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The Family Business: 5 Keys to Success

Background

"Family businesses play a major role in the New Zealand business landscape… The majority of family businesses are in their first generation and the numbers decrease significantly for those residing in later generations, indicating a certain lack of longevity… A lack of longevity of New Zealand family businesses detrimentally impacts on the country's economy in terms of provision of employment, GDP per capita, as well as business growth." (Decoding Family Businesses – Rebecca Hirsch, University of Auckland) [i]

Warren Buffet is often quoted as saying that compound interest is the eighth wonder of the world. This obviously relates to the wealth building effects of receiving interest on interest over a period of time, in an investment portfolio. Likewise transferring a business enterprise from generation to generation has the effect of compounding the wealth of a family.

The context in which this special report has been written is in relation to family businesses and in particular rural or farming businesses and the succession of these businesses.

This report follows the first special report we published in February 2010, "Preserving Your Farming Enterprise for the Benefit of Future Generations."

Despite the context of farming, the principles and insights included in this report can in our opinion be applied to most other businesses.

Most family business experts say that the critical issues facing family business enterprises are people issues, more so than business issues. This report offers some of the views and insights as to what in our opinion appears to be some of these key issues.

1. Letting Go

In Michael Hill's latest book "Think Bigger" there are many significant comments relevant to this topic. However, two in particular are worth considering. In the first he says "In a lot of companies, you will notice after one or two generations, there is a tipping point where the great established names start to vanish because they do not evolve. The vision of the founder got them established and kept them going but that founder was almost certainly a dictator. He never passed responsibility to anyone...". He then follows this by saying of himself "This founder has delegated his vision to other people and they will keep the business growing because I have encouraged them to think bigger." [ii]

Studies show that an incumbents inability to let go is the most cited barrier to effective succession. If the incumbent is too attached to the business, the potential successor might not be given the opportunity to develop the skills or earn the respect necessary to manage the business. [iii]

Letting go however can be a double edged sword and history will show that letting go is also a path littered with disaster tales! Letting go in a planned and managed process offers the best chance of success. The transition of the business should not happen overnight. It needs planning, discussion and commitment. As we mentioned in our earlier Special Report ("Preserving Your Farming Enterprise for the Benefit of Future Generations") change does not need to happen immediately, but planning for change does.

It is the planning of "how and when to let go" then the implementation of this that determines success. Caution should be taken however that delegation of areas that bring the most satisfaction to the incumbent don't jeopardise the process.

Most importantly "letting go" does not necessarily mean giving up control immediately, or even in the medium term. There are ways to "let go" whilst still retaining control. In fact, it is often preferable that the founder retain control for a considerable period to ensure that the business continues to be managed well, the successor proves himself/herself and to ensure that the founder continues to have access to income/capital as required.

Concentrating on some delegation of management roles (Management Succession) before dealing with any change in ownership (Ownership Succession) can play a significant role in managing the control factor, when commencing the "Letting Go Process".

2. Not Negotiable Commitments

It is fundamental that the following are addressed when developing an inter-generational plan. It may seem rather simplistic, but we have found that it really is a prerequisite that these 3 critical factors are articulated and committed to by the family very early in the planning process:

(a) Commitment to Growth

- It is recognised in the modern business environment that unless a business is growing, it is in reality going backwards.
- To involve additional owners in any business, there needs to be growth to ensure that there is sufficient income for all of the owners.
- There are many ways to target growth so it is important that a strategy that is appropriate for the business is considered and agreed to.

(b) Commitment to Pooling Resources

- As a generalisation, it is fair to say that the successful businesses now and in the future will be based on either economies of scale, or boutique/specialist models.
- Globally there has been a significant move to consolidation and creating scale operations over the last 10 years. Similarly there are those that are focusing on specialist (e.g. organic) or intensive farming models.
- Families who remain together as one will remain strong and able to compete with other operators following the above models. Those that become divided and remain as sole operators will find it increasingly challenging to compete.
- There could be limits to the number of generations that can be involved in any one business, however an existing large and successful family business can be a good foundation for generation three or four to leverage off.

(c) Commitment to Governance

- Adoption of good governance practices is a proven means for facilitating business implementation and also to manage risk in this age of volatility.
- It is important for family enterprises that there is focus on the right issues at the right times, otherwise tensions can materialise and strategic focus can be lost.
- Many will have experience of the situation that when family members fulfill multiple roles within a family business, this can lead to conflict. Commentators state unequivocally that governance structures are the best way to clearly set out the boundaries and responsibilities of each position, thereby providing transparency and clarification of each individual roles. [iv]
- Good governance is the glue that will hold the enterprise together. There are many and varied governance models that can be adopted. Agreement as to which model needs to be achieved at any early stage.
- The proposition here is that if these 3 critical factors cannot be embraced by all of the family, then perhaps succession of the business is not the best direction to take and an alternative exit strategy should be planned by the founders.

3. Discovery Process

In our experience there is "no one size fits all" solution. Every family and every farming enterprise is different – has its own DNA! There is no quick fix solution. A bundle of legal documents that your lawyer and accountant have prepared and probably barely understood by you and the family is not the answer.

Too much attention in our view continues to be focused on the technical matters (tax, family trust, business structures etc) with not enough attention being paid to the family and their expectations, aspirations and requirements.

It is “people power” that determines the success of a business. Similarly, it is the failure to address the people dimension and family dynamics that has proved to be a major hurdle in achieving success in many succession processes!

What the Discovery Process is designed to do is to identify the three most important requirements for a long lasting family business, namely:

- A clear vision and purpose for the business (the family dream).
- Motivation beyond money – the passion and purpose.
- A willingness to trust and support the successors.
- In summary it comes down to “Understanding what we are good at doing and why we are doing it?”

There are three main factors that must be taken into account in the Discovery Process. These are:

- **A profitable business:** Can the business generate enough income to support another household and can all family members be treated fairly when the founders retire or die? If the business does not currently meet this test, what changes can be made to ensure it will in the future?
- **Communication**: Family members will have different expectations of and priorities for, the generation transfer plan. Effective communication between the generations is perhaps the most important thing that needs to happen. Equally important is the timing of that communication. Are the non farming children to be involved in the business? What is the long term vision for the business? These are the some of the questions that need to be addressed earlier rather than later, in order to get alignment of the family vision and an understanding of individual members goals.
- **Time:** Change does not have to happen immediately – but planning for change does. The longer the period of time involved, the more critical it is to set milestones and have regular reviews.

4. Staging the Transition

It is much easier to let go if the first stage of the transition is not too intimidating! Some of the “war stories” that everybody has heard, happen when the final outcome is attempted in one step. Going from A-C and omitting the middle step is often the reason the problems occur.

An initial stage, allows everyone to get comfortable with change, allows the incumbent to assess the contribution of the successor, and allows the successor to gain confidence over time, without the whole of the world on his/her/their shoulders. Implemented correctly, it is akin to putting the training wheels on before going solo!

There are a number of ways staging can be achieved. Two mechanisms we favour involves firstly separating the land and business ownership; and secondly to have family members subscribe for a minority shareholding. This allows for a review date to be set, which is the opportunity to bring everyone together after an agreed initial period to review and preview.

A review date provides the opportunity to have a “carrot and stick” approach. If at the time of the review date all is going well, then the incumbent may consider offering a further transfer of shares to the successors. If not, then the incumbent can either take the shares back and/or defer making further decisions until the desired outcomes have been achieved.

Staging allows:

- Less risk
- Firm message that performance is required
- Opportunity for successor to get feet under the table
- Ability to revert back to square one if it is not working
- In terms of staging, it is usually beneficial for some form of Management Succession to be implemented before Ownership Succession. It is easier for the founder to implement Management Succession to whatever degree is comfortable, if the founder still retains control of ownership.

5. Leadership

In Michael Hill’s book he also says “visualisation is a crucial step in the process of setting and attaining our goals.” [v] Thousands if not millions of words have been written by many wise people about the need for purpose and that every human being and every business needs purpose to be able to achieve at the highest level.

As well as being prepared to "let go" the business founder also needs to have a vision (purpose) that becomes the guiding light showing what the succession process is really aiming to achieve.

There are two broad categories that this vision will fall into. One will be the most efficient and most equitable way for the business to be transferred to one (or possibly more) of the children. The alternative category will be the most efficient and most equitable way to involve all of the family in the evolution of a true family business enterprise.

Once it is understood as to which of the above categories apply, it will become a lot easier to identify and visualise what the goal should be. Like the 30 year goal that Michael Hill refers to in his book, it is good to set a long term goal – I suggest that in the context of succession planning, 20 years is the ideal time-frame to target i.e. what will the business look like in 20 years time if the transition has been successful?

The 20 year model allows a simple vision to be understood and committed to, which can be broken down into five year chunks. Over a 20 year period the value of a business enterprise should double. This rule of thumb is based on anecdotal evidence and a relatively modest growth projection of 5% per annum.

Clearly we cannot give confirmation that the 20 year model is correct in all situations. However, this does provide a simple foundation for articulating to the next generation as to what can be achieved. For example, in simple terms an 800 cow dairy farming business might be worth $10m today; but in 20 years time the vision would be that a successful transition could see the successors being the owners of a $20m business.

6. Conclusion

Sometimes the best plan is no succession! However getting to that point is just as important as planning for succession. This is because this decision means that a different course of action will be needed by those that get to that point.

It is the proposition of many that a number of farming businesses that have achieved scale during the lifetimes of the current founders could with the right planning, patience and vision become even larger and more successful business enterprises by involving the next generation. Commentators are divided however as to the success rate of the transfer of these enterprises to the next generation by the baby boomers.

Following the recommendations referred to in this paper is no guarantee of success and of course specific expert advice is required by any who seek to implement any of these recommendations. However it is the proposition of the writer that whilst there may be other components to a successful succession plan, the five keys to success identified in this paper are important ingredients that need to be included in the matrix.

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Owen works closely with farming families and businesses generally on commercial and property matters.
Cooney Lees Morgan has been part of the growth of the Bay of Plenty since 1918. The firm has deep roots in the rural community and a close involvement with New Zealand's primary industries. It ranks in the top 20 law firms in the country and received the Best Mid-Sized firm in New Zealand Award in both 2010 and 2011 at the Annual Law Awards.
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(iv) Adrian Cadbury "Family Firms and their Governance: Creating Tomorrows Company from Today's" (Egon Zehnder International, London 2000) at p 32
(v) "Think Bigger", Published by Random House New Zealand 2010 at p 47