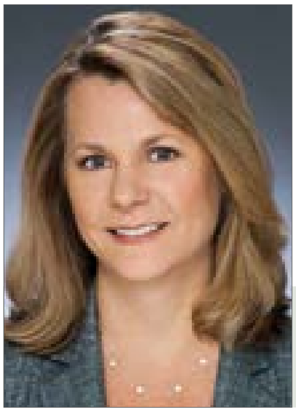
Why are family businesses better at weathering economic downturns?

BY CARRIE HALL

When it comes to family businesses, evidence suggests that which does not kill them makes them stronger—stronger than other enterprises. Family businesses tend to enter challenging economic times better prepared than others, with a more conservative orientation and far less debt. In a difficult economy, family businesses respond with a multigenerational perspective that informs their decisions, allowing them to survive and thrive, often by flouting conventional wisdom.

Research from family business consultancy Headwaters SC (HWSC) indicates U.S. family businesses with annual revenues of $100 million to $3 billion are statistically less likely to fail during economic downturns than comparable businesses with other forms of ownership. There are roughly 5,900 of these businesses in the 12 broad industry segments that HWSC serves, representing roughly 75% of all Standard Industrial Classification (SIC) codes. Of these, nearly 86% operate in industry segments that have low-to-moderate—as opposed to high-to-very-high—revenue volatility. Even considering all industry segments, including those with high and very high revenue volatility, HWSC found that roughly 73% are in the second to fifth generations of family ownership, indicating that these companies have withstood from 25 to 100 years of economic ups and downs.

"When analyzing the longevity of upper-middle-market, family-controlled businesses, there are also two important capitalization factors worth considering," says James Bly, HWSC founder and CEO. "First, most have lower debt-to-EBITDA ratios than private-equity-backed businesses. The owners typically do not want to place their equity value at risk to excessive debt leverage. Second, they have little structural pressure on the equity side, no market pressure attributable to quarterly earnings results or activist investors, and a longer-term shareholders' perspective that comes from patient capital."



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A long-term perspective

Family businesses' long-term outlook distinguishes them from other enterprises. By focusing on resilience, as opposed to short-term gains, these companies are better able to weather economic storms. "As a family business, we don't need to see the return next quarter; we can invest longer-term," says Charles Kittredge, sixth-generation chairman of the board and former CEO of Crane & Co., the paper company founded in 1801. Kittredge further explains that by not "cutting to the bone" in economic downturns, "Crane is better positioned to respond to upticks in the economy." This patience is at odds with the "fail fast" philosophy so prevalent today.

In addition, the family business perspective is often shaped by leaders who have a greater depth of management experience. This is due, in part, to the longer average tenures of family business CEOs—25 to 28 years, compared to four to six years for CEOs in non-family businesses, according to Andrew Keyt, clinical professor at Loyola University Chicago's Quinlan School of Business. And, in family businesses that have survived for two, three or more generations, there is greater institutional knowledge. "They've seen it before," says William Lauder, third-generation executive chairman of The Estée Lauder Companies Inc. (ELC).

Lauder believes "patient capital" and the ability of management to take a longer-term view as to how they invest and manage the business is key to longevity. ELC put its long-term perspective into practice during the mid- to late 1980s, when department stores and other retailers were suffering as a result of their debt structures. In some cases, ELC was the stores' largest trade creditor. The company's reaction was, "Don't panic; think through the options," says Lauder. The company chose to continue selling to the department stores, extending credit terms and maintaining its relationships with them. "The ability to take a longer-term view allowed us to ride through the crisis with the customers," says Lauder.

During the most recent recession, ELC's vendors also suffered. In some cases, the company represented 20% to 30% of the suppliers' businesses. ELC took out a $750 million line of credit as a "rainy day fund" in case it was needed to support the vendors, says Lauder. It next bought back excess inventory from the vendors, taking a write-down. This allowed the vendors to purchase ELC products that would sell better for them. "The short-term sacrifice of buying back and writing down inventory provided better results longer-term," says Lauder.

Protecting the firm's (and family's) reputation

Family businesses' patient approach is partly informed by their view that success or failure attaches not just to the business, but also to the family. This view was evident in the way Toyota Motor Corporation president Akio Toyoda, the grandson of the company's founder, handled the fallout after a U.S. family was killed when their Lexus exploded in 2009. Testifying before Congress, Toyoda said, "[T]he Toyota vehicles bear my name. For me, when the cars are damaged, it is as though I am as well." While Toyoda owns just a small minority of company stock, he remains a stakeholder with significant influence.

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When family is involved, not all business decisions are strictly business decisions. Family businesses often focus on survival so they can protect for the long term the benefits they provide their employees, family shareholders, suppliers, customers, the communities in which they work and do business, and the charitable and civic works they value. "We don't exist in a vacuum, but are dependent on others for our success," says Lauder. "We must think about who we are going to affect with what we do."

Family businesses tend to embrace the following key (and interrelated) practices to a greater degree than non-family businesses—and to especially good effect during challenging economic times.

- **More financial discipline.** In general, family businesses are more apt to self-finance, less inclined to carry debt and better able to foster stability—characteristics that help them seize opportunities that often present themselves in times of economic hardship and political instability.

This hesitancy to take on debt can lead to conflict, even when taking on debt would strategically expand the business. For example, in 2000 in order to diversify and remain competitive for the long term, Crane & Co. purchased a paper mill and banknote printing plant in Europe—a move that expanded its services and geographic footprint, as well as its debt. Some members of the family expressed concern about the investment, contending that the family should "stick to their knitting." While Kittredge knew it would take several years to realize a return on the investments, he believed it was riskier not to diversify. Ultimately the shareholders came together and accepted the risk. The move has subsequently proved to be very successful, Kittredge says.

When it comes to C-suite perks, family businesses also have different priorities. While the CEO of a non-family business may demand rewards for achieving short-term profits, for a family CEO the success of the business, and the ability to pass it on to future generations, carries more weight. "I want to make sure the business is as healthy as possible and positioned to last another 100 years," says Kittredge.

- **Better talent management.** Research published in *Harvard Business Review* indicates family businesses are better able to retain employees—their annual turnover rate is 9%, compared with 11% at non-family companies. The stronger, purpose-driven cultures that characterize family businesses attract employees and keep them engaged and loyal. Family businesses are also less likely than their non-family counterparts to lay off employees during economic downturns. Longer employee tenure, in turn, reinforces the culture, while increasing efficiencies.

Crane & Co., which now focuses on making paper for currency, currency design, banknote printing and anti-counterfeiting technology, demonstrated its loyalty to its employees during the recession of the early 1980s. Many of Crane's business customers stopped buying Crane's watermarked stationery as a cost-cutting move. "A public company would have made drastic reductions in staff and production," says Kittredge. "But the product line was intrinsic to our family values—the brand was culturally important for the company." Crane eventually spun the stationery division out of the company and did an employee buyout, keeping 400 people employed in the process. "This creative solution ensured our people and the surrounding community were cared for," says Kittredge.

- **More social responsibility.** A study published in *Harvard Business Review* found that family businesses maintain high levels of corporate social responsibility regardless of economic conditions. Further, in a study by EY and Kennesaw State University, 81%

of the world's largest family businesses said they are engaging in philanthropy. Corporate social responsibility (CSR) practices are closely linked to a family's legacy, demonstrating a commitment to the family, business and community. Unsurprisingly, this caring attitude results in better business performance—through increased operational efficiency, reduced waste and increased product differentiation.

"One of the amazing things our research shows is that families that prize CSR are healthier, and the businesses they own perform better," says Joe Astrachan, Family Business Chair, Kennesaw State University.

Additionally, the EY and KSU study found by taking steps to safeguard the future, family businesses show commitment to the future, their shareholders and their employees. A family business's focus on CSR was found to simultaneously reinforce a family business's financial discipline and talent management.

"We hold ourselves to a higher standard," says Fisk Johnson, CEO of S.C. Johnson & Son. "We work hard at nurturing a culture of caring and doing the right thing for the long term." The benefits of a sustained focus on corporate social responsibility become even more important during uncertain economic times, when consumers place a greater premium on trust.

Taking the long view

Family businesses that have weathered dozens of economic cycles offer a blueprint for enduring success that begins with a long-term perspective. These businesses see themselves as cohesive family units with a responsibility to engage the next generation and carry on their philanthropic legacy. With these perspectives, they prioritize financial discipline and loyalty to their employees, customers, suppliers and communities. These choices also serve to carry them through challenging economic times.

For family businesses, the stakes are simply higher. They include the family's identity, reputation and ability to provide for future generations. With so much on the line, options that might appeal to other enterprises, such as selling or extreme cost-cutting measures, seem unthinkable—even if they make short-term business sense. FB