FLASH NOTE

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Family businesses: Look beyond the caricature to find long-term growth

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Family-owned businesses have a reputation for conflict, nepotism and control issues. As a result, existing Environmental, Societal and Governance (ESG) ratings mark them down in Governance terms. Yet, there are several good reasons to invest in family firms, provided you take a selective approach.

Why are family businesses successful?

Looking past the drama

TV shows based on the dramas of family businesses have been popular for decades, but such histrionics have little basis in fact. The reality is that tens of thousands of companies with big family or founder holdings go on generating returns and value year-after-year, for decades. Today, family-run businesses represent 70% of the world's GDP and contribute to 50-80% of jobs in many countries[1]; that's because, the founders of family-run businesses are not gamblers – they are builders.

A purposeful and long-term view

A family business starts because someone has a vision coupled with determination. They thrive because they have a wider purpose that goes beyond the corporate belief in earnings growth. Often the desire to build is driven by innovation, the desire to do the right thing rather than doing things right. Family businesses also don't have the pressure of short-term investors demanding quarterly earnings improvements. By taking a long-term view, they are better at making decisions that don't have to pay off immediately.

Debt is less of a drag

Family businesses also demonstrate that taking a long-term approach doesn't involve excessive debt. In fact, family businesses tend to be less leveraged than other companies. The Carmignac "Family 500" database tracks global companies with a minimum of 10% controlled by family, founders, foundations or trusts. The data shows that, on average, their relative level of indebtedness is approximately three times lower than non-family businesses [2].

What to look at when selecting family businesses?

Geography matters

When it comes to performance, EU- and US-based family businesses have outperformed non-family businesses over the last 15 years by +50% and +40% in their respective geographies. Over the same period, family businesses within emerging markets have underperformed [3]. The Carmignac "Family 500" database shows that US family businesses offer the most investment potential.

Size makes a difference

While all categories of family businesses by capitalisation outperformed non-family businesses, mega caps[4] recorded the best performance over the last 15 years – posting almost 3x growth. Investing in family businesses should not be restricted to small and mid-caps, as there are clearly some larger family champions to consider. The generation of the family also counts. First and second-generation family companies tend to do well. However, from the fifth generation onwards, performance is more variable as the unique mindset of the family business established by the founder becomes too diluted.

Finding the sweet spot for family ownership

When it comes to listed family businesses, the percentage of voting rights owned by the family should be considered in governance terms: if the percentage is too low (<10%) the business doesn't really benefit from the family business advantages; conversely, if the percentage is too high (>80%) the views of the minority shareholders are disregarded. Non-executive directors need the wherewithal to stand up for non-family shareholders. How executives are rewarded should also be monitored, especially if they are connected to the family, as well as corporate behavior and the quality of accounting practices.

An active, selective approach is key

Family-owned businesses may never be able to shake off their reputation for intrigue and gossip; but overall, the success of family-run businesses reminds us that good governance can't always be measured purely by ticking boxes. The universe of investable family companies is vast, and diverse, and there is no 'one size fits all'. Finding the good ones requires a meticulous approach, and an understanding of the key indicators that can help to narrow down the search. With this at their disposal, investors can marshal the information needed to spot a corporate formula that will build long-term value for investors, while also contributing to the greater good.

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(1) Source: UBS, June 2019. (2) debt/ebitda ratio of 0.4x compared to the 1.1x. (3) Source: Carmignac's Family 500 database, 2019. (4) >50 Billion USD.