Family businesses exceed market performance: study

Large family-owned businesses listed on the S&P/TSX Composite Index primarily outperformed their non-family run counterparts from 1978 to 2012, says a recently issued report by the Clarkson Centre for Board Effectiveness, sponsored by the University of Toronto's Rotman School of Management.

The study found that the majority of the 23 firms designated as family run, defined as such when one individual or organization held at least 30 per cent of the voting power, outperformed the overall share price performance of 412 other sampled firms.

Matt Fullbrook, manager of the Clarkson Centre in Toronto, who oversaw production of the report, thinks the ability of management at family-run firms to look toward a more long-term horizon is likely the dominant driving force behind this result.

"One thing that's consistent among family firms is that sort of built into the desire to grow and maintain family wealth through the operation of [their] business is a longer-term perspective than what you'd likely see in widely-held firms," says Fullbrook.

"There's been a whole lot of discussion, particularly among the institutional investor community, about a growing distaste for 'short-termism,' and institutional investors are really starting to feel like the short-term perspective of managers and boards and even other investors, has taken its toll on the market."

Tom McCullough, adjunct professor of finance at the Rotman School, says public company CEOs are under pressure to produce good quarterly earnings. The CEO of a company that is owned and controlled by a family may not be focused so readily on that measure.

"They might think about generational wealth creation. That gives [them] a completely different perspective than a public company CEO that has to cater to quarterly results for shareholders," McCullough adds.

Paul Amirault, a partner with Norton Rose Fulbright in Ottawa, says a large family-owned business might be more agile than their counterparts with multiple stakeholders in the sense of being able to make quicker decisions and to change direction faster.

"I'm not surprised at all that those large, family-owned businesses are potentially more profitable," he says.

A key motivation behind the Clarkson study of family firm performance was to examine alternative models of good corporate governance and best practices, compared to most other studies which tend to stress director and committee independence, Fullbrook says.

the other side of the coin is an acquirer may not enjoy that same level of loyalty."

Moreover, just as employees can build up intense loyalty within a family-owned business, so might customers who have been dealing with the business for a long time, perhaps several generations. The firm may be viewed in the general community as holding a certain legacy.

"Their name is on the company. It's not just some passing fancy they want to sell off to somebody else," says McCullough. "If you buy XYZ business and there's no John and Sons anymore, that can affect the brand, for sure."

"We see some terrific long-term relationships with the family-controlled operations because some of these are second and third generation," says Lynne Fisher, senior manager of ExitSMART, which advises business clients on exit strategies, at MNP LLP in Edmonton.

It is therefore important for the potential acquirer to determine the commitment level of family members, to ascertain whether they want to stay on and lend their name and expertise to the transition. Even before the business is acquired, plans for how relationships with stakeholders will be handled need to be created. Once the business is acquired, a clear and focused communication strategy is imperative as the new owners need to make clear their intentions with existing stakeholders, she says.

"Get a strong transition plan in place to transition employee, client and supplier relationships because they are absolutely critical to the success of the acquisition," Fisher recommends.

Due diligence related to financial matters is required in any business purchase, but it's especially critical for family-run enterprises. Among the risks in a family-owned business is that people might have been promoted into senior management primarily because they are related. Therefore, the acquiring company of a family-owned business needs to determine the competency and qualifications of senior managers.

"Probably the easier family businesses to acquire are those that already have professional talent internally, like a professional CFO or controller," says Spooner. "That's going to make the transaction a little bit easier, if they have somebody that has brought good reliable reporting systems into the business. So that's something to look for."

There are also significant financial implications if managers in a family-run business are overpaid or underpaid compared to their peers in businesses that are operated at arm's length.

"I think anybody who's worth their salt who's doing due diligence is going to normalize management compensation," says McCullough. "They're going to say 'this person earns $200,000. If we're going to get somebody independent and good they're going to be $400,000.'"

Conversely, compensation to a family member might well exceed what the market would otherwise pay. "So somebody goes through those numbers and says 'why is the head of the mailroom earning $200,000 a year? He's not staying, and we're going to get somebody for $40,000,'" he adds.

Furthermore, bonuses could be awarded as favours to family members in a way that would never be done in a widely-held corporation, says Peter Lillico, a partner with Lillico Bazuk Kent Galloway, barristers and solicitors in Peterborough, Ont.

"The financial statements of a family-owned corporation could

FAMILY BY DANE_MARK / ISTOCKPHOTO.COM

"Family dynamics are a very complicated and messy piece of a family business. You can be buying into a rat's nest of hurt feelings and bad relationships and so on."
Tom McCullough, Rotman School of Management

be looking unrealistically profitable because [the company is] supporting Uncle Joe when he's not really producing much, or it looks like there isn't that much left for shareholders because a big bonus went out to buy Dad's boat. So you have to do more diligence on the details," Lillico says.

Intangibles and goodwill, including possible continued use of the original name, may need to be priced into the purchase agreement, he adds.

While it might be simpler to negotiate with a founder who has sole decision-making authority, co-operation is not always a guarantee. It is important to ensure at an early stage that no other family members are interested in purchasing or taking over the business.

"Sometimes you can get into a situation where the purported purchaser is really being used as a bit of a straw man to set a price for an inter-family transaction. Also, if there is strife within the family — like multiple family owners and some think something should go to nephew Billy, and others don't, that can create complications on approval for the sale," says Lillico.

"You'd want to have those things signed off [whereas] normally with a non-family business if the board of directors has authorized the president to negotiate a sale, that's the end of the story."

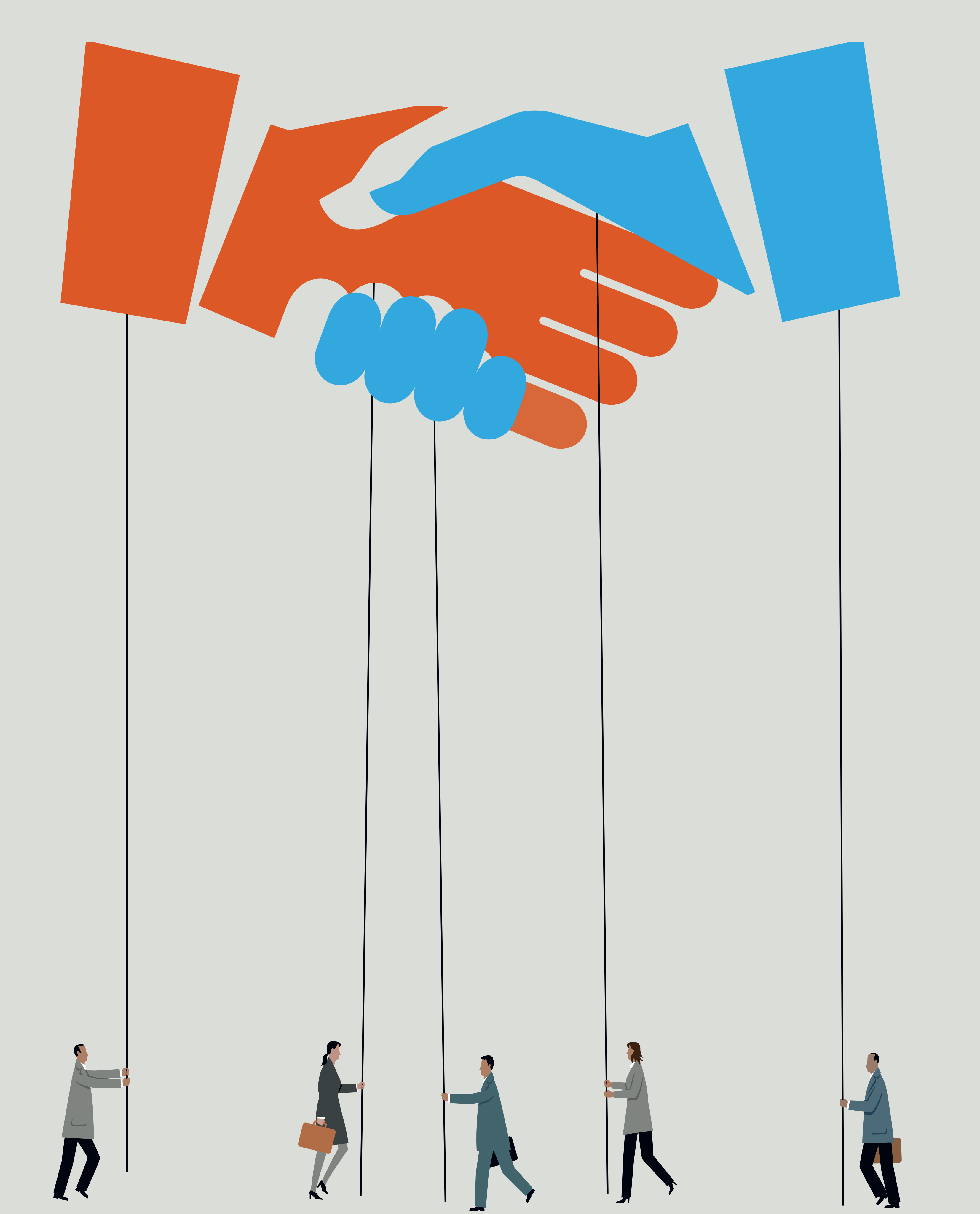
While there could be a potential advantage if a family-owned business is negotiating to acquire another family-run enterprise because they understand it better than a business operated at arm's length, experts stress compatibility is the most important element for any negotiation between parties.

"Purchasers and vendors need to understand whether or not there would be a fit before they started a negotiation," says Paul Amirault, an Ottawa-based partner with law firm Norton Rose Fulbright.

"To the extent there was a fit, the common way of running their family business would only serve to benefit the negotiations, because they would be that much more aware of the sensitivity, both internally and externally in terms of how they've run their family owned business in the past," Amirault adds.

But others may find that such a fit is elusive. One of the aspects of family businesses is that they seem to be run uniquely, according to Lillico. There might, for example, be a business being considered for purchase that has no outside directors, and is run with a very strong hand by the founder, who isn't necessarily using best governance practices.

"That could be very incompatible with how another family business is run," he says.



Family allowances

Beware of the internal dynamics in any purchase of a family-owned business

BY JEFF BUCKSTEIN

PURCHASING A FAMILY-OWNED and operated business can provide a much different set of challenges than an enterprise run by managers who are dealing at arm's length with one another.

"Family dynamics are a very complicated and messy piece of a family business. You can be buying into a rat's nest of hurt feelings and bad relationships and so on," says Tom McCullough, adjunct professor of finance at the Rotman School of Management at the University of Toronto. He is also the chairman and chief executive officer of Northwood Family Office in Toronto, a personal wealth management company.

For example, an original entrepreneur who is also the family patriarch, might want to sell. But his wife, another key owner in the family business though not actively employed, might not agree to a sale until her son is able to line up another job, says McCullough.

There are also a number of unique pros and cons that need to be taken into consideration when purchasing a family business is an option. Often, a history of trust has developed between family owners and various stakeholders, including employees and clients. These relationships can prove either advantageous or disadvantageous depending on how the prospective purchaser approaches the situation.

"There's often more loyalty from employees to their employer in a family business than a similar non-family owned business would have," says Carole Spooner, a partner and director of succession services at MNP LLP in Edmonton. "But