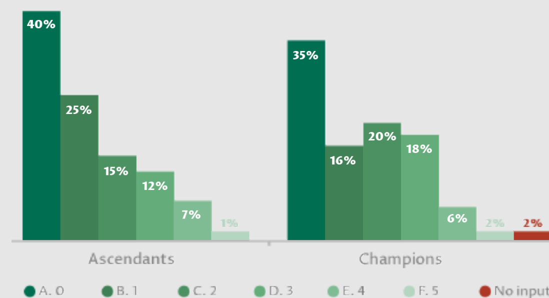
Do non-financial factors such as Environmental, Social and Governance (ESG) criteria play a role in your operational or investment decisions?



Are you/ would you be willing to trade market rates of return for investments that can create deep impact either socially or environmentally?



Has your activity as an ESG investor increased over the last three years? (0 = not at all; 5 = very much)



Comparing Europe with Latin America and Asia-Pacific & the Middle East

Having completed three phases in this research series - each covering a different geographical area, in this section we compare the output of the past two studies with our new dataset from Europe.

It is important to note that the comparison is constrained because of the limited number of data points for companies in the 4th+ generations from Latin America as well as Asia-Pacific & the Middle East (11 in Latin America and 11 in Asia-Pacific & the Middle East).

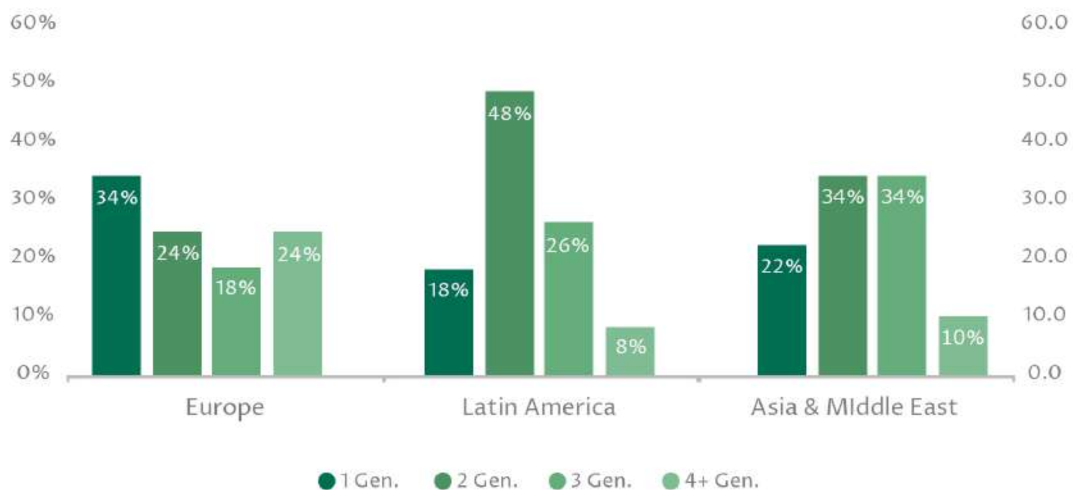
Exhibit 4 provides an overview of our global dataset across all three studies. It covers inputs from 375 family firms: 123 in Asia-Pacific & the Middle East; 131 in Latin America; and 121 in Europe.

Exhibit 4: *Global Dataset*

375 Family Firms Globally

When comparing the data across all three regions it is immediately evident that the European sample has a significantly higher proportion of family firms that are in the 4th generation or older than the other two samples. Exhibit 5 shows the distribution of the family business survey participants across generations for each sample set. In Europe, 24% of our survey participants are in their 4th generation or beyond; this figure is considerably lower for survey participants in Latin America (8%) and Asia & the Middle East (10%). The data corroborates empirical evidence that Europe has several family firms with histories that span multiple generations.

Exhibit 5: *Survey Participants by Generation*



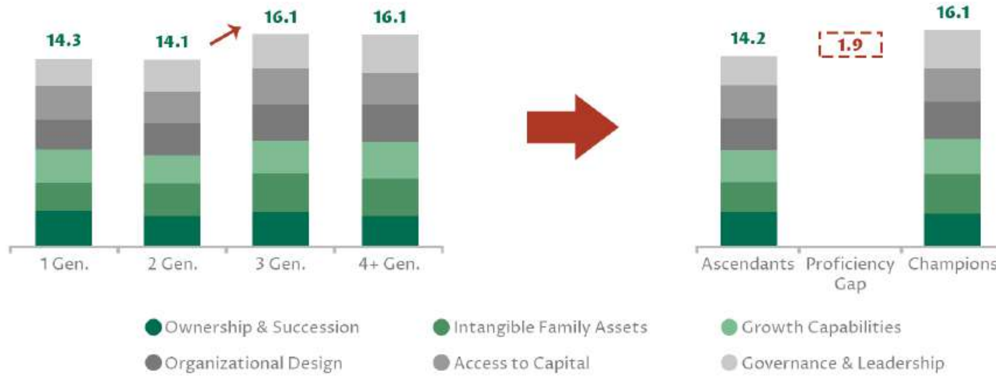
Takeaway 1: The European dataset has significantly more family firms in their fourth generation and beyond than firms in the Latin American, Asia-Pacific & Middle East datasets

Exhibit 6 compares the institutionalization trajectory of survey participants in the three regions covered in this research series[iv]. In all three datasets there is a point at which a proficiency gap is visible – when there is a spurt in the level of institutionalization. Interestingly, in Europe this occurs between 2nd and 3rd generation firms, whereas for the Asia-Pacific & Middle East and Latin America datasets, the surge occurs a generation later, i.e. between family firms in their 3rd and 4th+ generation. This difference is reflected in our definition of “Ascendants” and “Champions” for each region.

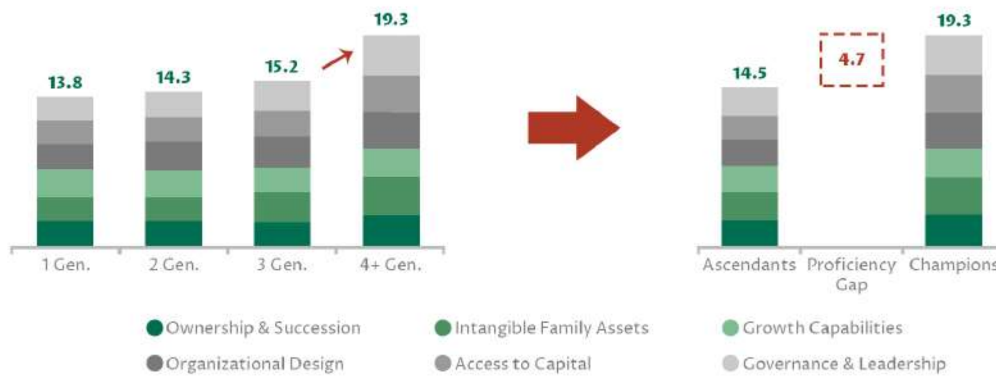
[iv] We calculated the institutionalization scores for each region separately by standardizing each region’s scores with the mean and standard deviation of that region’s dataset.

Exhibit 6: *Level of Institutionalization by Generation*

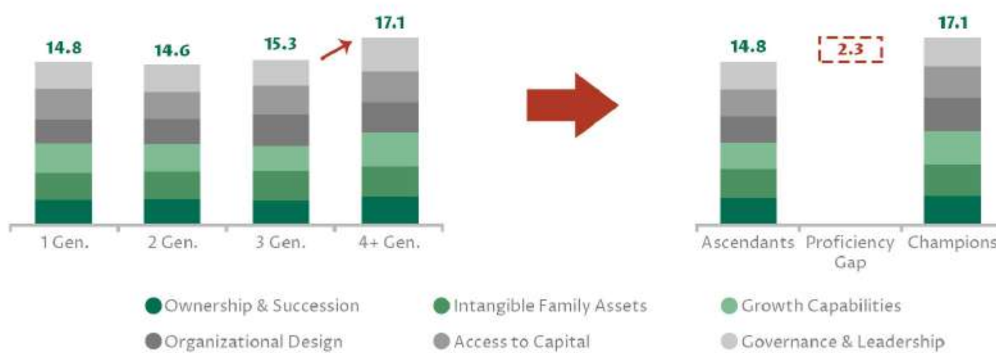
Europe



Asia-Pacific & the Middle East



Latin America

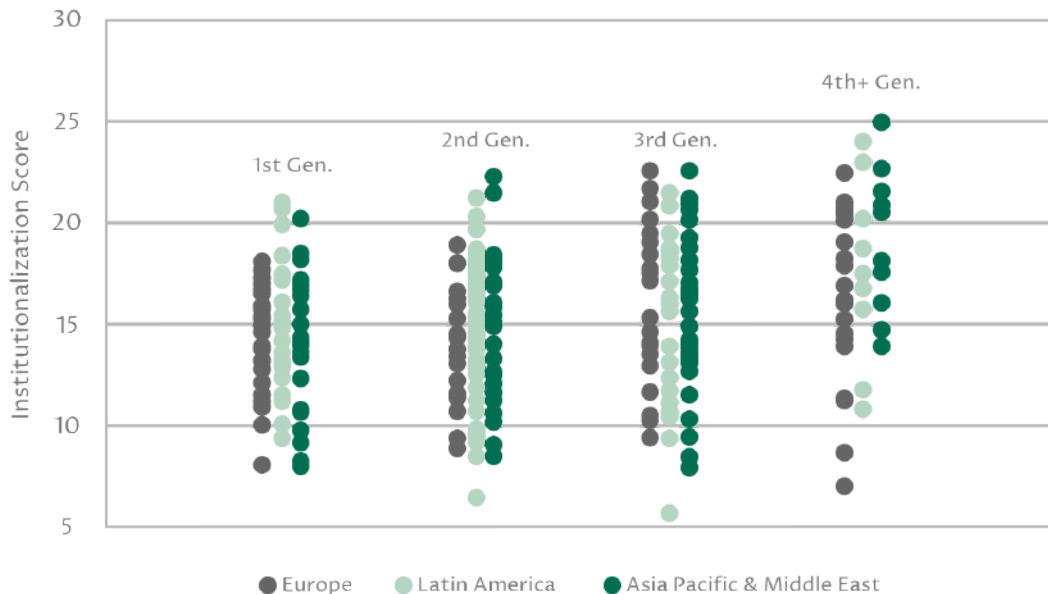


There is also a significant difference in the magnitude of the proficiency gap for each region. The proficiency gap is 4.7 for family firms in Asia-Pacific and the Middle East, which is more than twice that of the other two regions (Latin America: 2.3 and Europe: 1.9).

Takeaway 2: We identified a different set of "Ascendants" and "Champions" for the European dataset

To deepen the analysis, Exhibit 7 shows the institutionalization scores for every respondent in each of the four generational groups for all three datasets.

Exhibit 7: *Individual Institutionalization Scores*



The graph reveals an upward trend in institutionalization scores for all three regions, supporting our thesis that, across the world, family firms must institutionalize in order to survive generational transitions.

A closer look at the numbers suggests that, on average, European family firms that are led by 1st and 2nd generation family members have a slightly lower scores than similar firms in Latin America, Asia-Pacific and the Middle East. By contrast, the institutionalization scores for 3rd generation European family firms slightly exceed those of their peers, suggesting that they are further along in their institutionalization journey compared to 3rd generation family firms from the Asia & Middle East and Latin America. The reversal in Europe's ranking for 3rd generation firms implies that family firms have institutionalized rapidly. However, looking at the 4th+ generation family firms, we see that the scores in Europe are more dispersed than in the other regions.

It is interesting to note that, the highest institutionalization scores across all regions belong to 4th+ generation-led firms. In fact, barring a few outliers in Europe and Latin America, most family firms that are in its 4th generation or beyond are in the top half of the institutionalization score spectrum.

Takeaway 3: The level of institutionalization in family firms increases over time, irrespective of their location.

In summary, the key three takeaways are the following:

1) **the European dataset has more family firms in their fourth generation or beyond than firms in the Latin American, Asia-Pacific & Middle East datasets;**
2) **the European dataset identifies a new set of "Ascendants" and "Champions"; and**
3) **the level of institutionalization in family firms increases over time, irrespective of their location.**

While there are differences in the actual numbers, the data from all regions tell the same story: There is a clear institutionalization gap between Champions and Ascendants as seen by the marked difference in their overall institutionalization scores. As family firms mature, they must institutionalize their businesses in order to survive. Inevitably, family firms that have successfully concluded more intergenerational transfers of power have higher institutionalization scores.

While Ascendants can proactively pursue institutionalization, they often need help. The next section in this report explores how private equity investors can help bridge the proficiency gap by providing capital and expertise.

21%
OF ASCENDANTS
HAVE EXECUTED M&A
TRANSACTIONS
63%
OF CHAMPIONS
HAVE EXECUTED M&A
TRANSACTIONS

The PE Perspective

To complement our findings with an expert practitioners view on the level of institutionalization of family firms in Europe, we asked 7 private equity firms – all experienced investors in family businesses in the region – to share their experience.

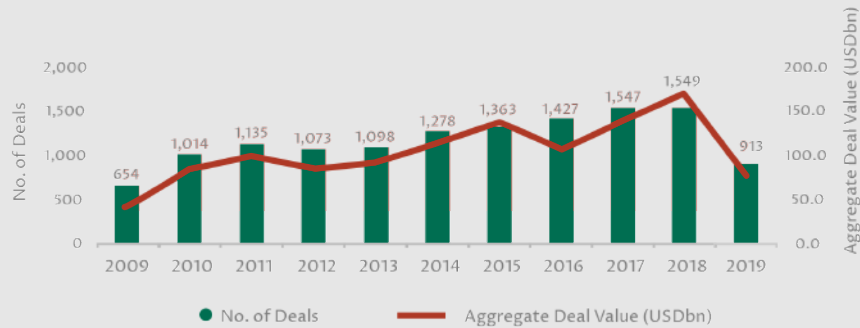
After a brief overview of the benefits and drawbacks of partnering with a PE firm, we examine how these firms invest in a family business and how they unlock value.

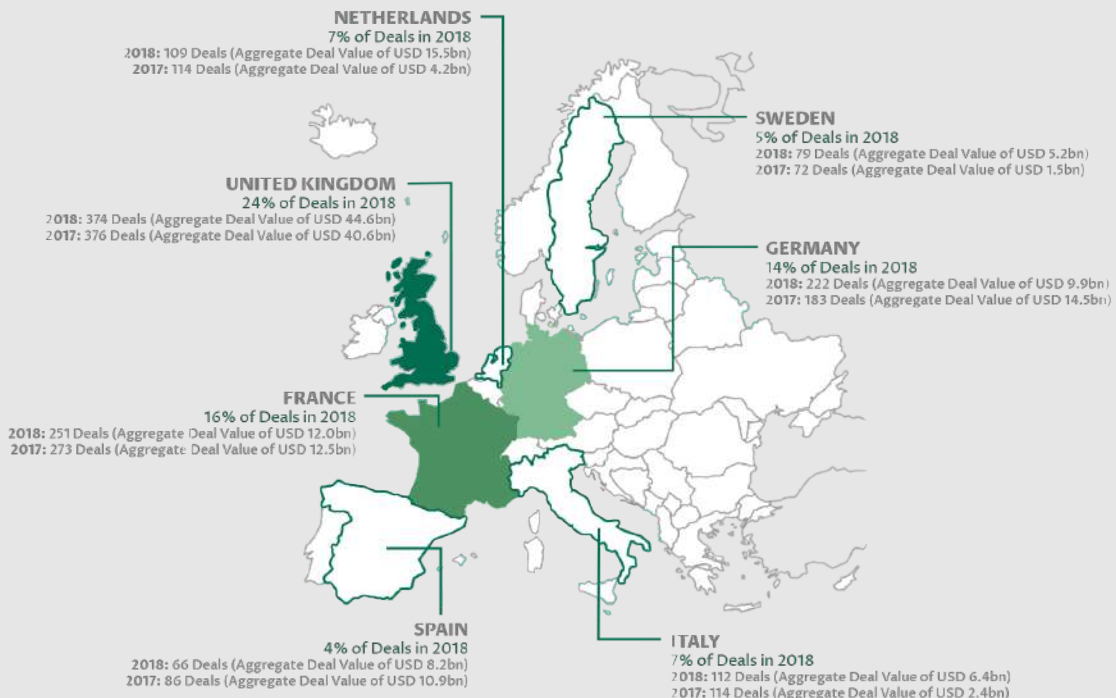
We would like to thank partners from the following firms for their engagement:

Afinum Management GmbH · Castik Capital · General Atlantic · Inflexion Private Equity · Montagu Private Equity · Providence Equity · Rigeto Unternehmerkapital GmbH

Buyout Deals

Private Equity-Backed Buyout Deals in Europe





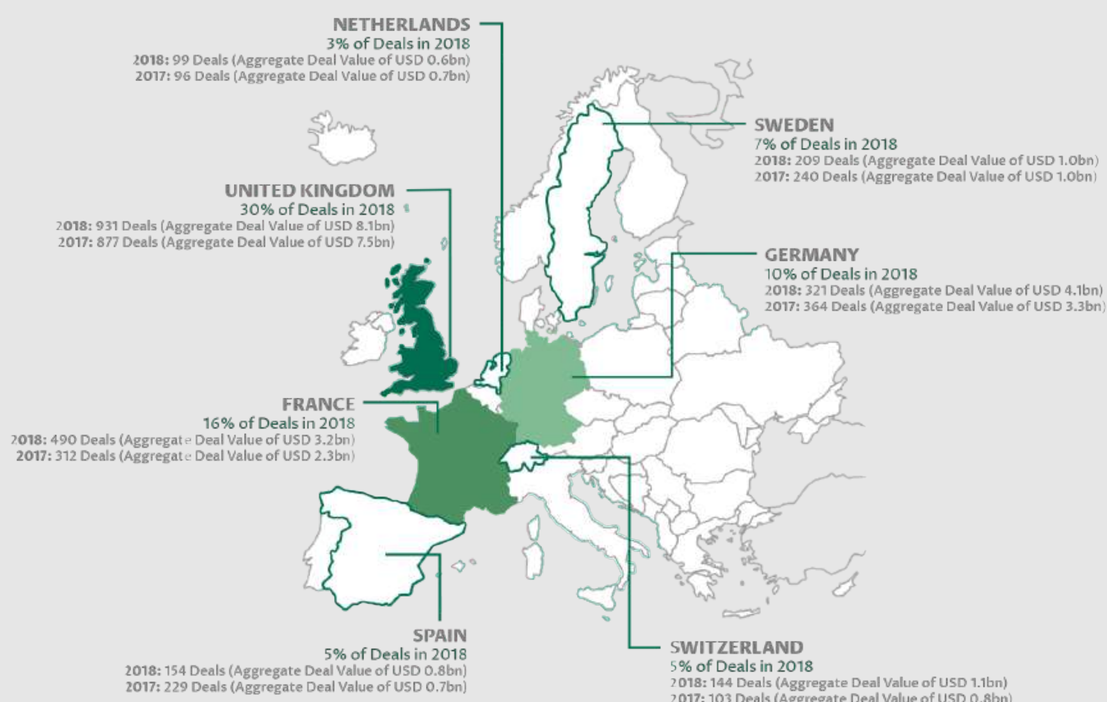
Largest deals - last 5 years

Firm	Investment Type	Deal Date	Deal Size (USD mn)	Investors	Location	Primary Industry
Refinitiv Limited	Buyout	01/30/2018	17,000	CPP Investment Board, Canson Capital Partners, Blackstone Group, GIC	UK	Information Services
NXP Semiconductors N.V.	Merger	03/01/2015	16,700	Permira, TPG, Freescale Semiconductor, Ltd., Carlyle Group, Blackstone Group	Netherlands	Semiconductors
Nouryon	Buyout	03/27/2018	11,251	Carlyle Group, GIC	Netherlands	Chemicals
Nestlé Skin Health S.A.	Buyout	10/01/2019	10,244	Public Sector Pension Investment Board, GIC, EQT, Abu Dhabi Investment Authority	Switzerland	Pharmaceuticals
Supercell Oy	Buyout	06/21/2016	8,600	Tencent, AVIC Capital, Zheng Hong Capital, Pagoda Investment, CITIC Capital, Sino-Rock Investment Management, Shanghai Pudong Development Bank	Finland	Software
Arm Limited	Buyout	03/08/2017	8,200	SB Investment Advisers	UK	Semiconductors
Unilever Spreads	Buyout	12/15/2017	8,051	KKR	UK	Food

Source: Preqin

Venture Capital Deals

Venture Capital Deals* in Europe



Largest deals - last 5 years

Portfolio Company Name	Investment Type	Deal Date	DealSize (USD mn)	Investors	Location	Primary Industry
Roofoods Ltd	Series G/Round 7	05/17/2019	575	Amazon.com, Inc., T Rowe Price, Fidelity Management & Research Company, Greenoaks Capital	UK	Internet
FlixMobility GmbH	Series F/Round 6	07/18/2019	561	Technology Crossover Ventures, Permira, HV Holtzbrinck Ventures, European Investment Bank**	Germany	Transportation Services
Delivery Hero SE	Unspecified Round	02/06/2015	552	Rocket Internet SE	Germany	Internet
Babylon Healthcare Services Limited	Series C/Round 3	08/02/2019	550	Kinnevik, Vostok New Ventures, Munich RE/Hartford Steam Boiler Ventures, Centene Corp, Public Investment Fund	UK	Healthcare IT
Spotify AB	Series G/Round 7	06/09/2015	526	Fidelity Investments, Coca-Cola Company, Northzone Ventures, Kleiner Perkins Caufield & Byers, Halcyon, Senvest Capital, Telia Company, Schoenfeld, D.E. Shaw & Co, Founders Fund, Digital Sky Capital, Technology Crossover Ventures, GSV Asset Management, Creandum, Goldman Sachs, Lansdowne Partners, Baillie Gifford, Accel, Wellington Partners, Discovery Capital Management, Rinkelberg Capital, Li Ka Shing Foundation, Abu Dhabi Investment Council	Sweden	Internet
Auto1 Group GmbH	Unspecified Round	01/14/2018	512	SB Investment Advisers	Germany	Internet
Improbable Worlds Ltd.	Series B/Round 2	05/11/2017	502	Horizons Ventures, Andreessen Horowitz, SoftBank Group, Temasek Holdings	UK	Software

** General Atlantic was a partial seller in this transaction, but remains a significant shareholder in FlixMobility.

* Figures exclude add-ons, grants, mergers, secondary stock purchase and venture debt.

Source: Preqin

Can the Partnership Work?

There is a fundamental difference in the way family firms and PE investors operate. Family businesses strive to create long-term value over generations. In contrast, PE firms, whose funds have a finite life, seek to transform investee companies over a relatively short period of time in order produce competitive returns for their investors (Appendix: Private Equity Investment Model). Nonetheless, their interests occasionally converge, particularly when family firms are in the process of institutionalization or to enter the next phase of growth. A clear understanding of the dynamics of the family business-PE firm partnership can help manage the expectations of both parties.

Benefits

PE firms can provide tailored solutions to meet the specific needs of family businesses; their approach differs depending on whether they acquire a majority or minority stake in the family firm.

Managing succession is the most common reason cited in academic literature for a majority purchase [16, 17]. Selling a majority stake to a PE firm allows a family to realize value, while remaining active within the business post-buyout. It also preserves, to some extent, the firm's identity and culture. A trade sale to a strategic investor, on the other hand, typically ends the family's involvement[18].

The literature also identifies the most common reasons for selling a minority stake as raising capital for growth or financing an acquisition[19, 20]. Other motivations include assisting in succession planning and providing an exit to one or more family shareholders.

Academic studies indicate that bringing in a PE shareholder, whether as a majority or minority investor, transforms family businesses. This transformation is usually achieved by improving corporate governance, professionalizing management teams, formalizing internal control systems and establishing incentive schemes for non-family managers[21, 22, 23].

Drawbacks

Despite the significant benefits of a PE partnership, family firms must be aware of the downside of raising capital from PE firms. Drawbacks most commonly cited in academic literature include the loss of managerial freedom, pressure to meet performance targets set by a third party, and dilution or loss of equity control[19, 20]. Additionally, PE investors conduct in-depth due diligence when assessing a target, which entails disclosing sensitive information often available only to family members[17]. Most family firms lack centralized data systems, which places additional pressure on the due diligence process making it even more disruptive.

Once a PE investment has been made, family firm owners ought to anticipate tension resulting from the relatively short investment horizon of their PE partner. PE firms have a contractual duty to return capital to their investors within a pre-specified time period, while most families have time-horizons that stretch over generations. In addition, bringing in a PE investor can disrupt the firm's culture and replace informal networks and operating practices with stricter reporting structures and performance-oriented goals[21].

10%
OF ASCENDANTS HAVE
A NON-FAMILY CEO
39%
OF CHAMPIONS HAVE
A NON-FAMILY CEO

Insights of PE Professionals into Investing in Family Firms

Partnering with a PE firm can significantly increase a family firm's institutionalization score and its value creation capability. Every PE firm-family firm partnership is unique and follows a distinct development path. In order to understand the complexities and dynamics of the PE investment process, we spoke to a few leading PE professionals experienced at investing in European family firms. The following section describes the challenges PE firms face and the means by which they unlock value at all three stages of the investment process: 1. Pre-investment, 2. Post-investment and 3. Exit.

Pre-investment

Frequently protracted and complex, the pre-investment stage forms the foundation of the partnership between a PE firm and a family business. The key to success at this stage is an alignment of interest and mutual trust between partners for which PE firms need to gain a clear understanding of the family firm's business vision. The following factors influence the nature and outcomes of this critical stage in the investment process:

Reasons for family firms to partner with a PE firm: At the outset PE firms need to determine whether the family wishes to sell a minority or a controlling stake in their business. Additionally, since every investment situation is unique, PE investors need to explore why the family firm wishes to pursue a transaction with them. From the interviews we conducted, the most common reasons are either linked to 1) company growth or 2) family involvement.

1. Company growth: Several interviewees mentioned that one of the most common reasons to partner with a PE firm is to accelerate growth. Family firms typically have successful regional operations and aspire to expand their sphere of influence by internationalizing operations or adding new products. As family businesses embark on this new growth phase, which could involve M&A or organic growth, they often experience the need for professional and financial support. Most often, they lack the funds to finance this vision or prefer not to tie their entire private wealth to the firm. An infusion of capital and managerial resources from a PE firm can help transform a single region-single product business to one that offers a broad product range in global markets. Specifically, PE firms can provide the operational and technological expertise required to realize this vision. One interviewee mentioned that PE firms are often called in by families hoping to scale-up their operations in sectors that are undergoing consolidation or witnessing high growth. Such family firms either decide to sell their business entirely or find a strategic partner to fund and manage accelerated growth.

> A PE firm can help transform a single region-single product business to one that offers a broad product range in global markets

> The key to success at this (pre-investment) stage is an alignment of interest and mutual trust between partners for which PE firms need to gain a clear understanding of the family firm's business vision

2. Family involvement: Most interviewees mentioned that partnering with a PE firm is often tied to the competencies, needs, aspirations and relationships of family members. Some examples that were mentioned are:

o **No "family" successor:** Families frequently partner with a PE firm when there is no suitable successor within the family who is willing to lead the business and no professional manager has been groomed to take charge. An interviewee described how a PE sale was once triggered when the founder's son and hoped-for successor confessed to his father that he has no desire to take over the business.

o **Retirement of a founder:** Between the ages of 55 and 65, founders often think about selling their family businesses to PE firms due to retirement, succession planning or health issues. Another reason why founders divest is to realize the value of what they have created in order to finance the next phase in their lives. One interviewee emphasized

> A PE sale was once triggered when the founder's son and hoped-for successor confessed to his father that he has no desire to take over the business

that they carefully consider the personal estate planning and tax structuring needs of the founder or owner when investing in a family business.

o **Shareholding changes:** Some firms require an infusion of capital to facilitate a transfer of ownership between family members. Occasionally, a PE partner is needed when family members wish to sell their stake to gain liquidity or de-risk their asset portfolios.

o **Weakening emotional ties to the business:** Interviewees described situations where a PE investor is brought in when family members' emotional connection to the business weakens. For example, families typically feel less emotionally vested in companies led by an external CEO. Furthermore, multi-generational businesses often reach a stage when there are many heirs with small shareholdings and progressively smaller dividend tickets. As emotional ties to the business weaken, it is no longer taboo for family shareholders to sell to an external investor.

o **Preserving family integrity:** An interviewee also described situations where multiple family managers struggle to agree on the firm's strategy. In such circumstances, selling the business to a PE investor can preserve family unity.

Deal Sourcing: While PE firms receive numerous deal opportunities, there are many steps from the first approach to a completed transaction. One interviewee mentioned that their firm invests in ca. 1% of the deal opportunities they come across. Deal sourcing is typically done in two ways: proactive deal sourcing (direct origination) or intermediated deal sourcing (through a third party). Intermediated deals, both large and small, follow the same process. With several mature markets, Europe has numerous M&A advisors or consultants who act as intermediaries for PE deals. One PE firm we interviewed has a network of around 1,500 consultants who regularly identify investment opportunities. PE firms also use "searchers", who receive a retainer and a success fee to identify potential targets.

PE firms do proactive deal sourcing by systematically identifying target companies. Firstly, PE firms put together relevant datasets of better performing companies, often building proprietary datasets themselves. They also curate strong business networks through active outreach, marketing efforts and networking events. Finally, they invest in building strong relationships with the founders, shareholders and senior executives of family businesses. These relationships are typically built well before an investment is in sight. PE firms that specialize in specific sectors seek opportunities in those sectors alone. One PE interviewee described their firm's search approach: They begin by looking for markets with macroeconomic or demographic factors that support above-average growth. Next, they narrow their focus to markets where accelerated growth is expected to be sustainable. Finally, they shortlist firms within those markets who are taking advantage of this growth potential.

How family firms select a PE partner: In situations where PE investors acquire a minority stake in a family firm, our interviewees made several interesting observations. Firstly, mutual trust and aligned interests were particularly critical; one interviewee likened a PE deal to "entering a marriage". Additionally, being unused to having other voices at the board table, family firms are usually concerned about the governance implications of having an external minority shareholder. Finally, it is absolutely crucial for minority investors to clearly understand the family's exit goals and finalize plans at the pre-investment stage itself.

> Most family members have more than just a financial connection with their firms; they often have deep socioemotional ties to the business, its employees and the local community

Family firms tend to be conservative in their approach to selecting a PE investor. Most family members have more than just a financial connection with their firms; they often have deep socioemotional ties to the business, its employees and the local community. This multi-faceted connection impacts all decision-making, including the selection of a PE partner.

According to our interviewees, non-family firms tend to focus exclusively on getting the highest price when selecting a PE partner. On the other

hand, being more emotionally involved in their businesses, families seek a partner who will provide "the right home" for their business. They look beyond the highest bid to a range of factors including the quality and reputation of the PE investor, the strategic fit, the value a PE partner can bring to the table and potential governance changes.

The pre-investment process can involve multiple meetings spanning several months. PE firms need to convince the family that they are a capable and trustworthy partner. One interviewee explained that the trust-building process is particularly challenging as family business leaders typically perceive PE firms as cost-cutting specialists with little interest in creating value for the firm. The negotiation process has to be handled sensitively as both parties are likely to work together for a 5-year period following the investment. A protracted pre-investment stage can be mutually beneficial for both parties; there is sufficient time for a robust process and the development of mutual trust and transparency which reduces the risk of a poor decision.

It is important for a PE firm to build an authentic and deeply personal bond with the family even before a deal is considered, so that it is included in the candidate pool when the family eventually decides to accept PE investment. When selecting a partner, family firms often speak to multiple PE investors; some also hire advisors. Family-owned businesses usually have limited investment windows which could be imminent or 10-years away. Staying close to family members and the management will ensure that a PE firm is able to seize the investment opportunity, whenever it occurs.

It is important for a PE firm to build an authentic and deeply personal bond with the family even before a deal is considered

There are also instances where PE firms create an investment opportunity themselves. They approach high-potential family firms, even those that have been passed down several generations and are not looking for an investor. In such circumstances, it is very important that the PE firm is able to convince the family of their strategic vision and their ability to take the company to the next level.

According to our interviewees, family firms increasingly have clear expectations of what they want to achieve from a PE partnership and are more thorough in doing their due diligence. They want to see the PE investor's past work and to understand their vision for the family business. Seeking resources beyond pure capital, family businesses look for evidence of skills and domain knowledge. One interviewee mentioned that every founder they have partnered with has taken the time to conduct in-depth interviews with other portfolio CEOs, prior to entering into a deal.

One interviewee mentioned that every founder they have partnered with has taken the time to conduct in-depth interviews with other portfolio CEOs, prior to entering into a deal

Post-investment

PE firms extract value from a family firm's operations largely by eliminating inefficiencies. They identify and rectify these inefficiencies by taking a few important steps discussed below:

Appointing an effective board of directors: One of the principle reasons family firms bring in an external investor is to get a fresh perspective on their business, particularly at the strategic level. Governance, therefore, is often the first area of focus in the post-investment stage.

Most PE partners install a board at their portfolio companies soon after they make an investment. An effective board is key to improving governance as it formalizes the working relationship between the principal shareholder and the management. Where a firm already has a functioning board, adjustments are made to improve its effectiveness. While the board's size and composition depends on the PE firm and the business context, there is always shareholder representation. One interviewee mentioned they typically institute boards with five to six experienced and competent members: the CEO, the CFO, two representatives of the majority shareholder, a representative of the minority shareholder and a non-executive Chairman. In a control deal, the board is typically dominated by the PE firm and management.

Most of the PE firms we interviewed appoint independent directors on the boards of their portfolio companies. A great deal of thought goes

into the selection of such independent directors; our interviewees primarily look for experienced individuals who have "been there done that". While independent directors need not be sector specialists, they must have situational knowledge - an understanding of how the business should evolve, how to bring in external senior managers and how to manage the exit process. The specific skillset required of an independent director depends on the challenges and opportunities the family business is facing. In particular, where significant operational changes are anticipated, the independent director should have experience of leading such change. In situations where the market is undergoing a structural change, PE firms will likely choose a person who can identify possible paths for the business given the prevailing uncertainty. An independent director may also be a coach for the CEO, providing support with challenging leadership tasks including change management, succession transition or business growth.

Some PE firms also create board sub-committees for issues such as remuneration, audit or strategy.

While independent directors need not be sector specialists, they must have situational knowledge

Meeting talent shortages: Businesses that have experienced rapid growth inevitably outgrow the human resources that facilitated that growth. It is therefore important to determine the capability set that is required to realize the firm's business ambition; identify the gap between current capabilities and those required; and develop a plan to bridge the gap. A third party such as a PE investor can provide invaluable support for this transition, which can be very difficult for family firms.

While the absence of a deep talent bench is perhaps the most common human resource challenge in family-owned firms, it also carries huge potential for value creation. The talent shortage is most acute at the C-suite level, in part because some family firms resist paying market compensation for functional specialists. PE firms can upgrade the management team by appointing senior executives with new capabilities and fresh ways of thinking. Invariably, one of their first appointees is a CFO who can position the business for rapid growth by making it efficient and nimble. According to our interviewees, family firms often hire a bookkeeper or an accountant, but they rarely have a professional CFO who may cost twice as much but performs a broader role akin to a commercial partner to the CEO.

Another role that is almost always missing in family firms is a COO. As with the CFO role, the COO role is usually played by the founder in founder-led businesses. Adding these C-suite executives often relieves the founder of substantial leadership responsibility. PE firms also may appoint a CSO (Chief Sales Officer) to strengthen the sales management and marketing (including digital marketing) functions.

The talent shortage is most acute at the C-suite level, in part because some family firms resist paying market compensation for functional specialists

The compensation structure of family business's frequently needs attention as it can hinder talent acquisition. For example, high-performing employees are rarely rewarded with equity in family firms, so PE firms often install ESOPs as a motivational tool.

One PE firm we interviewed mentioned that they have a panel of experts available in areas such as talent management, digitalization, pricing and internationalization. They strongly encourage portfolio companies to draw on this talent.

Managing family members in the business: A particularly complex issue PE firms have to deal with post-investment is to determine the role of family members in management positions. While there is no one-size-fits-all solution, some interviewees acknowledged that the employment of close relatives in senior positions goes against the notion of independent management and a healthy governance structure. However, one PE firm we spoke to described how they approach this sensitive issue by focusing solely on competence: Any executive, whether a family member or not, that is not able to fulfil the requirements of the position, is replaced with a more capable manager. Founders who are also the CEO of their company, usually remain in their position following the PE deal – at least during the transition period – or assume a board position. This is especially true in cases where the founder retains a stake in

the business after taking on a PE partner. Where founders sell the whole company, they often sever ties with the firm.

In every deal, PE firms ensure that the management transition plan is carefully thought-through and pre-agreed, so there are no surprises post investment. One PE interviewee said that his firm drafts a detailed set of management rules identifying the decisions that management can take by themselves and those for which they have to seek approval - typically decisions that relate to acquisitions, strategic changes or financing that exceeds pre-determined monetary limits.

In every deal, PE firms ensure that the management transition plan is carefully thought-through and pre-agreed, so there are no surprises post investment

Strengthening systems and processes: Implementing robust and efficient systems and processes always creates value for family businesses and PE firms can play an important role in this effort. In fact, understanding what can and cannot be improved is itself a valuable process. A PE firm we interviewed scrutinizes processes across all functions including production, supply chain, R&D, sales, marketing and administration, regardless of the nature of the investment. In particular, they evaluate whether: a) the processes are well defined, b) everybody is aware of them, c) they are adapted to the business, and d) they lead to efficient results.

Most PE firms prioritize the overhaul of processes in the financial reporting and control function. A comprehensive and reliable financial planning and management information system facilitates better decision making. However, family firms frequently lack clear KPIs which are necessary for such a system. One PE interviewee described how they approach this challenge: They convene monthly performance review meetings in addition to having a quarterly reporting system and use a standard reporting template that covers financials as well as other key KPIs. This performance data and any other potentially important issues are then discussed in the monthly review meetings.

There is usually scope for improvement in the sales and marketing function of a family business. Several interviewees pointed out that family firms rarely invest in developing an integrated sales and distribution platform; many do not use a basic Customer-Relationship-Management (CRM) tool. A PE investor can institutionalize this function by implementing the right customer tools, setting up an integrated website, introducing digital marketing, and providing social media expertise. One interviewee mentioned that they often have to completely overhaul the family firm's website, which may look attractive but is inefficient. PE firms can boost the business' online presence and measure online performance by introducing Search Engine Marketing (SEM) and Search Engine Optimization (SEO) tools to understand how Google's search engine behaves and to measure conversion rates[v].

There are several emerging areas where PE firms can strengthen their partners' operations. One PE firm we spoke to generates value by boosting cyber security and data compliance auditing across their entire portfolio. Since these areas are new to many of its family business investees, the PE firm insists that directors discuss these topics at least once a year to fulfil their safety and compliance responsibilities.

Most PE firms formulate a 100-day plan with a strategic review within the first year. During the review they re-examine the whole investment hypotheses and develop an action item list for the subsequent four or five years.

One PE firm we spoke to generates value by boosting cyber security and data compliance auditing across their entire portfolio

M&A and internationalization: M&A is a well-recognized capability of PE firms; it is part of their DNA. An M&A transaction, particularly one that involves international expansion, can be a daunting step for a family firm or founder-led business, who rely heavily on advice from PE partners about the right time to invest, the expected ROI, and how the

[v] The conversion rate is defined as the number of website visitors that complete a desired goal (a conversion) out of the total number of visitors, e.g. the percentage of website visitors who buy something on the website.

acquisition will change their growth profile. Some PE firms have expertise in doing platform deals and add-on acquisitions; they take time at the pre-investment stage to build a rich M&A pipeline, speak to the competition and verify that the family firm's vision relating to M&A is achievable.

> An M&A transaction, particularly one that involves international expansion, can be a daunting step for a family firm or founder-led business

Maintaining strong stakeholder relationships: Family businesses are seen as dependable business partners and therefore have loyal suppliers and customers. PE firms must invest in understanding and nurturing these relationships as they are a source of competitive advantage. For example, loyal suppliers could be willing to extend payment deadlines to their family firm clients when the need arises. A family business' relationships with customers also tend to be very strong. Many firms and, in particular, their founders, have developed the product themselves; most successful family firms have also been in the market for decades. They understand customer needs and the nuances of the market far better than the average professional CEO.

While the benefits of loyal, trusted suppliers and customers cannot be quantified financially, they provide stability and resilience to the business in difficult economic circumstances. The downside of these close relationships is an overreliance on the family members or employees who manage them. PE firms need to tread cautiously with these individuals as they are close to the customer and are the architects of the product vision.

Since average employment tenures at most family firms are long, employee relationships tend to be deep and there is a strong unifying culture. Unfortunately, this creates a challenge for a new manager, who is neither from the family nor part of the team that built or grew the business. Occasionally clashes arise between the new external leadership and long-term employees who are strongly loyal towards the family. The transition from a family or founder-centric culture to a more meritocratic and pragmatic culture needs to be managed with great sensitivity. Unfortunately, it is not always possible to anticipate these challenges during the due diligence phase and they only emerge post investment.

Family firms can be relatively centralized organizations with every decision requiring the approval of the family patriarch, matriarch or founder. To make decision-making more efficient, PE firms invariably restructure the business to reduce dependence on family members. However, as our interviewees pointed out, it often takes time to reconfigure entrenched chains of communication. In one case, old employees circumvented newly hired superiors and dealt directly with the founder with whom they had worked for over 20 years. Making sure that employees respected appropriate channels of communication without creating their own secondary reporting structure was both a difficult and time-consuming process.

Overcoming resistance to change: Some family businesses stagnate once they achieve a predetermined level of growth. Subsequent generations hesitate to challenge the status quo because "it was how their grandfather built it". This sense of obligation towards their ancestors' legacy can, in certain instances, constrain a family leader's ambition.

Several family firms have built successful brands over the years. However, brands that have driven growth in the past often falter in today's fast pace market environment. Changing brand strategy, particularly for successful brands, is invariably met with resistance from the family and long-term employees.

> The transition from a family or founder-centric culture to a more meritocratic and pragmatic culture needs to be managed with great sensitivity

Exit

While PE firms invest resources to transform the operations of their family business partners, their goal is to make a successful exit within 5 to 7 years. It is therefore imperative for them to ensure that the family firm understands that an exit is inevitable and is committed to it. The principle issues in the exit stage are:

Alignment on exit terms: It is absolutely crucial that all exit-related issues are discussed and agreed upon before entering into the deal. This is especially true of minority investment situations. For control deals, the PE firm decides when and how to exit. Nonetheless, they still have to take into

account other shareholders and the management team, especially in mid-sized businesses where these stakeholders can have a strong influence on the prospective buyer.

It is absolutely crucial that all exit-related issues are discussed and agreed upon before entering into the deal

Despite agreeing on this critical issue at the pre-investment stage, the exit process can get derailed due to misalignment between the family and the PE investor. In most cases, this is because family leaders change their minds over the investment period, misunderstandings develop or there are unmet expectations.

To minimize these challenges, PE firms protect their positions with legal documentation relating to their exit's timing and route. However, written agreements are not sufficient and PE firms must also ensure that their verbal discussions with the family reflect complete alignment on exit terms. As one interviewee explained, "if both parties get to a stage where they are quoting legal terms to each other, you know you're not in a great place."

… "if both parties get to a stage where they are quoting legal terms to each other, you know you're not in a great place."

Exit routes: The choice of exit route is a key topic that is covered in the investment agreement. The main exit routes are either selling to a strategic or financial investor (a trade buyer or another PE investor) or an IPO. Some families also request the option to buy back the firm at exit.

Choosing an exit route depends on the vision the family has for the firm. Where the family wishes to remain a shareholder following the exit, the relationship with the new strategic or financial investor is particularly important. A key concern is the role of the family in the post-exit structure.

Selling to a trade buyer is a popular option, unless the family wishes to remain independent over the long-term. Families that partner with a PE investor and then sell to a trade buyer, do so only if they believe that the PE investment will create value and so boost the exit price. Without this expectation, they could decide to sell the firm directly to a trade buyer without any PE involvement.

Some family leaders welcome the opportunity to be the CEO of a public business, believing that going public will give them sustained control and preserve their legacy. At the other end of the spectrum, there are family leaders who view public markets as the absolute antithesis of family ownership and influence.

One interviewee indicated that family firms increasingly seek the option to buy back the equity they sold. This is mostly seen when families sell a stake during a significant event such as inter-generational succession, an acquisition or a new initiative such as internationalizing the business. They take on a partner to implement these moves but hope to restore the family's full ownership once they are completed.

Family firms increasingly seek the option to buy back the equity they sold

There are occasions when PE firms do not explicitly specify the exit route at the pre-investment stage. Instead they focus on their strategic vision for the business, financial targets and ROI expectations.

Exit terms: Occasionally families stipulate a minimum investment timeframe as a prerequisite to partnering with a PE firm. One interviewee told us that such extended partnerships are written into the contract; for example, the agreement could include a clause that forbids an exit for the first four years (lock-up period) or until a minimum return is assured. Deal tenor is particularly important if the PE firm is the family's first institutional capital provider because family firms do not change their capital structure frequently.

Minority deals often include exit terms, such as the appointment of a third-party advisor, a timeline to test the market for a potential buyer, or priority buying rights for existing shareholders. Drag along and tag along clauses can also be included, although one interviewee highlighted that entrepreneurs or family owners rarely agree to them.[vi]

[vi] A drag-along right enables a majority shareholder to force a minority shareholder to join in the sale of a company. The majority owner doing the dragging must give the minority shareholder the same price and terms and conditions as any other seller. If a majority shareholder sells its stake, a tag-along right gives the minority shareholder the right to join the transaction and sell its stake too.

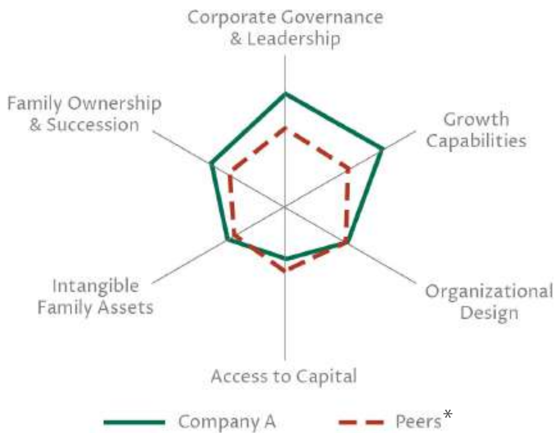
Case Studies

We gave our participating family businesses an opportunity to share their stories and comment on the institutionalization process within their firms. Featuring 2nd, 3rd, 6th and 9th generation firms, these case studies share lessons learned from a diverse set of families.

Each case study links back to our survey by comparing the family firm's score to its peer group; two cases have partnered with an external investor.

100% family-owned for over 260 years

This case shares the perspective of a ninth-generation family member who is currently the Chairman of his family firm. A transparent corporate governance structure, a sustainable asset diversification strategy, and the existence of a "family home" have helped ensure business continuity over three centuries.



Founded over 260 years ago, we are one of Europe's largest privately-owned family businesses with over 18,000 employees. From our headquarters in Germany, we manage a diversified portfolio of companies with varying business models. Today, our well-known, entrepreneurial family has over 700 members, none of whom are employed by the firm. Our firm's management is fully professionalized with the family represented at the board level.

Corporate Governance & Leadership

Our family has always believed in the importance of effective corporate governance. With clearly defined roles for family members and professional managers there is a strict separation of management and control. Non-family managers have run the business for over 100 years, while the family is represented on the firm's Supervisory and Advisory Boards. The Supervisory Board consists of six shareholder representatives: four family members and two external members, and six employee representatives. The Supervisory Board comprises of several sub-committees, including audit and personnel committees. The 30-member Advisory Board consists solely of family members and is responsible for all communication between the company and the family. Family members on both boards are elected for a 5-year term at the annual shareholders' meeting.

Growth Capabilities

Our firm has a long-term investment strategy whereby it owns and actively manages a diversified portfolio of companies. In order to achieve greater returns with prudent risk diversification, the management regularly reviews each asset in its portfolio and asks the question: "Are we (still) the best owner?". Our investment strategy is driven by a clear vision to only invest in high-potential business areas and to operate in markets where the firm can achieve a leading position. When a business area is no longer considered suitable for the portfolio, the asset is divested and the proceeds reinvested in a new business area. This strategy of flexibility and nimbleness has served us well and we have successfully entered and exited several industries over the course of our 260-year history.

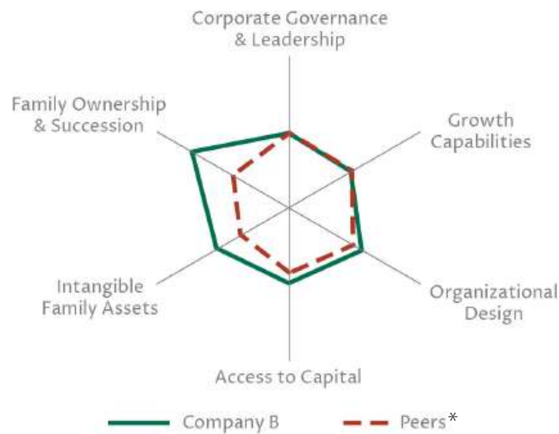
Intangible Family Assets

Our family has a very strong shared identity and mutual core values. In particular, spending time together is of utmost importance to us. The annual shareholders' meeting and all official family gatherings are held at the family home which carries high emotional value for us. These meetings provide us an opportunity to stay abreast of the company's activities, learn from leading family members and deepen internal networks. In addition, every two years, the company organizes a weekend at the family home where younger family members are briefed on one of the company's business units.

** Family firms of a similar size (# of employees) and from the same region.*

A Thriving Family Firm with Only Two Family Members

This case shares the perspective of a sixth-generation family member who undertakes business development and holds an operational position in his family firm. A unique succession plan, a closely monitored shareholding structure, and a family-wide attitude of humility have helped the company prosper over its 180-year history.



We are a sixth-generation family business based in France, operating in the automotive industry. Founded over 180 years ago, our firm has survived multiple crises and wars. In the late sixties, my grandfather and his cousin began to rebuild and reposition the company. Over the years, we have developed into a global, well-diversified firm with around 4,500 employees. I entered the family business several years ago to pursue business development, primarily in Asia, Central Europe and North America. To develop a better understanding of our operations, I am now based in Brazil and manage the Latin American region. With a growing global footprint, we remain focused on continuously adapting the business to the needs of the time.

Family Ownership & Succession

When it was founded in the late 1830s, our family business was engaged in industrial textile production. The founder's two sons inherited the business and from then on, only one child from each of these two branches of the family was permitted to become a shareholder and work for the firm. No pressure was exerted on family members to join the company and in every generation, the two family shareholders – originally brothers and then cousins - enjoyed a close relationship with each other and with the firm's professional managers. The current family members working at the company have an age gap of 20 years, allowing them to have clear roles and contribute effectively to the company's success. While this succession approach enabled our company to remain family-owned for several generations, the situation has changed. Our company has grown rapidly over the last 40 years, and solutions that worked for previous generations may no longer be appropriate today.

Access to Capital

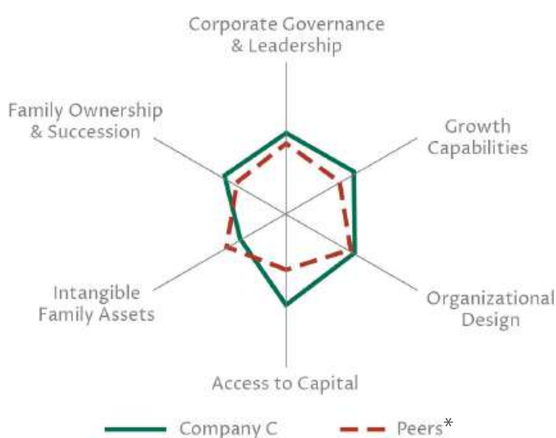
Faced with challenges following the global financial crisis, we decided to give an external investor a minority stake in our business. This investor has one board seat and has worked closely with us for the past 10 years but is not involved in the firm's operations. Following the success of this first significant step to open up the company, we have professionalized management and hired an external CEO.

Intangible Family Assets

After 180 years, our family business has a rich history and a well-defined culture. We believe in being humble, appreciating what we have and continuously embracing an entrepreneurial spirit. We have strong, long-term relationships with our employees, customers and suppliers. We also care deeply about our professional reputation, not merely because our family name is associated with the business, but because we want to set high professional standards for everyone we work with.

From a Small Handicrafts Business to an International Company

This case shares the perspective of a third-generation family member who is the current owner and managing director of his family firm. A new, more customer-centric business model, digitalization as well as adequate liquidity have enabled the company to achieve extraordinary growth.



We are a German family firm engaged in the metalworking industry. Around 90 years ago, my grandfather started a small handicrafts business. My father took over the business in the early sixties and transformed it into a machine-tool manufacturer. In the late eighties a vacancy arose in the business and my father asked me to step in for a short period of time prior to doing an MBA. While studying, my father offered to hand over the reins of the business to me upon graduating. I welcomed the challenge and am now the Managing Director and sole shareholder of the firm.

Growth Capabilities

When I took over the family business in the early nineties, the company was facing financial difficulty. By adapting our business model, I was able to turn the company around. Over the 30 years that I have led the company, our employee strength has tripled, and turnover has recorded a 14-fold increase. We expanded globally and set up subsidiaries in the US and China. This turnaround began with a conscious decision to focus on our customers. We undertook a market segmentation exercise that scrutinized our customer groups and gave us a clearer picture of what they wanted. This customer-centric approach led to a fundamental shift in our business model. We are no longer constrained by "what can we produce"; instead we ask ourselves "what do our customers want". Today, we can offer our customers a wider variety of machines because we are no longer limited by what we can manufacture in-house. This strategy of constantly refreshing our product line has been so successful that our company has developed into a role model for a small German machine tool builder.

Organizational Design

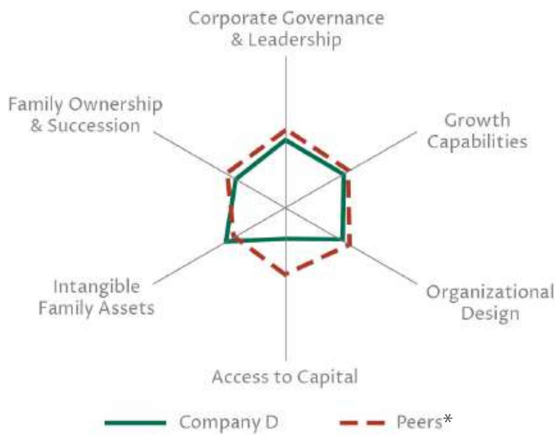
The machine tool industry requires absolute precision. We therefore needed strong internal processes for quality management and control. Additionally, I implemented an effective financial control system. I quickly realized that this would require a shift in mindset - our employees had to understand that supplying the best machines possible was not our only imperative; we also had to be financially viable. Moreover, our customer-focus evolved into a broader interest in marketing. Today we have 4 employees working in the marketing department - a big team for a company our size. The team has a progressive digitalization strategy that uses tools such as Google optimization to strengthen our marketing efforts.

Access To Capital

The machine tool industry is highly cyclical. Surviving market downturns requires adequate liquidity. We are well capitalized and have limited debt on our balance sheet. However, there was one occasion when we brought in an external investor for a 5-year period. This enabled us to finance our growth initiatives whilst remaining independent of banks.

Leading Through Strong Personal Relationships with Stakeholders

This case shares the perspective of a second-generation family member who is an Executive Director of his family firm. Strong family values, significant inorganic growth, complete operational control and a sophisticated corporate governance structure have ensured strong growth and stability



Founded by my father and his brother, we are a second-generation family business based in the UK, owning and operating pharmacies. The business is now owned by our side of the family but my uncle, an important founding figure, still holds a non-executive position on the board. In 2016 my father, who was our Chairman & CEO and the driving force behind the business, suddenly passed away. My two siblings and I, already part of the senior management team, took over the business and continue to lead jointly as executive directors

Intangible Family Assets:

We are very visible family owners and managers – as an example, my mother hosts our office Christmas party at the family home. We have a personal connection with our senior colleagues, many of whom have been in the business for a long time and known us since we were children. Even though our children are still very young, we bring them to the office and stores regularly. We also have close personal ties to our suppliers and customers, many of whom are family businesses too. On my father's demise, his 75% equity stake was transferred to a trust for the benefit of the family. We hope to transfer the remaining shares to the trust thereby eliminating individual share ownership.

Growth Capabilities

Our growth - from 30 stores in 1990 to around 300 stores today - came about largely through acquisitions. Pharmacies in the UK frequently change hands providing us with several acquisition targets. By limiting dividend payouts to the family, this inorganic growth was primarily funded by reinvesting profits. Moreover, we ensure that we have adequate liquidity by maintaining leverage levels on par with private equity funded firms. We also grow organically, by running our pharmacies more profitably and reinvesting the returns. Future growth, however, may come from new initiatives such as digitalization, vertical integration or entering related industries.

Corporate Governance & Leadership

Since we have complete operational control, we are not affected by traditional governance concerns such as bridging the gap between distant shareholders and management. Instead our focus is on making sure the business operates well. We have a relatively large senior management team: Us three siblings, our uncle and several non-family senior managers who head key functions including purchasing, marketing, HR, IT and finance. We also have six experienced, non-executive directors, each with a unique skillset, to guide us on important matters. We meet every six weeks to discuss strategic challenges and opportunities. We also have four sub-committees: two "operational" sub-committees and one each for "finance" and "non-commercial risk".

Conclusion

Family firms are a key driver of economic growth and well-being in Europe. As they develop, family businesses need to institutionalize their operations to ensure long-term value creation.

Our survey of 121 family firms identifies a proficiency gap between ‘Champions’ and ‘Ascendants’ and shares recommendations from the owners of mature family firms. In particular, Champions outperformed the Ascendants in relation to five attributes. However, Champions underperformed Ascendants in terms of “Family Ownership & Succession”, underlining the importance of this attribute along the institutionalization journey.

Selectively drawing on expertise from external sources – such as private equity investors, independent directors or professional managers – can help a family business leapfrog the institutionalization curve.

Appendix

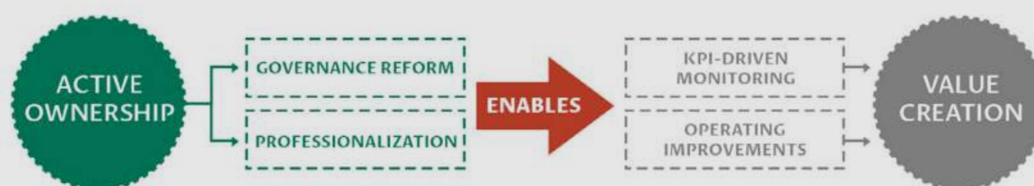
The Private Equity Investment Model[vii]

PE firms have traditionally financed their investment activity by raising closed-end funds with a 10-year term. The structure of a typical 10-year fund includes a 5-year investment period (i.e. from year 0 to year 5) during which the PE firm acquires equity stakes in private companies; the PE firm is required to sell all fund stakes and return capital plus a portion of any profits to investors by the end of the tenth year. Successful PE firms typically raise a fund every three to four year to provide a continuous supply of investment capital and finance their day-to-day operations (Zeisberger et al, 2017).

As a result of this closed-end fund structure, PE firms hold stakes in their portfolio companies for a relatively short time (typically 4 to 7 years). To maximize an investment's value during this period, firms engage regularly and directly with companies' senior management teams, and often at a granular operating level, to shape strategy and management style, monitor performance, and drive change. As highlighted by Michael Jensen in "Eclipse of the Public Corporation" in the Harvard Business Review (1989), this "active ownership" model has been the bedrock of PE investing from the industry's inception.

Exhibit 8 provides an overview of two core elements of the PE investment model – Active Ownership and Value Creation.

Exhibit 8: *Value Creation In Private Equity*



Active Ownership

PE investors have a defined approach to influencing and monitoring their investments, placing emphasis on sound corporate governance and professionalizing its investee company's systems, processes and human resources. Implemented in a repeatable fashion, active ownership allows PE investors to align key stakeholders in a portfolio company and efficiently monitor performance.

Governance reform: PE firms employ specific corporate governance mechanisms to oversee and coordinate activity at their investments. The board of directors is the main channel through which PE investors execute their rights as owners and influence the performance of their investee companies; influence is ensured through a controlling equity interest in a majority investment and via a board seat, or – at a minimum – board observation rights, in a minority investment. PE investors also seek to align their economic interests with existing shareholders and management to

[vii] This section is based on the following book: Zeisberger, C., Prahl, M. & White, B. (2017). Mastering Private Equity: Transformation via Venture Capital, Minority Investments and Buyouts. New York: John Wiley & Sons.

driver performance, either through a significant, personal investment in company equity from senior management in a majority investment, or via shared equity ownership with existing owner-managers in the context of a minority investment.

Professionalization: PE investors engage from the beginning of their ownership period to professionalize their investee companies. This begins with ensuring that the right management team is in place. When a gap in the team is identified, new managers will be recruited to complement the existing team; in some instances, managers will be replaced. PE investors focus specifically on the finance team to ensure accountability and professional standards in financial reporting. PE firms also leverage talent both within their organizations – operating partners and operating teams – and from outside – executive mentors and consultants – to augment the professional resources available to an investee company. PE firms also typically implement comprehensive management information systems that provide accurate, on-demand metrics of business performance. Other initiatives may include IT system upgrades and the optimization of pensions, insurance and tax.

Value Creation

Value creation activity in a PE-backed company focuses on driving performance improvements in a company's existing operations to build a more efficient, better-run business. Leveraging the active ownership model, PE investors are able to identify and drive specific operating improvements backed by KPI-driven analysis.

Operating improvements: PE investors often engage beyond the board to drive targeted operating improvements during their period of ownership, often leveraging specific, in-house domain or functional expertise to drive change. An in-depth examination of the previous owner's operating model will not only aim to build on the company's established strengths but also look for new ways to release cash or increase profit margins. Driving revenue growth through increased sales volume is the preferred lever for value creation in PE, with overhead reduction and working capital optimization also commonly employed. PE firms typically focus on a small number of operating improvements at any one time to avoid over-burdening management, often beginning with priorities identified during due diligence.

KPI-driven monitoring: PE investors closely monitor financial and non-financial key performance indicators (KPIs) to drive fact-based decision-making. Leveraging data from management information systems, PE investors identify and track the evolution of a handful of KPIs that represent the performance of critical areas of a business model. KPIs also provide simple metrics through which to measure employee performance and to implement performance-based compensation schemes.

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About Us

The Wendel International Centre for Family Enterprise (WICFE). INSEAD's activities in family business started in 1997, when the Large Family Firm Chair was founded by Wendel with the purpose of studying the unique dynamics of family enterprises; in the same year, the first cohort of students attended the MBA Family Business Elective. Two decades later the Centre has grown into a leading international resource for family business learning and we are continuously generating and sharing knowledge that benefit family businesses. The Centre has also adopted a wider advocacy role by raising awareness and understanding of the importance of family enterprise as a business model.

The Global Private Equity Initiative (GPEI) drives teaching, research and events in the field of private equity and related alternative investments at INSEAD. It was launched in 2009 to combine the rigour and reach of the school's research capabilities with the talents of global professionals in the private equity industry. The GPEI aims to enhance the productivity of the capital deployed in this asset class and focuses attention on newer areas shaping the industry such as impact investing and operational value creation, and specific groups of LPs like family offices and sovereign wealth funds. Its core supporters are:

Project Supporter

Clayton, Dubilier & Rice (CD&R) is a private investment firm founded in 1978 with a strategy based on building great businesses by growing the top and bottom lines sustainably. Since inception, CD&R has managed the investment of more than $24 billion in 75 companies, representing a broad range of industries with an aggregate transaction value of more than $100 billion. The firm is recognized for driving operational and strategic initiatives through a combination of growth, talent, productivity, and capital efficiency improvements – approximately 78% of the firm's historical returns have been the result of EBITDA growth. The firm has offices in New York and London. For more information, visit www.cdr-inc.com.