

THE INSTITUTIONALIZATION OF **FAMILY FIRMS**

From Asia-Pacific to the Middle East



OCTOBER 2017

This report would not have been possible without the engagement of the 123 families who participated in our survey and the countless families that made time for our interviews. We would also like to thank the 14 private equity professionals who met with us in person or spoke with us over the phone to share their experiences.

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This report was produced by the team at the Global Private Equity Initiative (GPEI), which included Bowen White, Associate Director, Alexandra Albers-Schoenberg, Research Associate, and Claudia Zeisberger, Senior Affiliate Professor of Decision Sciences and Entrepreneurship and Family Enterprise and Academic Director of GPEI.

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123 Family
Firms

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PE Firms

Over 30% of Asia's family firms will go through a generational change in the coming 5 years; not always is the next generation able or willing to step into the shoes of their elders. Bringing in the right Private Equity partner allows family firms to ensure business continuity and institutionalization to facilitate sustained growth.

Claudia Zeisberger

**Senior Affiliate Professor of Decision Sciences and Entrepreneurship & Family Enterprise
Academic Director, Global Private Equity Initiative**

This project has great value in that it provides a source of granular, targeted data on the state of institutionalization of family firms in Asia. This dataset fills a gap in information on family businesses in growth markets, adding to our growing body of credible and analyzable emerging markets data.

V. (Paddy) Padmanabhan

**The Unilever Chaired Professor of Marketing
Academic Director, Emerging Markets Institute**

Long Term Planning related to the transition of family firms across generations is without doubt the biggest challenge that Asian family businesses have. This report provides new perspectives on how to institutionalize the transition process. With its focus on transition and the role of Private Equity, it builds an important bridge that can help sustain growth and stability for Asian family businesses.

Morten Bennesen

**The André and Rosalie Hoffmann Chaired Professor of Family Enterprise
Professor of Economics and Political Science
Academic Director, Wendel International Centre for Family Enterprise**

Overview: *How Can Family Firms Ensure Long-Term Value Creation?*

As family firms account for 70% of GDP in the global economy and 60% of global employment, the importance of long-term value creation extends beyond individual families – it is among the main drivers of economic growth and business innovation, as well as livelihoods.

An entrepreneurial spirit and close relationships are key elements at the start of a family's journey. Initial success typically relies on one or two individuals with a vision for a new business, the energy to execute, and the determination to persevere. However, as a family firm matures and transitions to the second and third generations (and beyond), introducing formal policies and procedures to institutionalize the firm's mission and values is critical to preserve its competitive advantage and enable sustainable growth over the generations.

To understand how families in emerging markets approach these topics, INSEAD surveyed 123 family firms in Asia-Pacific and the Middle East to measure their level of institutionalization across six key attributes: family ownership and succession, intangible family assets, corporate governance and leadership, growth capabilities, organizational design, and access to capital.

This report sheds light on how institutionalizing aspects of a family firm can help ensure its long-term health and survival. Case studies will help families understand their own strengths and weaknesses, learn from their peers, and derive food for thought for improvements within their own businesses.

By nature, family firms are often inward looking and at times reluctant to seek external advice when faced with challenges. Taking a close look at the partnership opportunities between family firms and external investors, and interviewing 14 leading private equity firms, we report on how the PE industry can help family firms unlock value and expand.

Our exploration of the institutionalization of family firms focuses on businesses in Southeast Asia, South Asia (India & Sri Lanka) and the broader Middle East.

Why Institutionalization Matters: Long-term Value Creation

The family business ownership model presents a unique set of benefits and drawbacks in the battle for competitive advantage in today's globalized marketplace.¹ Its strengths include concentrated, flexible ownership, a recognizable heritage and brand, and a long-term perspective. These provide a stable platform with a values-based, inclusive culture that enables the company to survive from one generation to another. Commonly cited weaknesses include a heavy reliance on founders or individual family members for decision-making, the absence of succession mechanisms, and lack of external talent – which may yield suboptimal business performance or even threaten the future of the business. This duality is reflected in the academic literature on family firms, as summarized below.

Family firms exhibit unique characteristics that distinguish them from non-family firms. These typically include the family name and history, the family's political and business connections, and values-based leadership – none of them easily transferred to an external owner (Bennedsen & Fan, 2014). Most families with established businesses strive to retain ownership, taking a long-term view of relationships, reputation and value creation, and ensuring a consistent interface with customers and suppliers (Miller & Le Breton-Miller, 2005). As many family owners actively manage their businesses, there is minimal agency risk as they are on hand to monitor the behavior of non-family managers on a day-to-day basis (Anderson & Reeb, 2003). Concentrated ownership in family firms enables more flexible leadership and decision-making, and allows the business model to adapt swiftly to changes in the external environment (Miller & Le Breton-Miller, 2006).

However, certain characteristics of the family business model lead to inefficiencies and biases that can negatively impact long-term value creation. We explore some of those challenges in the text below:

Leadership challenges: Multiple academic studies identify strong, sustainable leadership through effective succession planning as the primary challenge facing family firms (Bennedsen & Fan, 2014; Lansberg, 1988). Yet family business owners often postpone or avoid the topic; they find it difficult to openly discuss it with subsequent generations (Lansberg, 1988). Even when succession is on the table, identifying an appropriate succession model

that addresses the priorities of current family leaders and the abilities and ambitions of potential successors can be a challenge (Le Breton-Miller et al, 2004). Even an apparently smooth transition of leadership is no guarantee of future success. Multiple studies have found a drop in performance when leadership of a family firm is passed from one generation to the next, particularly in the transition from the founder (Bennedsen et al, 2007; Villalonga & Amit, 2006).

In owner-managed family firms, top managers are typically chosen from a small group of family members rather than the company's general talent pool (Barth et al, 2005). As a result, senior management often lacks diversity and expertise. "Under-qualified" family members ascend to leadership positions not on merit or experience but because of family connections. Once in a leadership position they rarely receive an honest assessment of their performance, removing a valuable feedback mechanism that could have helped them mature and develop the skillsets required to be effective leaders (Stalk & Foley, 2012).

Corporate governance deficiencies: Family firms often have less effective corporate governance mechanisms than non-family firms, and therefore suffer from suboptimal control and decision-making. A survey of 1,000 corporate directors found less diversity within family boards than non-family boards (Groysberg & Bell, 2014). Indeed, at an early stage of development, there may not be a board; and those that do exist are likely to be "paper" boards that simply "rubber stamp" the family leaders' decisions (Davis, 2001). As subsequent generations become

¹ We define a family firm as a company in which a family is significantly involved as owners, managers or both.

involved in the business, family members “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” (Davis, 2001).

Decision-making inefficiencies and bottlenecks: First-generation businesses often struggle with inefficiency if the founder’s approval is required on every part of day-to-day operations, to the detriment of setting a broader vision and strategic goals (Dyer, 1986). Second-generation businesses can suffer if too many family members have to have a say. The family often retains a firm grip on decision-making even when there are minority shareholders, by maintaining a high ratio of voting control (Villalonga et al, 2015).

A thin talent pool: Family firms often struggle to attract top professional talent. In addition to a predilection for promoting from within the family, there are fewer openings; one study found that the average tenure of family CEOs was roughly three times that of CEOs of non-family firms (McConaughy, 2000). Family firms can be reluctant to pay competitive market rates for talent. The largest pay deficits occur in first-generation businesses (Werner et al, 2005).

Family members may lack skills to meet the demands of a changing business environment.

Family firms are slow to “retrain and retool” to foster internal capabilities (Pounder, 2015). Having a natural inward focus, they don’t nurture the qualified human capital needed to capitalize on growth opportunities (Wulf et al, 2010). A survey of 1,000 corporate directors found a similar lack of expertise in nearly all business functions on family firm boards, and a pronounced deficit related to HR-talent management, technology (innovation) and compensation – compared with the boards of publicly-owned companies (Groysberg & Bell, 2014).

Economic priorities are trumped by ‘family-first’ priorities. These can include maintaining family control, employing family members, instilling family values and maintaining the family’s standing in the community (Mahto et al, 2010). While they make sense to the family, they may lead to inefficient allocation of resources and sub-optimal firm performance.

Optimizing family wealth rather than business value: The total invested capital in the business may be limited to a level that simply guards against major losses and ensures appropriate diversification of the family’s assets (Góriz & Fumás, 2005). Risk aversion is common among owners, who tend to eschew growth opportunities in favor of consistent cash flows (Gomez-Mejia & Wiseman, 2007).

The family business ownership model produces unique benefits and challenges that impact the performance and day-to-day operations of an organization. By introducing formal policies, processes and procedures to guide business activities, families can institutionalize their unique strengths and identify areas where improvement is needed to ensure long-term value creation.

37%
OF ASCENDANTS
HAVE A WRITTEN
SUCCESSION PLAN

73%
OF CHAMPIONS
HAVE A WRITTEN
SUCCESSION PLAN



The Survey

To build a database on family firms in Asia-Pacific and the Middle East, we asked 123 family firms from these regions to complete an online survey assessing their level of institutionalization across six key attributes.

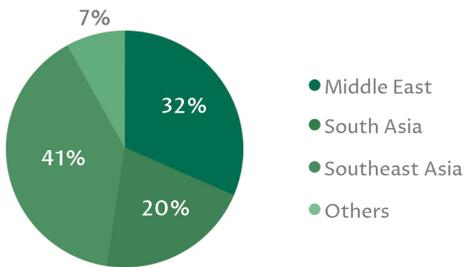
From their input we distinguish 'Champions' – family firms that outperform – from 'Ascendants', and identify specific areas where Ascendants can improve to close the gap in institutionalization.

We would like to thank members of the following organizations for their engagement:

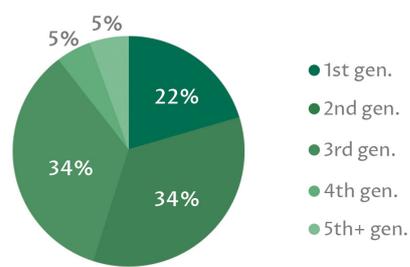
FBN Asia • FBN Levant • YPO Global Family Business Network

123 Family Participants

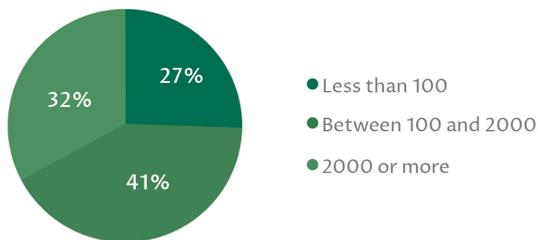
Region



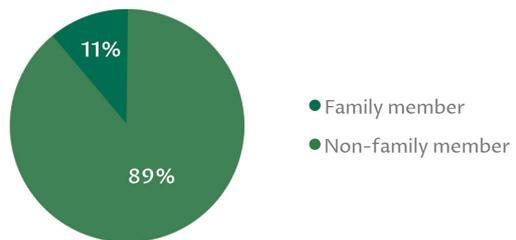
Generation



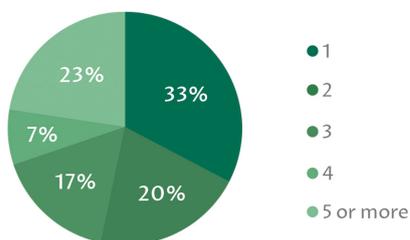
Number of Employees



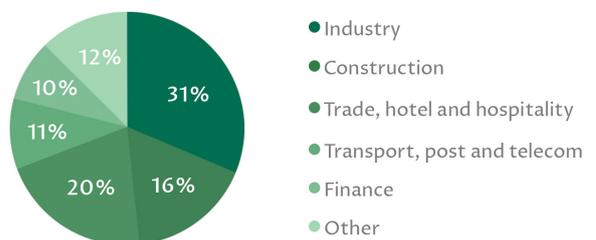
Company CEO



Number of Industries



Industry/Sector

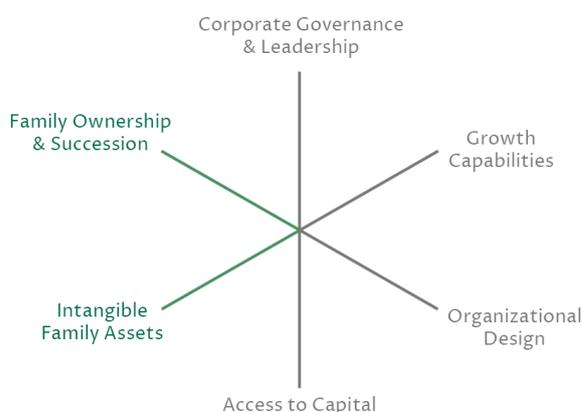


19 Countries • 1st to 15th Generation • 4 to 60,000 Employees

Survey Framework

Our survey framework measures a family firm’s institutionalization across the six attributes shown in Exhibit 1. The survey was designed to capture both standard measures of institutionalization – “business attributes” – as well as characteristics unique to a family firm – “family attributes”. When combined and normalized, the output for each business across these six attributes provides a total institutionalization score, allowing us to compare and contrast it with its peers, and then draw insights from the dataset.²

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.

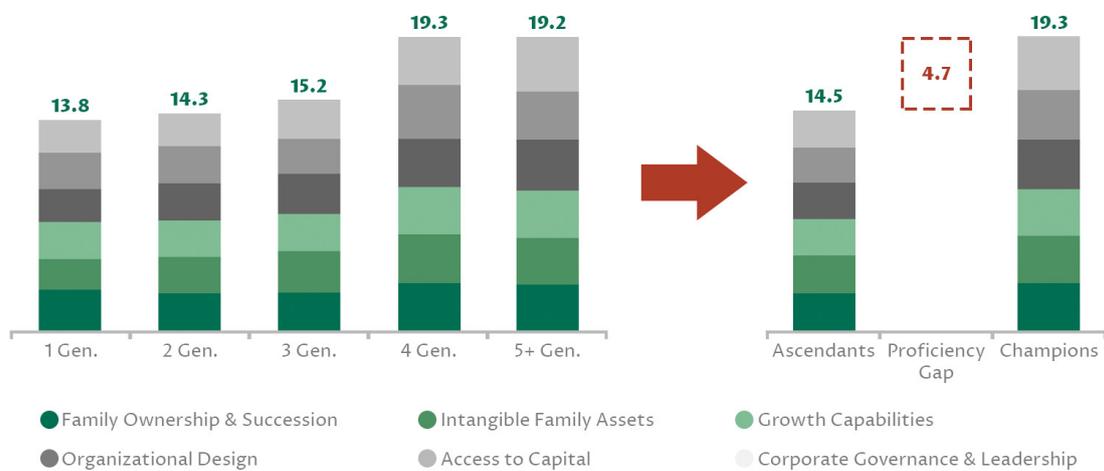
6. Access to Capital: Assesses the family firm’s ability to raise debt and equity capital to fund current and future business operations.

²The scores for each attribute were calculated as follows: we assigned points (from 0 to as much as 5) to every question relevant to the attribute, added the points together, standardized the total points (z-scale), and added 2.5 in order to make the standardized numbers positive. The higher the score, the higher the level of institutionalization.

Survey Findings: Bridging the Gap

Exhibit 2 presents the average institutionalization score of our survey participants by generation, with the different color segments of each bar representing the contribution of the six attributes measured in our survey to the total score.³ The most notable feature is the significant jump in total institutionalization score between 1st to 3rd generation family firms and 4th generation firms and beyond.

Exhibit 2: *Level of Institutionalization by Generation*

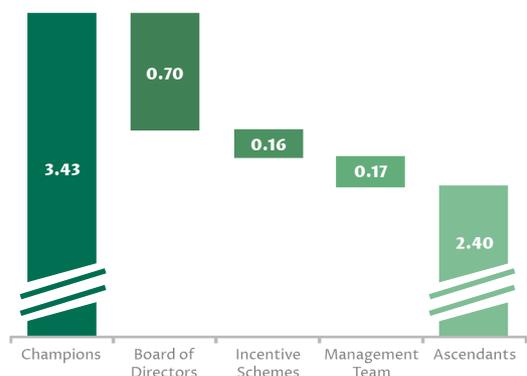


To enable user-friendly analysis, we combine 1st, 2nd and 3rd generation family firms (“Ascendants”) and 4th generation & beyond (“Champions”) into two groups. In addition to outperforming in aggregate, Champions outperform Ascendants on each of the six attributes measured in our survey, underscoring the proficiency gap across business functions between these two groups.

We explain the gap by ‘zooming in’ on the underlying performance in each of our six attributes for our two groups, describing the attributes in order of divergence in score - from highest to lowest - in the section that follows.

³ This analysis is based on responses from 113 families; 10 survey responses were either from the same family firm or incomplete.

Corporate Governance & Leadership



The average performance of Ascendants on this attribute deviated the most from that of the Champions, accounting for 22% of the total proficiency gap (1.03/4.73).

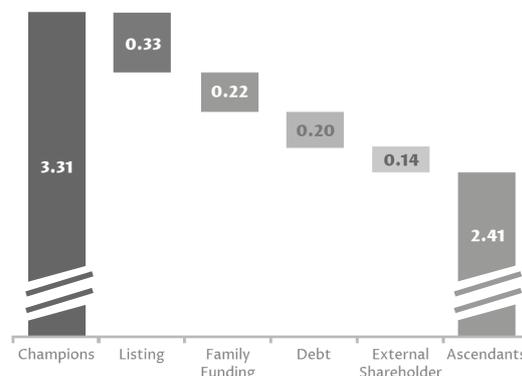
The main reason for this differential was the lack of independent directors and appropriate subcommittees on Ascendants' boards.

In fact, 34% (35 out of 102) of Ascendants did not have a board at all. A further 21% had a board consisting entirely of family members but no independent directors.

The existence of an employee stock ownership plan (ESOP) for non-family managers was another key differentiator: 55% of Champions vs. 33% of Ascendants employed this powerful tool to align economic interest.

Management team diversity accounted for much of the remaining difference between the two groups.

Access to Capital



The Ascendant's ability to access capital accounted for the second largest gap in total institutionalization: 19% of the differential (0.90/4.73).

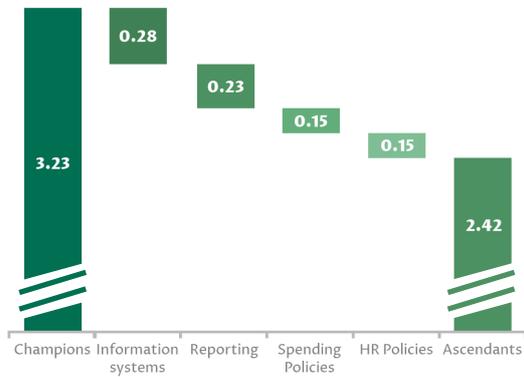
The primary driver was the presence of listed public equity on the balance sheet: 55% of Champions vs. 18% of Ascendants had a public market listing.

Champions also benefited from superior access to additional funding from the family and more ready access to a diverse range of debt-financing instruments, in particular unsecured bank loans and corporate bonds.

Ascendants were often limited to working capital financing and secured bank loans.

Champions were more likely to have raised equity capital from external investors, including private equity funds, strategic investors and high net worth individuals.

Organizational Design



At 17% (0.81/4.73) of the total differential, organizational design was the third largest driver of the proficiency gap.

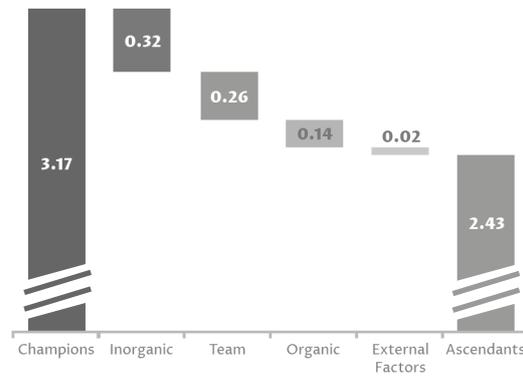
This was primarily due to the robustness of enterprise resource planning (ERP) systems at the Champions; for example, 64% employed a customer relationship management system vs. 31% of Ascendants.

Champions also followed more formal resource allocation and reporting processes than Ascendants. In particular, Champions monitored KPIs more rigorously – on average every month vs. quarterly for Ascendants.

Pre-approved spending authority was more dispersed throughout Champions’ organizations, enabling efficient decision-making.

Champions also had more developed HR policies related to hiring, incentivizing, training, evaluating and firing employees.

Growth Capabilities



Champions’ ability to execute an array of growth initiatives accounted for 16% of the total proficiency gap (0.74/4.73).

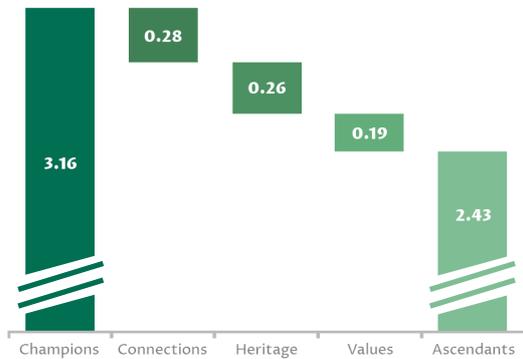
The primary driver was their use of inorganic growth strategies: 55% of Champions had executed M&A transactions, and 64% had equity alliances (e.g. minority equity investments or joint ventures), vs. 22% and 38% respectively for Ascendants.

Champions were better equipped to execute growth initiatives: 55% had in-house corporate development/M&A teams vs. 23% of Ascendants.

Champions had more robust organic growth activity, predominantly due to the scalability of their business model.

While Champions and Ascendants scored roughly the same in terms of how external factors impacted their business models, Champions were more impacted by changes in regulation, whereas Ascendants were more affected by corrupt behavior of government officials.

Intangible Family Assets



Champions’ outperformance in the intangible family assets category accounted for 15% of the overall differential with Ascendants (0.73/4.73).

That related to “Connections” was driven by more established relationships with central and local government officials, as well as with other business families, suppliers and customers.

Their superior scores on “Heritage” stem from more actively leveraging the family’s name and brand in their products and services, just as next-generation Champions more effectively leverage the family’s reputation in transitioning to leadership positions.

They also outperformed Ascendants on the degree of shared moral and ethical “Values” among family members, as well as with non-family employees.

Family Ownership & Succession



The composition of family ownership and the structures underpinning families’ involvement with their businesses accounted for the remaining 11% of the proficiency gap (0.53/4.73).

A primary driver was the existence of formal conflict-resolution mechanisms at the Champions, providing a means to diffuse disagreement over the direction of the family and the business.

Another was the presence of an indirect shareholding model, e.g. ownership via a trust, foundation or family holding company – 64% of Champions employed these vs. 39% of Ascendants.

More robust succession planning was another differentiator: 73% of Champions had a written succession plan vs. 37% of Ascendants.

The gap between Champions and Ascendants and its underlying drivers are clear. While a proactive approach to institutionalization can help Ascendants narrow this gap, family firms often need help. Particularly for families in transition, partnering with a private equity investor can provide an infusion of capital and expertise to accelerate company development.

A man in a white thobe and ghutra is shown in profile on the left, holding a smartphone. He is looking towards a woman on the right who is wearing a black abaya and hijab. They appear to be in a conversation. The background is a blurred outdoor setting with greenery and a building.

26%

OF ASCENDANTS HAVE A
PROFESSIONAL BOARD

55%

OF CHAMPIONS HAVE A
PROFESSIONAL BOARD

The PE Perspective

To complement our findings with an external view on the level of institutionalization of family firms in Asia-Pacific and the Middle East, we asked 14 private equity firms – all experienced investors in family businesses – to share their experience.

After providing an overview of the private equity model, we highlight how these firms approach investing in a family business and areas where they look to unlock value.

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

*Baring Private Equity Asia • Everstone Capital • General Atlantic • KKR
Kedaara Capital Advisors • L Catterton Asia • Mekong Capital • Navis Capital Partners
Principle Capital Advisors • Quadria Capital • Southern Capital Group
Standard Chartered Private Equity • Tata Capital Private Equity*

Can the Partnership Work?

Family firms and private equity (PE) investors operate in very different ways. While the priorities of a family firm focus on creating sustainable, long-term value over generations, PE is all about deploying fund capital, managing risk and transforming an asset over a relatively short holding period to produce a competitive return for investors. However, while their motivations may differ, in some instances their interests overlap, particularly for family firms in transition.

In order to manage expectations for both parties, a clear understanding of the dynamics of such partnerships is needed upfront. Findings from the academic literature are summarized below to highlight the most common benefits and drawbacks.

Benefits

PE firms can provide tailored solutions to meet the specific needs of a family firm; the solutions provided depend on whether the PE firm acquires a majority or minority stake in the family firm. In instances of a majority purchase, managing succession – e.g. when there was no suitable family successor or no interest in involvement – was the most commonly cited reason for raising PE capital (Howorth et al, 2004; EVCA, 2005). Selling a majority stake to a PE firm often allows a family to realize value, remain active within the business post-buyout, and maintain the firm's identity and culture. A trade sale to a strategic investor, on the other hand, will likely end a family's involvement (Scholes et al, 2008).

The reasons most commonly cited in the literature for selling a minority stake were to raise capital for growth or to finance an acquisition (Achleitner et al, 2008; Poutziouris, 2011). Other frequently-cited motivations include assisting in succession planning and providing an exit to a family shareholder.

Whether a majority or minority investment, academic studies found that bringing in a PE shareholder enabled business transformation at a family firm by, for example, improving corporate governance, professionalizing management teams, formalizing internal control systems and establishing incentive schemes for non-family managers (Wright et al, 2008; Scholes et al, 2009; Wulf et al, 2010).

Drawbacks

Family firms must be realistic about the impact that raising capital from PE firms can have. Drawbacks frequently cited in academic literature include the loss of managerial freedom, pressure to meet performance targets set by a third party, and dilution and/or loss of equity control (Achleitner et al, 2008; Poutziouris, 2011). PE investors will also conduct in-depth due diligence when assessing a target, requiring disclosure of sensitive information often available only to family members (EVCA, 2005). The disruption caused by due diligence can be compounded by a lack of centralized data systems, adding additional pressure to the process.

Once a PE investment has been made, family firm owners should anticipate tension resulting from PE investors' relatively short investment horizon – PE firms have a contractual duty to return capital to their investors within a pre-specified time period, while families' horizons stretch over generations. In addition, bringing in a PE investor can disrupt the firm's culture, replacing informal networks and operating practices with stricter reporting structures and performance-oriented goals (Wright et al, 2008).

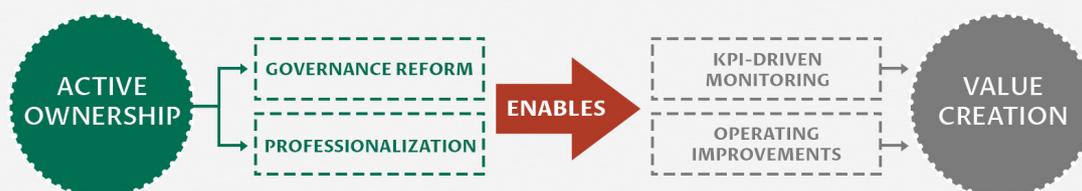
Box: The Private Equity Investment Model

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 years 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 3 provides an overview of two core elements of the PE investment model – Active Ownership and Value Creation.

Exhibit 3: *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 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 overburdening 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.

Things You Need to Know When Considering a PE Partner

This section provides insight into the opportunities and challenges facing family firms in Asia-Pacific and the Middle East from the perspective of 14 PE professionals. Our interviews explored their experiences engaging with family firms across the PE investment process – from pre-investment to post-investment to exit – and highlighted areas where family firms can focus to unlock value, as summarized below.

Pre-investment

Similar to findings in academic literature, the reasons most commonly cited in our interviews that a family firm would pursue a transaction with a PE partner were to manage succession and to unlock growth.

While no two investments were identical, our interviewees all underscored the importance of taking a long-term view when exploring an investment in a family firm; building a relationship based on trust and mutual respect was described as a pre-requisite. PE investors sought to understand the priorities of both the family and the business, engage with multiple family members to understand the different motivations within a family, and focus conversations on creating value in the business. The vast majority of investments described in our interviews were proprietary in nature, underscoring the importance of developing a strong working relationship.⁴

Several interviewees provided tangible assistance and shared advice with family members during the pre-investment period. For example, one investor leveraged his network to help a family firm gain access to prime retail store locations; another suggested improvements to a firm's product line based on a detailed assessment of consumer preferences in the family's market. Since many family firms have no immediate financial pressure to transact, proactively demonstrating how the investor can add value operationally – rather than pointing to a track record – helped build the case for investment. Providing actionable assistance pre-investment also allowed the investors to gauge whether the family would accept an external view, foreshadowing the relationship if an investment was made.

Once the broad strokes of an investment was agreed, the deal terms relevant to our interviewees depended on whether the investment was a minority or control transaction. In instances of a minority investment, agreeing to a specific strategic plan and defining the PE investor's role during the holding period were priorities, with 100-day plans and explicit financial targets often included in co-signed share purchase agreements. As contracts are often difficult to enforce in the Asia-Pacific and Middle East regions, establishing these terms in writing was often more about ensuring alignment than developing an enforceable contract. In majority investments, our interviewees were more focused on identifying the family members crucial to the business and securing employment agreements to ensure these members remained active post-investment.

The most challenging terms to negotiate for our interviewees related to valuation, board and operational control, rights to replace family members in management positions, and exit (see 'Exit' section below). Many investment processes were derailed by families' high valuation expectations. Nonetheless, several interviewees acknowledged that they often secured more predictable and reasonable prices when investing in family firms due to the often proprietary nature of these deals.

In addition to price, negotiations focused on structuring the board and establishing a template for operational decision-making. Interviewees highlighted the importance of professionalizing family firm boards, for example by splitting the chairman and CEO roles – which were often held by a single family member – and bringing in qualified independent directors. From an operating perspective, our interviewees stressed the importance of agreeing on how the

⁴Families often hire advisors once an in-principle agreement has been reached with an investor to assist with executing the deal.

business would be run post-investment: if family leaders continued to operate in a ‘business as usual’ manner, the likelihood of achieving stretch targets and operating improvements at the business was diminished.

Aligning expectations pre-investment was critical not only to efficiently explore the opportunity, but also as it fed directly into post-investment value creation. Indeed, once the broad strokes of a deal and the case for adding value were established, interviewees said that formalizing the agreement in transaction documentation was a relatively smooth process.

Post-investment

All of our interviewees mentioned that a continued focus on their relationship with family leaders was critical to ensuring a smooth transition from a purely family-owned firm to one with an external PE shareholder. Interviewees often took a gradual approach to influencing and reshaping the business, given that many family firm leaders were used to having the last word on a wide array of crucial business decisions with minimal external input. Indeed, they stressed the importance of not overhauling the target company in a few months following a buyout or immediately trying to reshape board decision-making in the instance of a minority deal, but rather carefully considering the family’s current way of doing business. One interviewee emphasized the need to value other people’s views and to find acceptable compromises.

As management teams of family firms often lack diversity and specific expertise, strengthening and professionalizing management teams was a key priority described by our interviewees; adding to the finance team – often by hiring a non-family CFO – was a key area of focus. Strengthening management teams with HR and IT professionals were other commonly-cited measures taken by our interviewees. Indeed, in one instance, the family’s primary motivation for partnering with the PE firm was to attract top managerial talent. Aligning remuneration

practices at family firms to properly incentivize non-family managers was also a priority.

From an operating perspective, our interviewees stressed the importance of identifying what made a family firm successful and institutionalizing the business based on these strengths. Interviewees described instances where a family’s brand or specific expertise was leveraged to expand into new geographies, product categories, or up and down the value chain. Several investors also helped execute M&A and roll-up strategies post-investment, expertise which families often lack. In addition to assisting with the transaction, interviewees also helped integrate acquired businesses into family firms’ operations.

Two additional topics mentioned in the context of company operations were innovation and digitalization. Infusing new technology and management techniques were key elements in many of our interviewees’ business plans, and helped family firms adjust to new market realities. Digitalization was crucial for creating new marketing and sales channels, implementing cyber security and setting up proper reporting systems. Many interviewees described how having access to proper data allowed family leaders to base decisions on metrics rather than gut feeling or “what feels right”.

Exit

For all interviewees, exit was the number 1 challenge in any investment with a family firm. To manage expectations, interviewees made it clear from the start that they would need to exit their stakes in a relatively “short” time period (years rather than generations). Especially in minority deals, it was critical that families understood and agreed to contractual provisions that would enable the PE firm to exit within a certain time period, as well as understood their necessary role in that sales process.

Exit waterfalls were cited by multiple interviewees as the main mechanism that ensured they could exit a minority investment. As described by one interviewee, each step in

the waterfall became more onerous for family owners: if the preferred exit route defined in transaction documentation – say an initial public offering (IPO) – was not achieved by a certain date, contractual provisions allowed the PE firm to market and sell its stake to an external investor over a predetermined time period. If the valuation from that sales process did not achieve a predefined target return, a drag along clause allowed the investor to sell a controlling interest (though not 100% of the equity) in the

family firm. If no sale was completed at that stage of the waterfall, a put mechanism allowed the PE investor to sell its stake back to the family for a guaranteed return.

While the waterfall provides the legal right to force an exit, interviewees underscored that finding a mutually agreeable solution and renegotiating contractual provisions when necessary was preferred to imposing terms of a waterfall.

Institutionalizing and professionalizing companies is core to the private equity investment model. Family firms that partner with private equity investors must understand their strengths, priorities and biases in order to maximize value from a partnership.

23%
OF ASCENDANTS
HAVE IN-HOUSE
M&A TEAMS

55%
OF CHAMPIONS
HAVE IN-HOUSE
M&A TEAMS



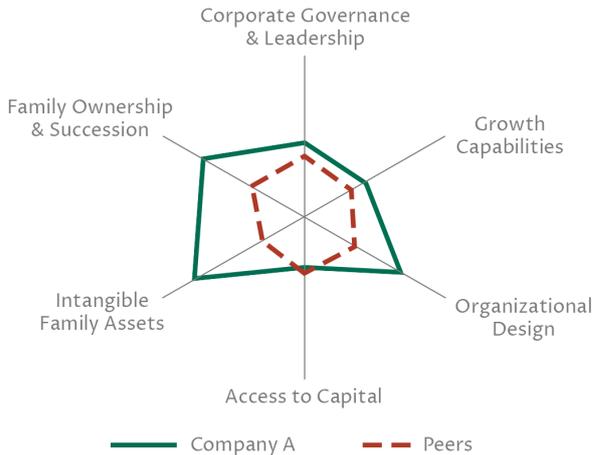
Case Studies

In the final section of our report, we wanted to let the families themselves share their stories and talk about the institutionalization process within their firms. Featuring 1st, 2nd, 3rd and 4th generation firms, these case studies share lessons learned from families across our core geographies.

Each case study links back to our survey by comparing the family firm's score to its peer group; two describe partnerships between a family and private equity investor. This section closes with a look at common challenges faced by family firms in our dataset.

The Generational Transition

This case shares the perspective of a third generation family member who recently assumed both an ownership and leadership role in his family firm. Clear lines of communication, formal family-related agreements, and his experience working outside the family firm have helped ensure sustainability.



Our company is based in the Middle East with distinct business lines in retail and real estate. My father recently passed formal ownership and management of the company to my brother and me, the third generation of our family to run the business; we both own a 50% stake. Before we took over the business, our father was the sole owner-manager of the company and was the key driver in scaling the business, bringing it to its position today. He remains a key ambassador for the business and represents our family in various industry associations.

Family Ownership & Succession

The transition in leadership required trust. I was working abroad when my father asked me to come home and join my brother in taking over the business. My father had always been a very hands-on owner, which is one of the reasons I left to work outside of the business. For me to get comfortable with the move and to give my father something meaningful to do after he stepped back, I proposed that he become involved in the industry association linked to our business. There was no guarantee that the transition would be smooth, but I trusted my father to keep his promises as he always has in the past.

In order to have clearly structured family governance, we spent time defining the roles and rights of the family members involved and not involved in the business. This helped us understand who should be included at various levels of decision-making and was eventually formalized in our family constitution and shareholder's agreement. In order to ensure best practice, we engaged external advisors and attended several family firm seminars and workshops at universities.

Organizational Design

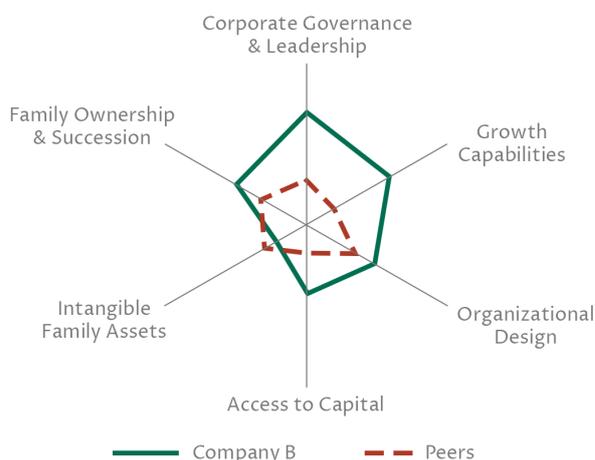
I drew extensively on my experience working at a large multi-national corporation as a financial controller when designing the formal processes and procedures to control and monitor the business. I also leverage my education in IT engineering to ensure that we have appropriate and up-to-date systems. My ongoing graduate education ensures that we remain abreast of best practice with regard to processes guiding resource allocation, appropriate KPIs and P&L metrics, and HR processes and procedures.

Intangible Family Assets

My father ensured that we were exposed to the family firm from an early age, taking us to his office after school, during the summer and on the weekends. We "helped" negotiate with clients and were around for meetings with suppliers. From a young age, we understood and lived by the culture and values that guided the company. My father then put us in positions of authority where we had tangible responsibilities from the age of 18.

The Professional CEO

This case shares the perspective of a non-family CEO in one of the more mature markets in our study, Australia. Incorporating the governance requirements of a publicly-listed company and institutionalizing the family’s expertise in retail have helped ensure sustainability.



Currently in its third generation of ownership and more than 100 years old, our company is based in Australia and active in the retail industry. Our business grew to scale largely under the hand of a second generation family member, who secured key contracts and expanded the business from a regional operator into a country-wide success; we are currently looking to expand our operations abroad. While still 100% family-owned, both our management team and board have been fully professionalized and the family has minimal tangible impact on the day-to-day running of the business.

Corporate Governance & Leadership

Although we are a private company, we try to emulate the standards expected of a publicly-listed company. Our board of directors predominantly consists of independent directors and we have appropriate sub-committees. The composition of the board has evolved over time, consisting of only family members when the first and second generations controlled the business to today where only one family member has a board seat.

In terms of day-to-day leadership, the business transitioned from family to non-family management at the tail-end of the second generation’s period of control. After the operating model underwent a major restructuring to ensure its competitiveness, the family believed that outside professionals with a new skillset would be best placed to manage the business. The family is currently very hands-off, and is only consulted for key decisions such as a new CEO appointment or a major investment.

Growth Capabilities

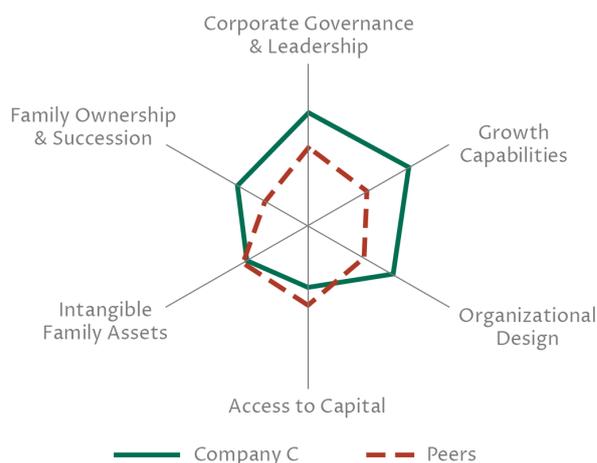
As the retail industry evolved over the years, we have had to adapt to new market realities on a constant basis. The company grew immensely over the generations – from 1 outlet to more than 500. The stability of our business is ensured through long-term agreements with global retailers, while the successful acquisition and integration of a competitor helped us transform and grow. We continue to draw on the reputation of the family and the business to launch new partnerships with other international retailers.

Access to Capital

Capital is not a massive constraint for moving forward and we are not likely to bring in any equity partner. As the company grew, the family established a family office that manages liquidity generated from the business and the family’s other holdings. We typically draw funding from profits generated by our mature operations of from the family office to finance new growth initiatives.

The Next Gen

This case shares the perspective of a second generation family member working in the international operations of his family’s firm. A diverse board and management team, formal review mechanisms, and the successful integration of an acquired asset have helped ensure sustainability.



Our company is headquartered in South Asia with a major presence in Europe and is active in the IT industry. Currently, my father – the company’s founder – and I work at our company. A few years after my father launched the company, it was listed on the stock exchange and subsequently a majority stake was purchased by a large multi-national company. However, we were able to buy back the multi-national’s stake a few years ago and obtained majority again, which we don’t intend to give up. Our family firm had a rebirth after that: as we didn’t have a big brother guiding us anymore, we had to chart our own course.

Corporate Governance & Leadership

Our corporate governance activity benefited significantly from our time as a listed entity and as a subsidiary of a large multi-national. We currently have a strong board consisting of two family members and five independent directors, all of whom are high-profile professionals and very engaged in developing the company’s strategy. We monitor and assess performance at each of our four business units on a standalone basis; each has its own KPIs and must add value to our operations. The company’s management team is also quite diverse; my father and I are the only family members involved in the operating business; all the other managers are non-family members. To help ensure alignment, we provide non-family managers with stock options.

Growth Capabilities

In the last few years, our company grew significantly via both organic and inorganic growth initiatives. Organically, we have launched new products and services and are expanding our presence across the industry value chain. We recently invested in a new greenfield plant

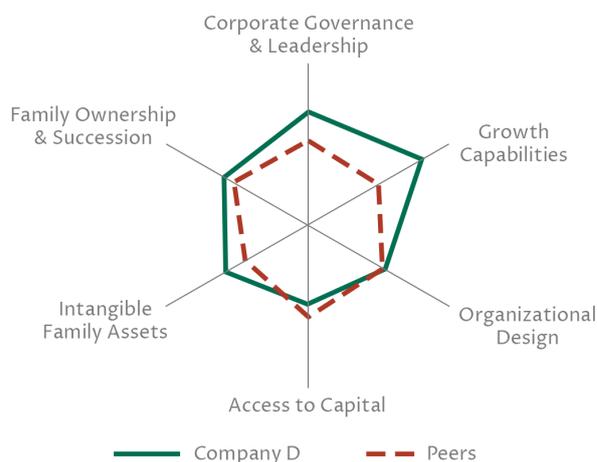
in India to expand our manufacturing capacity, as well as a business in Europe; the latter acquisition nearly doubled the size of our group. I oversee post-merger integration and general profitability improvement in our European business. As the acquisition has to-date been a success, we would like to make M&A an integral part of our strategy moving forward. However, we don’t want to give up equity control of the business, which limits our financing options for growth investments. We have, so far, financed growth with internal accruals and a bit of debt.

Organizational Design

Our listing and time as a subsidiary of a multi-national corporation helped institutionalize our business from an early stage. The multi-national implemented appropriate systems and processes in our business; after the buy back by the family, we kept these systems and processes in place and are committed to updating them on a continuous basis. We are currently incorporating our internal processes into the newly acquired European entity to ensure consistent reporting across our organization.

The Professionalized Conglomerate

This case shares the perspective of a second-generation family member currently serving in both Chairman and CEO roles in different companies of a family conglomerate. Effective corporate governance, professionalized management teams, and unique insight drawn from across the organization have helped ensure sustainability.



Our family firm is a conglomerate based in Southeast Asia with over 5,000 employees. One of our operating businesses is listed, with the remaining business lines owned by the family. My father, the founder of the company, built our company from scratch. Family members from the second generation currently own and drive decision-making in our business; we each hold top positions in different companies of the conglomerate. Some members of the third generation have already started to work at the company.

Corporate Governance & Leadership

When my father passed away, we (the second generation) restructured the business and focused on upgrading the company's governance structure. Each of our business lines now has its own well-functioning board with appropriate sub-committees and experienced independent directors. We also put in place tools that enable data-driven decision-making. In the old days, you could never trust the figures, but this mindset has changed; today, we have formal processes and procedures in place and our employees have learned how to weigh the facts. Management teams of our different business lines predominantly consist of non-family, professional staff. We very much insist on meritocracy when it comes to hiring people. The best people are chosen for each management role; if family members are chosen, they must be highly capable and fit the role.

Growth Capabilities

Our company is currently active in more than five industries and we are continuously striving to expand our business lines and diversify into other sectors. We benefit substantially from

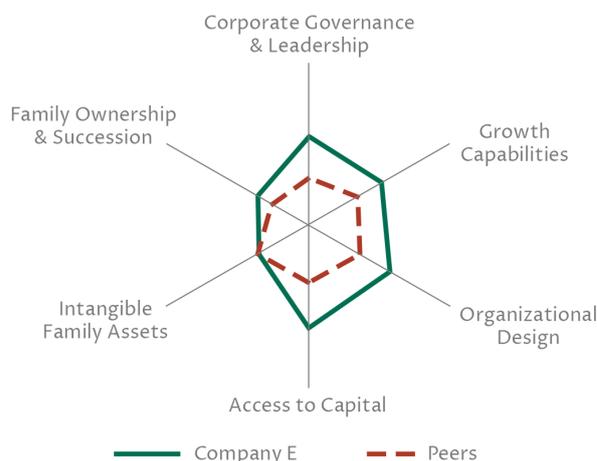
the high visibility that this diversity affords, particularly via our international partnerships and aggregated information collected from across the organization. This helped us identify a fast-growing market adjacent to one of our core businesses; as a result, we launched a new business line seven years ago that has added substantially to both our top and bottom lines.

Intangible Family Assets

My father had very high moral and ethical values and wanted to be a role model in Southeast Asia and run a responsible business. Before he founded the company, he had to go overseas to work on a project. Seeing how business is done in the Western world, he drew on many perspectives when he founded his own company. My father involved us from an early age and encouraged us to speak up and form our own opinions, something that is not typical in Asian families. The company, to this day, has a very strong family culture and we do our best to share our vision with our employees. My siblings and I also hold leadership roles in industry and family firm associations as well as academic institutions.

The Growth Story

This case shares the perspective of the founder and CEO of a family firm in Southeast Asia. Improving diversity on the board of directors, hiring a second layer of management to free up the entrepreneur’s time, and tapping funding and expertise from a PE partner have helped ensure sustainability.



We are a first generation family firm in the logistics sector, based in Southeast Asia. I am the founder and CEO of the business and, together with my wife and brother, we hold a majority interest in the company. As the logistics sector and our business grew rapidly over the years, we decided to sell a minority stake to a PE firm in order to fund growth and draw on the firm’s management expertise. Before choosing our PE partner, we talked to many potential candidates. We chose our current PE partner from a small group of candidates because they share our vision for the business and offered tangible, hands-on support.

Growth Capabilities

In my previous job – also in the logistics sector – I saw how much potential the market had and therefore decided to build my own business. As new retailers entered the market to tap the growing middle class, the demand for retail logistics exploded. In order to keep up with the demand, we needed to grow quickly – we couldn’t hire enough trucks. With advice from our PE partner, we invested in our truck fleet and diversified into storage. In just a few years, we grew our fleet by four times, and built an integrated warehouse. To drive new business, we professionalized and expanded our sales team and trained them to sell our services across the value chain. Today we have increased our employee count ten times and our volume and revenue are way up.

Organizational Design

Our PE partner helped us tremendously with professionalizing our organizational design. With their guidance, we implemented systems, such as an ERP system, to track operational and financial aspects of the business. Also, we hired an HR manager, an IT manager and an accounting team, positions we did not have in the past. These changes have allowed us to be more nimble and efficiently tap new growth opportunities.

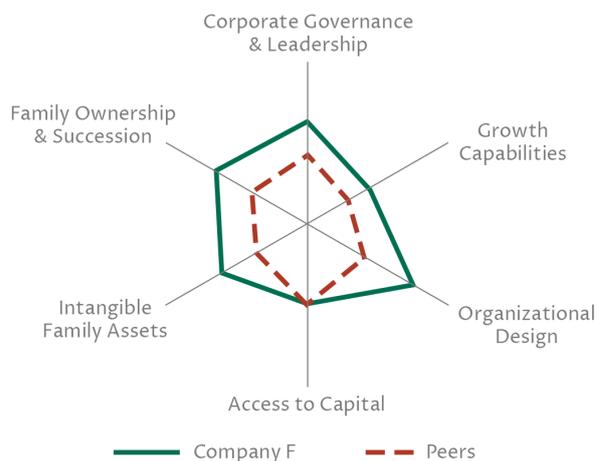
Corporate Governance & Leadership

One of the first things we did after the PE firm invested was professionalize our board. Understanding the need for efficient management, I decided to step down as Chairman of the Board to focus my energy as the company CEO. We also gave a board seat to the PE firm and brought in an independent director. The independent director is a seasoned professional from the industry and has helped me understand how to take advantage of the growth opportunities in the market in a responsible manner.

We also took steps to build out our management team so that I would have more time to focus on business strategy instead of the day-to-day decision-making that frequently took up all my time. I was originally the “everything manager” of the company, managing and guiding all aspects of the business. However, with our new funding we were able to hire additional layers of managers throughout the company: supervisors, managers and a COO. Our PE partner also helped us recruit these new managers. I now concentrate more on the vision of the company as well as training and mentoring our COO and managers.

The Serial Partner

This case shares the perspective of a fourth generation family member currently serving as the CEO of his family firm. Leveraging the family brand, multiple partnerships with PE, and ensuring good communication across family generations have helped ensure sustainability.



Our family firm is based in Southeast Asia and is active in the healthcare industry. Our company's history and brand name are unique and stands for tradition and quality. The fourth generation currently runs and is the active shareholders in the business; the fifth generation is also active. Over our history, we have partnered with PE investors and external shareholders on multiple occasions to help with succession, provide liquidity to family members and to improve our business model. The company is currently majority-owned by external investors, with the family holding a minority stake.

Family Ownership & Succession

My grandfather, who led the company during the second-generation ownership period, had many children and divided the company equally among all of his sons. This dispersed ownership made it difficult to reach consensus and complicated family dynamics in the third generation. Many family members were uninterested in the company's initial business line. My branch of the family took action to consolidate ownership, using multiple listings and capital from PE investors to provide liquidity and take control of the business. Over the years, we have partnered with PE more than once to help consolidate control and professionalize our business.

I have taken guidance from my family's history and try to ensure open lines of communication with other family shareholders; I make myself available and we have regular meetings to discuss potential issues. I also think it is important to ensure open communication with my children and the next generation, as very often in Asia the current generation does not speak openly with its successors, and vice versa. I am a big believer in exchanging ideas with peers, family advisors and consultants, and members of family associations.

Corporate Governance & Leadership

As the company has been listed in the past and has been PE-backed on multiple occasions, we have learned a lot about sound corporate governance. As we are now minority shareholders, corporate governance mechanisms and our relationship with the company's majority shareholders are crucial to protect our family's legacy. Our management team benefits from sound advice from both the PE investors and an independent director on our board. The current PE owners also helped us hire and incentivize new management team members.

Intangible Family Assets

The brand name of our products is linked to our family's long history in the industry and our strong family heritage. We continuously work to ensure that our brand stands for quality, and that consumers trust our offerings. This has been core to what we do for over 100 years.

Common Areas Where Family Firms Can Improve

This final section highlights a number of challenges faced by family firms – drawn from academic literature, our survey output and our interviews with families and PE investors – with the hope of providing food for thought. The six most frequently mentioned challenges are:

Lack of a Written Succession Plan

This was one of the most common challenges – absence of a clear, written plan outlining future ownership and management of the family firm. Succession is a delicate topic that many families choose not to discuss; failure to proactively manage succession can lead to tension between family leaders and the next generation as well as uncertainty regarding the business's future.

Centralized Decision-Making

Family firms often rely heavily on founders and other family leaders to approve decisions related to all aspects of a business; at the same time, it can be difficult for families to relinquish control of a business they founded. Spending too much time on day-to-day decisions can limit family leaders' ability to develop a coherent long-term strategy and vision for the business.

Inward Looking & Lack of External View

Families may shy away from bringing in external investors or external expertise as they are used to being in control. This can lead to a family relying on historical competitive strengths and may restrict future growth potential.

No Professional Board of Directors

Many family firms do not establish, or may under-utilize, a board of directors; often, boards consist of only family members, and meetings are unstructured and informal. Lack of independent directors may lead to gaps in expertise on the board and failure to form appropriate subcommittees may inhibit the firm's ability to set unbiased governance policies.

Difficulty Attracting External Talent

Many family firms struggle to attract qualified, professional talent due to a perceived lack of upward mobility and lower expected pay. Absence of employee stock ownership plans and other equity-based compensation can constrain family firms' ability to recruit top managerial talent, which may erode a family firm's competitive position over time.

Limited Access to Capital

Family pressure to pay dividends rather than re-invest profits, unwillingness to raise equity capital from external investors, and limited public information available for credit assessments can constrain a family firm's ability to finance growth.

Prioritizing institutionalization can help a family firm gain a realistic view of its unique strengths and overcome many of the challenges described above.

Conclusion

Family firms are key drivers of growth, employment and livelihoods in the economies of Asia-Pacific and the Middle East. As these companies mature, it is critical that families institutionalize their values and competitive advantages to ensure long-term value creation.

Our survey of 123 family firms identified a proficiency gap between 'Champions' and 'Ascendants' in our dataset. Outperformance in both Corporate Governance & Leadership and Organizational Design underscores how formal policies and procedures underpin leading family firms' operations and success.

As leadership of a family firm is passed down the generations, selectively drawing on external resources – from independent directors to private equity capital and expertise to non-family managers – can help infuse best practice and accelerate institutionalization.

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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:



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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.



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.