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Scale, skills, and succession

Tackling the tipping points for family firms

PwC Family Business Survey

October 2012

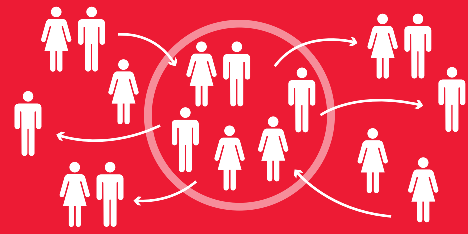
pwc

The family firm in 2012

Family businesses are thriving globally

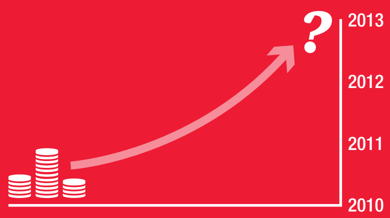
Family businesses are ambitious and confident about their prospects

The economic environment remains the key external challenge



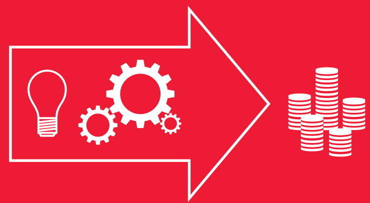
Internally, the main issue is the recruitment and retention of skilled staff

Looking ahead:
Emerging issues for 2017



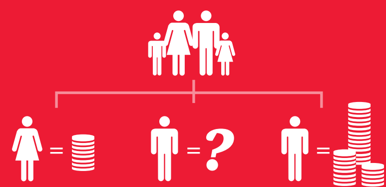
The economy remains a cause for concern

Globalisation will be crucial to success – or failure



Innovation will be vital to secure competitive advantage

The 'war for talent is still waging – certainly for family businesses



The transition between generations can build the family firm – or break it

Introduction

Highlights

The PwC Family Business Survey 2012 shows that family firms across the world continue to be profitable, resourceful, and confident about the future

With strong values, long-term decision-making, and a commitment to employment and local communities, the family way of doing business has unique strengths

However, there are also specific challenges, and long-term success depends on the effective negotiation of three key tipping points: scale, skills, and succession.

This year's PwC Family Business Survey covered almost 2,000 firms across the world, from both developed and emerging markets, and representing sectors as diverse as manufacturing, retail, automotive, and construction.

The survey revealed that this is a resilient group of extremely ambitious entrepreneurs, many of whom are running high-growth successful companies. The family business sector brings much-needed stability to national economies, and espouses a 'patient' and responsible approach to investment that many governments could do more to support.

So what are the special qualities of the family firm?

- **Longer-term thinking and a broader perspective**

  These are businesses which are willing to invest for the long term, and do not suffer from the constraints imposed on their listed competitors by the quarterly reporting cycle and the need for quick returns.

- **Quicker and more flexible decision-making**

  Family businesses often believe they are more agile and flexible than their listed multinational competitors, which means they're better able to fully exploit potentially profitable new niches.

- **An entrepreneurial mind-set**

  Family firms pride themselves on being more entrepreneurial than other sectors of the economy, and on their ability to reinvent themselves with each new generation.

- **A greater commitment to jobs and the community**

  The typical family business has a long-term commitment to its local community and its workforce, and will make more strenuous efforts than other companies to keep its staff, even during tough times. This in turn translates into greater loyalty and commitment from its employees.

- **Strong values, and a more personal approach to business based on trust**

  Family firms believe they have a stronger culture and more enduring values than other companies. Many are convinced they win business because they have a closer and more personal relationship with their customers – indeed that they are chosen precisely because they are not listed multinationals.

Family firms consider all these distinctive qualities to be a source of real competitive advantage, and integral to their business model.

But other aspects of this structure can hamper growth, and at certain key points in the firm's evolution there can be the potential for internal conflict or a reluctance to take the right risks. That's why it's so crucial that the family firm recognises its tipping points, and takes effective action to address them.

Scale:
Size does matter

> *"[The greatest challenge is] consolidation through globalisation. Customers are getting bigger, which will put greater pressure on size of the family businesses as against large multinational or publicly owned corporates. In other words, scale."* **Family business, Australia**

Every business faces challenges as it grows, but this process can be particularly tricky for the family firm. It raises complex questions about the resources your business can draw on, your ability to access finance, and the risks you are prepared to take.

This tipping point could manifest itself in a change in the market precipitated by the actions of one of your competitors or the launch of a new product, or a breakthrough by your own firm which you need investment to exploit.

But according to our survey findings, by far the most common instance of this tipping point is internationalisation. We'll look now at some of the issues this raises, and what family firms have told us about the specific challenges they face in entering new overseas markets, and becoming exporters for the first time.

Our survey shows that family firms are ambitious to grow, so many of them will face this challenge in the near future.

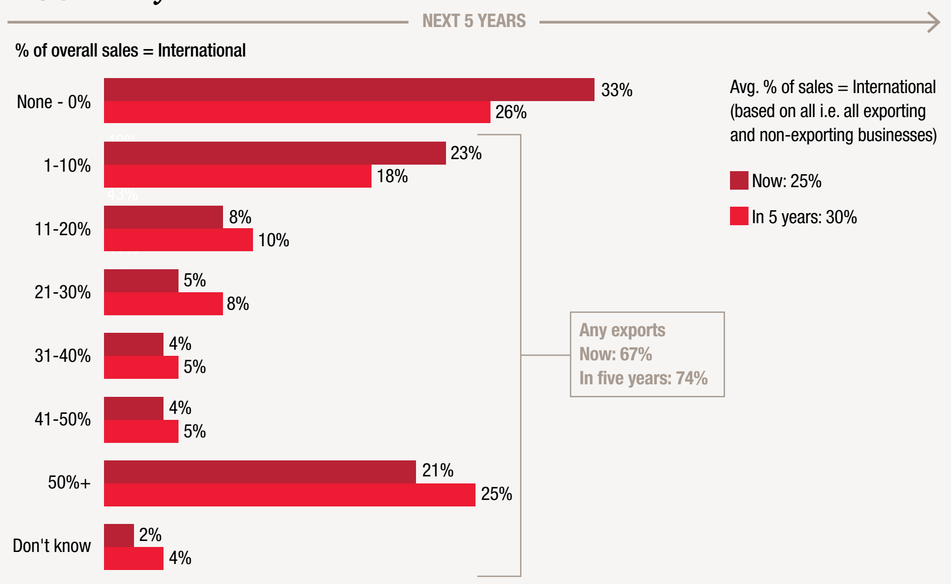
What issues does going global raise?

Any significant expansion – domestic or international – will confront the family firm with the challenge of raising new finance. Conventional businesses can approach their banks, mortgage their assets or debtors, or (if they are large enough) go to the capital markets. Smaller start-ups can leverage their balance sheets in the expectation of a quick sale, or attract venture capitalists or business investors with equity stakes.

All of these options are more problematic for family firms, which tend to control their balance sheets very tightly, and are understandably wary either of over-leveraging or 'selling the family silver' by opting for asset-based finance or offering shares to outsiders. Likewise, long-established family firms often support a significant number of family members, many of them reliant on their dividends, and are unlikely to have the resources to invest new capital in the firm. For these reasons, bank debt has historically tended to be the most popular route, but at present bank finance is both expensive and restricted.

Moving into overseas markets presents additional practical and commercial challenges.

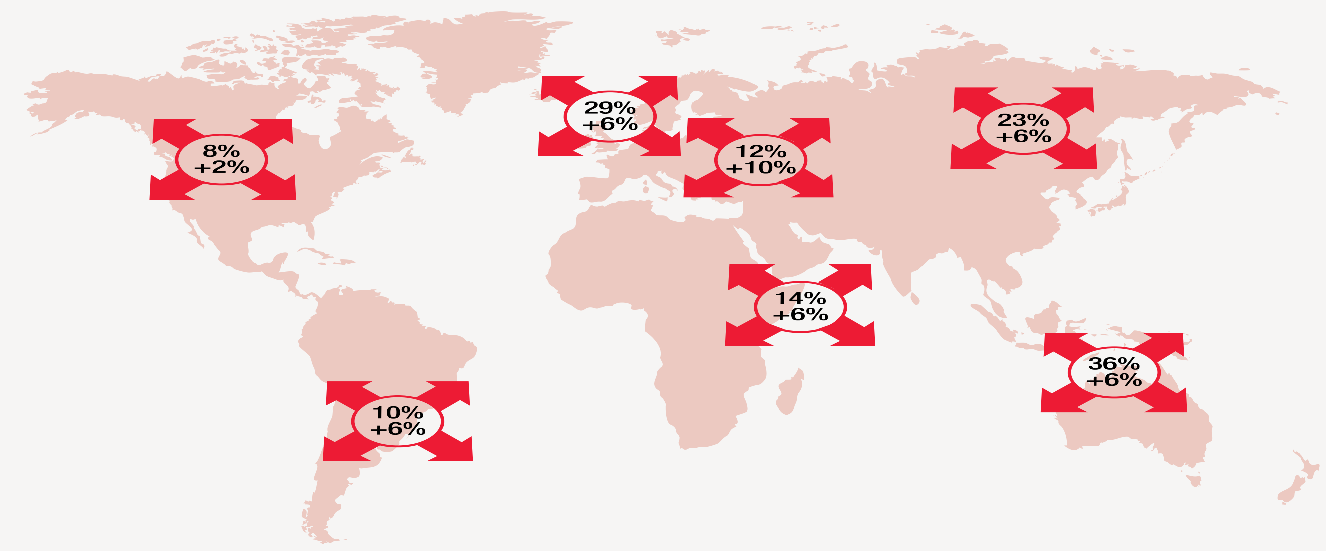
67% of family businesses have international sales. This is expected to rise to 74% in 5 years' time



Source: PwC Family Business Survey 2012

Scale:
Size does matter

There are some big differences by country in terms of how much family businesses currently export



Expanding into overseas markets becomes particularly complex for family firms, as they often draw strength from their long-standing local ties, which cannot easily be replicated elsewhere. Our survey suggests that the three most significant issues here are understanding the local culture and ways of doing business, competition, and dealing with local regulations.

Considerations

- **Work out what 'scale' means to you**

  Scale may not always mean internationalisation. Some family firms grow their businesses by very successfully exploiting new niches in their home markets. So the first question you need to ask yourself is what exactly you would be scaling – is it product, brand, or capability?

  If it's product the challenge may indeed be to find export markets for an existing range, because the ability to grow market share at home has become limited. If it's brand it may be that diversification into a new or related product field in your domestic market could be the best option. Or if it's a capability – like construction, for example, or IT – you need to do plenty of research about how that sector operates in overseas markets before you commit yourself. It's all about asking the right questions.

- **Do your homework**

  If you decide that growing your international operations is indeed the right way to scale your business, there are more questions you then need to ask yourself.

  You need to be very clear about why a specific market might be the right one for your goods or services. Can you articulate in a simple sentence why a particular market or country needs your product or service. Will customers there know your brand? This could have a huge impact on the type of sales model you need, and the costs of implementing it.

  Who would your competition be, and is there a gap in the market or a niche you can effectively exploit? Do detailed research and sales projections upfront – even if it seems expensive – because that will save you time and money down the line.

Scale: Size does matter

"Operating in many places is hard work. We operate in 50 countries and they all differ from each other. We have to learn local cultures and habits, and financial legislation and taxation vary from country to country"
Family business, Finland

- **Assessing strategic fit**

  Are you choosing specific markets for the right reasons? It may be that another market that speaks the same language or has cultural connections with your own is the best target to choose – but don't do it for those reasons alone. Customers overseas may not have the same tastes, even if they do speak the same language. Likewise emerging markets may look appealing because of their overall economic potential, but make sure they have sales potential for your particular business as well. In other words, ensure that the markets you select align with your strategic goals.

  Do you have the skills and people you need, and are they in the right place? Many family firms have no hands-on experience of the export process, and family members may be reluctant to relocate, so it's vital to have people on the ground who have already worked in different cultures or are willing to spend the time learning local customs and ways of working.

  In short, you need a clear methodical strategy, and a detailed, costed implementation plan.

- **Understand the risks – and the costs**

  Whatever type of expansion you're planning, you need to do a full cost and risk assessment upfront. Look at different scenarios, and evaluate the impact they could have. And remember that risks aren't just related to exchange rates or sales – they can be political, regulatory, or reputational, or relate to product quality, tax, governance, suppliers or employees.

  As with any business, overseas expansion will primarily be about growing the top line. An overseas operation will always cost money in the early years (and invariably proves more costly than originally anticipated), and turning it to profit will take time. Family firms do have an in-built advantage here because they're often more willing to invest for the long term, but you need to 'pace yourself' – this is marathon not a sprint. And always ensure you have plans in place to protect the business if your sales projections prove over-optimistic.

- **Determine the right route to market**

  Depending on the nature of your business, there will be many different routes to market, some of which will fit more easily with the family firm ethos than others.

  For example, if you run a retail business it may be better to concentrate on opening a few high-end stores overseas, as the youth clothing brand Jack Wills has done, rather than trying to achieve blanket coverage, with all the extra finance that would require. For the same reason, franchising may be another alternative worth exploring.

  If, by contrast, you're exporting finished goods, there are a number of options for international expansion ranging from staffing your own export operation, through to using local agents, and the cost and risk profile clearly varies very widely.

- **Review your business structure**

  In general, family firms tend to prefer to grow organically, and therefore more slowly, rather than to buy turnover by acquisition. This matches the natural caution and longer time horizon of the typical family firm, and has the additional benefit of not requiring large amounts of capital expenditure upfront. However, if the route you want to take with your business does require a significant capital injection, this can be a good moment to reassess your whole business, and identify whether some non-core assets could be sold to fund the growth you're looking to achieve.

- **Think laterally about finance**

  If bank funding is too expensive and equity off limits, off-balance sheet funding may be an option, at least for acquisition finance. PwC recently advised a UK family business who created a special purpose vehicle to fund an acquisition, and succeeded in obtaining Private Equity investment for that standalone venture. This avoided the need to dilute the family's shareholding in the main business.

- **Get all the help you can**

  Most governments have a range of schemes and incentives designed to help SMEs grow their businesses, and become international. These can range from financial support such as export guarantees, to help and advice about the issues new exporters will need to address, including cultural and commercial considerations. Some of these initiatives are not as well publicised as they might be, so it pays to persevere. You should also investigate other ways to make useful connections, whether through trade fairs, business networks, or family business organisations in your own or your target markets.

Skills: Mind the gap

"[We need to] bring outsiders onto the board of the company, and learn how to deal with that. Also the organisation of internal processes to streamline our operations. In other words, the professionalisation of management."
Family business, Brazil

Like many businesses, family firms see skills shortages as a major issue for the next few years. But there's an additional complication for the family firm, because it can be a huge challenge to recognise and address a lack of skills among family members themselves.

In many markets family firms are in competition with listed companies to attract the brightest and the best. The challenge can be that the most highly-qualified people have not traditionally opted to work for family firms because they believe that their progress will be artificially constrained by the shareholding structure, and they will achieve greater financial rewards and career fulfilment elsewhere.

There are complications here that aren't easy to solve, but if family firms are to achieve their ambitions for growth, the skills gap is an issue they have to address.

What issues does it raise?

One of the stumbling blocks family firms often face is a failure to seize new opportunities internationally or domestically because they lack the skills to exploit them. This 'skills gap' may range from general management and strategic capabilities, to quite specific fields such as IT, innovation, risk management, and Intellectual Property.

Filling this skills gap may sound like a relatively simple task, but it can be complicated by the fact that family firms often assign titles based on seniority or family ties, rather than role and responsibilities. In PwC's experience there are many firms where CEOs hold that title by virtue of age and family status alone. This can lead to a lack of clarity within the management team, and will make it extremely difficult to identify which skills are really lacking.

Hiring in external managers to supplement or replace family members in key positions is one obvious solution, but this raises challenges of its own, and it can be understandably difficult to gain family consensus to do this, especially where it involves giving up an equity stake. Given the special culture and way of working of the family firm, it's even more important to ensure the right person is hired for the job, and that means doing the groundwork first.

Considerations

- **Map what you have – and what you need**
  The first and most important step is to carry out a full and honest assessment of the skills you already have within the business. Family businesses could learn a lot from the other corporates in this respect: a typical large corporate will have a formalised talent management process which will map the skills and capabilities within each team or department, and then develop a plan to ensure there is a pipeline of suitably-qualified people coming through in the short, medium, and long term. This plan will include training and development needs for the individuals concerned.

Skills: Mind the gap

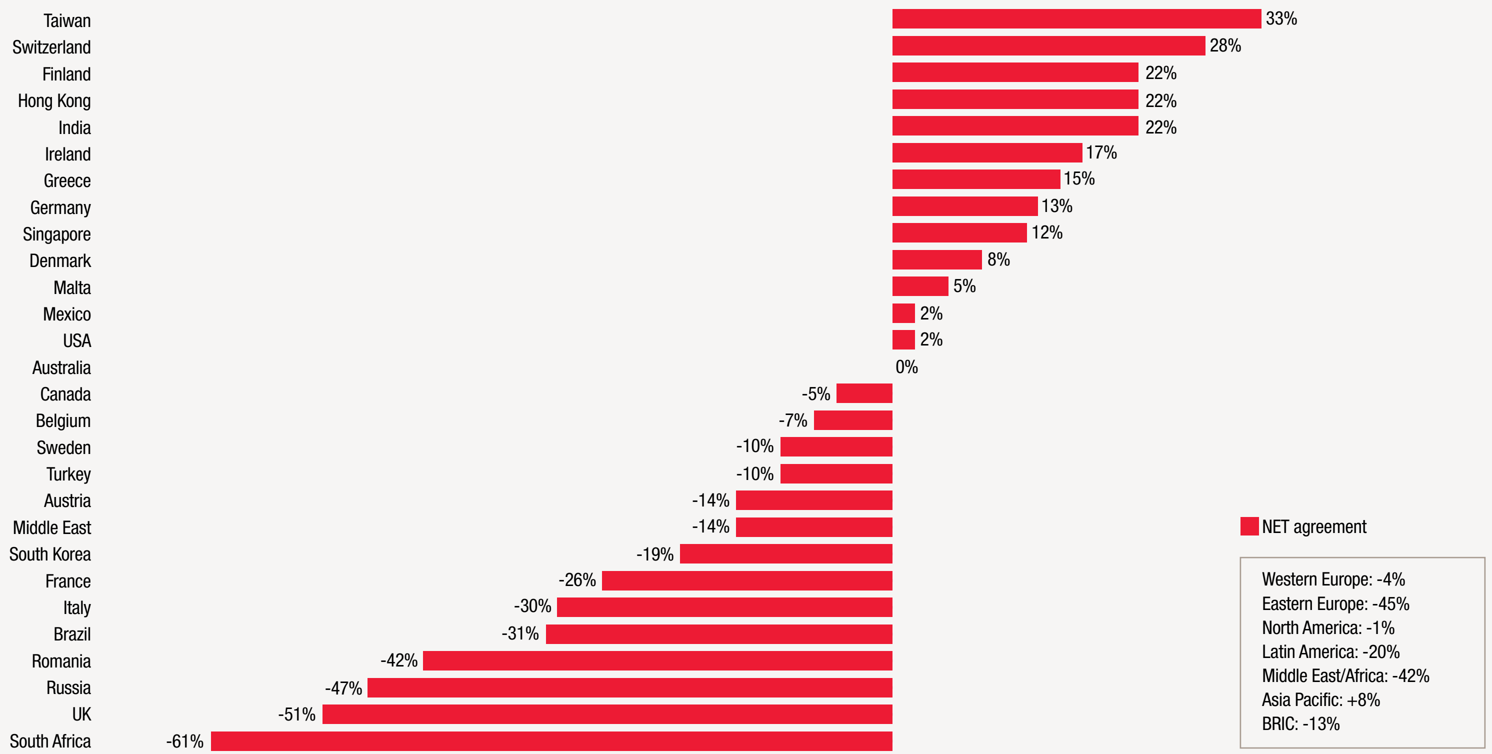
"Limitations in the skills base [of family firms is an issue]. They may be lacking some skills amongst the family members. This could be particularly evident in the next 5 years when Dad moves on" **Family business, Ireland**

Family businesses could usefully borrow the same idea, and use it to ascertain which skills the family members already have – or could develop. This would then need to be supplemented by a parallel assessment of the skills the firm needs, both now and in the future. Plans can then be put in place to determine which of these skills could be developed internally – and how to go about achieving that - and which might need to be recruited from outside, whether now or at some future point. It can be helpful to have assessments like these conducted by an independent third party.

As with the succession issues discussed later, the earlier a skills assessment is done, the easier it will be to plan. It's particularly crucial to do this preparation in advance of hiring a CEO or other senior director. Without a comprehensive and objective assessment of the skills required, and the exact scope of the job, the decision to hire in from the outside can mean that the wrong person is recruited, which will make it all but impossible for that executive to do the job they were hired to do.

Countries are polarised when it comes to whether they have the right skilled people entering the job market. Attitudes on this issue are more negative in Eastern Europe, the UK and South Africa.

Net agreement that young people entering the job market within your industry sector have the right skills and education*



*NET agreement = proportion of those agreeing and subtracting the proportion of those disagreeing
Source: PwC Family Business Survey 2012

Skills: Mind the gap

- **'Manage the manager'**

  It's no surprise that some family business founders and owners find it difficult to 'let go' after hiring a new CEO from outside the firm. The key here is for the family to learn how to 'manage their managers', and recognise that the skills required in an effective shareholder are very different to those needed to run the business day to day.

  One of these skills is understanding when intervention by the founder or family will be unhelpful, and when it can be useful, or even crucial. Family members will have a particular role to play, for example, in protecting the unique culture and values of the firm.

  At the same time, CEOs joining a family firm for the first time need to appreciate that this type of business is not the same as a listed corporate, and adapt their working style accordingly. They will need to be sensitive to working practices that may have evolved over many generations, and recognise that the employees of family firms often have very different expectations from those in other companies, and that these will need to be managed carefully if changes are to be made.

- **Strengthen the Board**

  Hiring independent non-executive directors can be a very effective way to gain access to valuable expertise without handing over either equity or managerial control. The obvious challenge is to find people with the right background, and if they're willing to accept the role, you have to allow them to do it properly, and listen to any constructive and objective input they may have.

- **Exploit all available sources of support**

  In some territories governments offer a variety of training and mentoring schemes, which can help family businesses develop the skills they need.

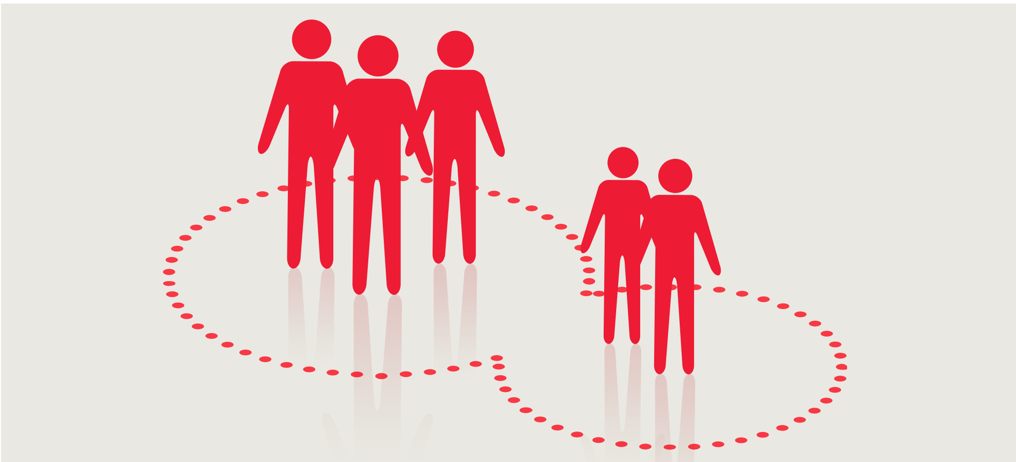
- **Collaborate to innovate**

  There are also government schemes in some markets which facilitate collaboration and networking between SMEs, family firms, and multinationals, especially in areas like innovation and R&D. Some of the schemes run in the UK by the National Endowment for Science, Technology, and the Arts (NESTA) are good examples of this.

Succession: Make or break

The one unique quality that sets all family businesses apart is their ownership model – that fact that the firm passes from one generation to the next. This can either be a source of strength and longevity, or a structural weakness that can undermine an otherwise healthy business.

This particular 'tipping point' is rarely completely straightforward, and it is often the most likely source of family conflict - and business breakdown.



What issues does it raise?

This is where it gets personal. Many family firms find it difficult to manage the moment of transition from one generation to the next, and some of the other problems we've already discussed can be traced back to issues left unresolved here. For example, some family businesses attempt to solve the conflicts that can arise at succession by allocating senior job titles by way of compensation to those who are perceived to have 'lost out'.

Conflict can arise from a whole range of causes at this point, which is one reason why it's such a dangerous time. There can be disagreement about whether to sell the business or hand it down, and many of the businesses we surveyed this year were unsure about either the aptitude or appetite of the next generation.

There can also be disagreements about future strategy and direction, and across the world PwC has seen numerous examples of younger family members returning home from an overseas MBA with new ideas that may be at odds with their parents' view of the future.

Remuneration can also – unsurprisingly – be extremely divisive, especially where there is a long-established pay framework in place that does not adequately recognise the different contributions made by each family member. In some firms, for example, all family members are paid the same, regardless of the role they play.

And finally, the tax consequences of transferring the ownership of the business can be significant, and in extreme cases can see all the value added by one generation wiped out at the moment that the firm passes to the next.

Considerations

- **Prepare, don't postpone**

  Because succession is such a sensitive moment in the firm's evolution it can be tempting to postpone any discussion of it, but this is almost always a bad idea. It's crucial to anticipate how the transition process is likely to evolve - and the issues and emotions it's likely to generate – so that you can start preparing as early as possible.

  As the owner, you need to have a long-term vision for the future of your business and a strategy for achieving this though this will inevitably be closely tied in with your personal goals, it's important to keep the two things separate. Once the long-term strategy is in place, this will help clarify the options you'll have when you retire, and it may also help you decide if some parts of the business are no longer core to the firm's growth plans.

- **Evaluate the options**

  Most family firms have four options at the point of succession: a full handover to the next generation, the transfer of ownership but with non-family professional management, a sale, or a flotation. Each raises different issues. For example, if the next generation is to take on the business, younger family members may need support, and perhaps specific training, whether they're going to manage the business themselves, or are to be effective shareholders for a new non-family CEO. This type of handover will often be a gradual one, with the owner retaining a significant role for some time, and perhaps a right of veto for a specified period.

Succession: Make or break

"Mentoring and developing the next generation family members is crucial to the success of the family business." **Family business, Middle East**

If, by contrast, the decision is made to sell or float, quite major changes may be needed to ensure that your firm is an attractive prospect for a Private Equity house or commercial buyer. Both of these routes will also require an objective valuation of the business, which may not always tally with what you or the rest of the family believe it to be worth. It's worth remembering that it's always challenging to value a family firm, because there are rarely direct market comparisons that can be made.

- **Anticipate conflict – and act to prevent it**

  This year's Family Business Survey suggests that many family firms have measures in place to manage potential conflict, but we suspect that a significant number of these may prove inadequate should an actual dispute arise.

  It's important to review your conflict management mechanisms well in advance of a succession point, as part of a thorough review of your governance procedures. When ownership and/or management passes from one generation to the next it's almost always necessary to formalise the decision-making processes within the business.

  People who have worked together for decades may have evolved informal procedures that have served the firm well, but they will always rely on personal relationships and trust, and a larger group of next-generation family members may need a more structured framework. The moment of succession is an ideal opportunity to develop or update a comprehensive family charter, and to do that in a way which involves everyone who has a stake in it.

  Any charter or framework of this kind should include clear definitions of roles and responsibilities, and an objective system for appraising performance, both of family members and any externally-recruited managers.

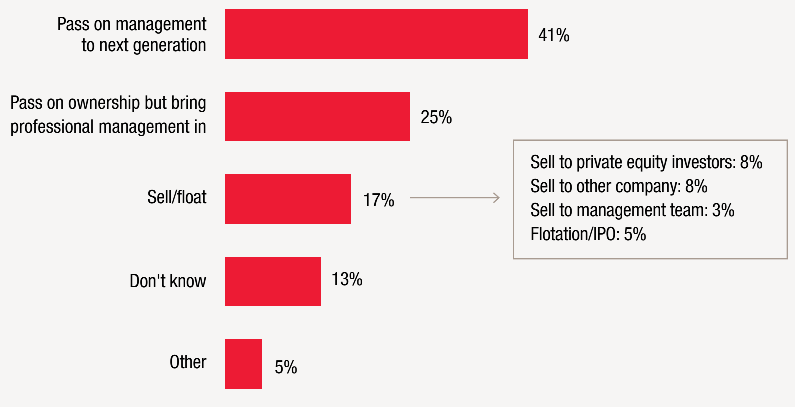
  Remuneration is a key component here too. The way work is rewarded within the firm needs to be – and be seen to be – transparent, fair, and proportionate.

- **Optimise your tax position**

  It's vital that you're fully aware of the full tax implications of selling, floating, or handing over your business.

Fewer than half of family businesses plan to pass the business fully (ownership and management) to the next generation

Future plans



Source: PwC Family Business Survey 2012

There will be a range of both personal, inheritance, corporate and sales tax implications for the owner of the firm at the point of succession.

Proper planning well before the event can ensure that the business is structured in the best way to minimise tax, and the firm can take advantage of all the tax reliefs that could be available.

How do you match up?

PwC has developed a benchmarking tool, drawing on the results of this year's Family Business Survey. This allows you to assess the position and progress of your own firm against the 2,000 businesses we spoke to in over 30 markets around the world.

The tool is divided into key areas such as growth and expansion, talent and reward, succession, and government and society, and allows you to refine your comparisons by size, region, and number of generations.

The tool is easy to use, and helps you identify action points and areas for improvement, and once you've completed all of the questions you can download a customised report.

To access the tool please go to www.pwc.com/fambizsurvey

Definitions

For the purposes of this survey, a 'family business' is defined as a business where

1. The majority of votes are held by the person who established or acquired the firm (or their spouses, parents, child, or child's direct heirs);
2. At least one representative of the family is involved in the management or administration of the firm;
3. In the case of a listed company, the person who established or acquired the firm (or their families) possess 25% of the right to vote through their share capital and there is at least one family member on the board of the company.

Survey methodology

1,952 semi-structured telephone interviews were conducted via Kudos Research in London with key decision makers in family businesses across 28 countries worldwide between 7th June and 18th September 2012. The interviews were conducted in the local language by native speakers and tended to average between 20 and 35 minutes. The results were then analysed by Jigsaw Research.

How PwC can help

PwC has worked with hundreds of family firms across the world, in every conceivable sector.

We've helped them become effective exporters, assess and develop their skills, and manage the transition between one generation and the next.

We've helped them prepare for a successful sale, hire the right external executives, access all the tax and other incentives available to them, and ensure their governance processes reflect international best practice.

We've even created tailor-made programmes to help younger family members understand their responsibilities as future directors.

If you'd like to talk to one of our family business experts about your own firm, then please feel free to contact:

Contact details

Eric Andrew
Global Network Middle Market Leader
Tel: +1 604 806 7500
Email: eric.s.andrew@ca.pwc.com

Oriana Pound
Global Middle Market Director
Tel: +44 (0) 20 7804 8611
Email: oriana.d.pound@uk.pwc.com

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