5

GOVERNANCE CHALLENGES FOR FAMILY-OWNED BUSINESSES

Chapter 5
Governance Challenges for Family-Owned Businesses

KEY MESSAGES

To an extent, family control yields benefits. Academic research and experience from many companies and investors all show that a certain degree of family ownership/control provides positive benefits to the family business and its shareholders.

Family-owned firms face unique challenges. However, many failures of family-owned companies indicate that such firms also face a multitude of challenges which risk destroying shareholder value or even the business itself.

Corporate governance measures lead to long-term success and keep peace in the family. Corporate governance measures at the family and business levels provide good solutions to family ownership challenges and often are indispensable to the long-term success of the family business—and peace in the controlling family, especially with succeeding generations.

"…We have two options; there is no right or wrong decision, nor one that is better than the other. But whatever is to be done, will be definitive. There is no turning back. We can continue being a family business, like in my grandfather's and father's days, or become a professional company with a strong and clear capital market strategy."

—David Feffer, Suzano, Chairman of the Board, speaking to his relatives after his father's death

Family Business Challenges

Family-owned or controlled companies are the leading form of business organization in Latin American countries, even among large listed companies: one recent study from Brazil revealed that 51.5 percent of the 200 largest listed companies are family-controlled.[59]

This predominance of family companies shapes particular corporate governance challenges and opportunities not always considered in markets where ownership is dispersed and management is mainly composed of external and hired specialists. But for Latin American markets, any discussion of corporate governance improvements must address the unique governance challenges that family companies face.

This chapter examines:

- How investors view family businesses and the benefits of family ownership
- Challenges related to family control
- Governance solutions to address investor concerns related to family ownership
- First-hand stories of governance challenges in family-controlled companies

1 Family Business Edge

Family ownership may be seen as an opportunity or a threat, depending on a variety of factors. The family ownership and commitment to the business may be understood as adding value, provided that the company and the controlling family can respond to the concerns of the investor community.

Investors—both shareholders and creditors—may look with distrust on family-controlled companies, because of the risk that the controlling family may abuse the rights of other shareholders. So investors likely will scrutinize such companies with care before taking the plunge and investing.

There is a long and storied history of family-owned companies with highly-concentrated ownership, poor transparency and absence of accountability and fairness principles that led to abuse of minority shareholder rights.[60]

From an investor perspective, the key is to establish the right corporate governance conditions so that the positive aspects of family ownership are coupled with assurances that investor interests will be recognized and addressed.

Investor perception on ownership concentration, and the value associated with it, is revealed in a report of emerging market firms published at the beginning of 2007 by Citigroup Global Markets. The analysis suggests that investors place a three percent valuation premium on firms in which family insiders wield significant, but not absolute, control. Conversely, for emerging market firms where families are majority owners, investors assign a valuation discount of 5-20 percent. See Figure 5.1.

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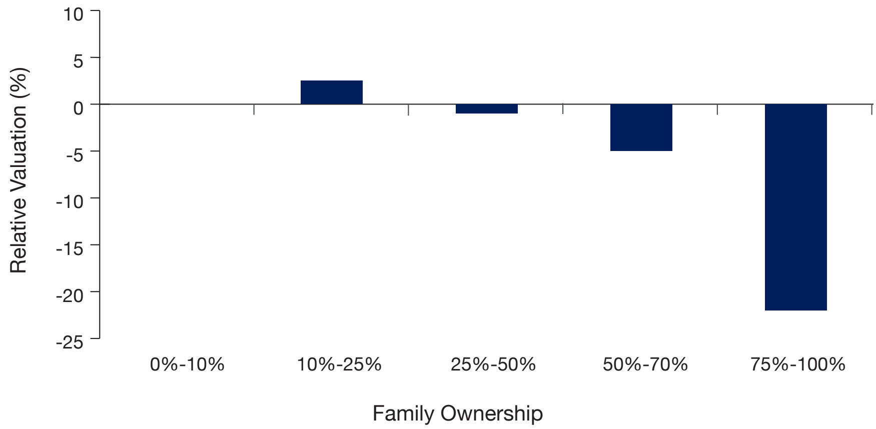
59 SILVEIRA, A. DI M. DA, LEAL, R. P., CARVALHAL-DA-SILVA, A. L., & BARROS, L. A. (2007). Evolution and determinants of firm-level corporate governance quality in Brazil. Available at SSRN <http://ssrn.com/abstract=995764>

60 LA PORTA, R., LOPEZ-DE-SILANES, F., SHLEIFER, A., & VISHNY, R. (2000). Investor protection and corporate governance. *Journal of Financial Economics,* 58, pp. 3-27.

ANDERSON, R. C.; REEB, D. M. (2004), Board Composition: Balancing Family Influence in S&P 500 Firms. Administrative Sciences Quarterly v.49, *http://ssrn.com/abstract=590305,* pp. 209-237.

CLAESSENS, S.; DJANKOV, S., and LANG, L.H.P (1998), Expropriation of Minority Shareholders: Evidence from East Asia, Mimeo, World Bank, Washington D.C., Research Paper 2088, pp. 33.

Figure 5.1 Relative Valuation by Family Ownership in Emerging Markets[61]



Sources: FactSet and Citigroup Financial Strategy Group

Research quantifies the value of good governance in family businesses. In a study by Professor Panikkos Poutziouris[62] of the Cyprus Institute of Management of 42 companies on the London Stock Exchange, listed family firms outperformed their listed non-family rivals by 40 percent from 1999 to 2005. But the study also shows that the outperformance of the Family Business[63] Index only applies when the interests of shareholders and management are aligned.

Credit Suisse[64] research also showed that family-owned companies perform better: over the long term, such firms tend to achieve superior returns and higher profitability than companies with a fragmented shareholder structure. Credit Suisse analysts compared the stock performance of European companies with a significant family influence to firms with a broad shareholder base. The study uncovered several factors that contribute to the success of family-owned firms:

- Longer-term strategic focus of the controlling shareholders and management, instead of operational focus on trying to surpass quarterly results
- Better alignment of management and shareholder interests
- Focus on core activities

Anderson and Reeb found a similar result when investigating the link between founding-family ownership and firm performance in large, publicly-traded U.S. firms listed on the S&P 500 in 2003.[65] The main finding: family firms outperformed non-family firms and had higher valuations as well.

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61 CITIGROUP GLOBAL MARKETS. (2007). What investors want: how emerging market firms should respond to the global investor. This report examines shareholder patterns among 1,500 largest listed firms in the emerging markets (the "EM 1500"). The EM 1500 represents the top 1,500 firms by US dollar market capitalization at the end of 2005. It is a subset of the Citigroup/BMI and IFC indices that essentially comprises every listed company with a market capitalization above $ 300 million across Asia (excluding Japan), Central and Eastern Europe, the Middle East, Africa and Latin America. All financial data for the EM 1500 is from Bloomberg.

62 POUTZIOURIS, P. Z. (2004). Views of family companies on venture capital: empirical evidence from the UK small to medium-size enterprising economy. *Family Business Review, 14, n. 3*, pp. 277-291.

63 A family business was defined by the study as one where at least 10 percent of the shares of a company were owned by the founding family and also had a family member on the board.

64 Credit Suisse Family Index, 2007.

65 ANDERSON, R. C., & REEB, D. M. (2003). Who monitors the family. *SSRN Discussion Papers*. Available at SSRN: http://ssrn.com/abstract=369620 or DOI: 10.2139/ssrn.369620.

The research shows that family businesses can generate value for all shareholders, based on several factors, known as 'the family business edge.' This is what attracts many investors to invest in family-owned/controlled companies:

- Long-term view in decision-making
- Ability and willingness to adopt unconventional strategies, enabling family businesses to respond rapidly to changing market circumstances and giving them the flexibility to take advantage of opportunities and address emerging risks
- Desire to build a business for future generations, translating to a focus on sustainability and reducing the risk that controlling shareholders will run down company assets and destroy value
- Commitment of family management to their company, providing continuity in the way the business is run

"I am certain that high ethical standards and good corporate governance in business generate value and increase the public investors' trust."

—Eustaquio de Nicolás Gutierrez,
Homex, Chairman of the Board

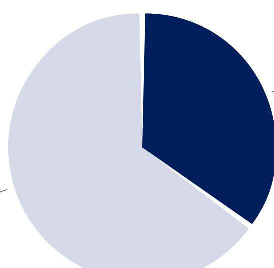
A number of Companies Circle members have significant experience in the area of governance for family-owned companies. Here is a highlight.

Homex implements governance practices

With the goal of generating value for all shareholders, Homex has implemented a series of governance practices.

Since going public in 2004, the company's controlling family has held a sizeable stake in the company. Still, the family has relinquished a larger portion of shares for public purchase over the years: the 2005 IPO launched with 22.2 percent of shares available for purchase. Today, other shareholders control 64.9 percent[66] of ownership, as shown in Figure 5.2.

Figure 5.2 The Ownership Structure of Homex



Source: Homex

[66] As of October 31, 2008.

This ownership structure demonstrates the De Nicholas family's commitment to the Mexican housing market, and confidence in the company's continued prosperity and ability to create value for all its shareholders. In turn, Homex' controlling family has found that this approach resonates with other investors, giving them greater confidence in the company.

Homex sought to do its best to ensure all shareholders that their rights and interests will be properly protected by introducing high corporate standards in its by-laws that focus on protection of minority investors' rights. Moreover, it has never incorporated provisions like anti-takeover practices, diluting schemes or the existence of different types of shares that provide for different voting privileges.

Homex' leaders see additional advantages of having 35.1 percent of company's ownership such as:

- Aligning shareholder interests that leads to better decision processes
- Attracting investment and increasing share liquidity
- Increasing investor confidence: high percentage of shares in the market gives minority investors confidence that a dominant group will not make decisions contrary to their interests—an important factor in Homex' success.

"Walking the path of true institutionalization and creating value with it requires a powerful level of commitment, internal control and high corporate governance practices are critical tools to get this job done."

—Gerardo De Nicolás, Homex, CEO

2 Family Business Governance Challenges

Together with certain advantages in comparison to non-family owned firms, family businesses also face a set of challenges which they need to address to obtain the trust of investors and, in many cases, to make the company sustainable in the long run.

Through the years, numerous academic studies have looked at some of these challenges and weaknesses:

› In 1988, Holderness and Sheehan[67] found that among US corporations, family firms have a lower market value than non-family firms.[68]

67 HOLDERNESS, C. G., & SHEEHAN, D. P. (1988). The role of majority shareholders in publicly held corporations. *Journal of Financial Economics, 20*, pp. 317-346.

68 The study measured companies' "Tobin's Q," a proxy for corporate market value calculated as the market value of a firm's assets divided by replacement value of the firm's assets.

- In 2001, Pérez-González found that the stock market reacts negatively to the appointment of family heirs as managers.[69]
- In 2004, Villalonga and Amit reported that family control exhibits specific weaknesses when descendants are involved in top management.[70]

So, even if family businesses are recognized as a valuable asset, the risks associated with concentration can drive away additional sources of finance, thereby reducing the company's value or restricting available credit terms.

The main challenge in family business governance relates to the existence of an additional layer of relationship that the owning/controlling family brings to the business.- For shareholders this complexity includes understanding the various interconnections among the owning/controlling family members. These roles include:

- Family member/owners
- Family member/directors
- Family member/managers
- Family member/employees
- Family members who are not shareholders, but are extended family and heirs
- Family members who are some combination of these roles

Typically, family businesses in the first generation—and sometimes in the second generation—are managed by the founders and other family members. These businesses often face the challenge of attracting good specialists to assume management positions. They face even more difficulties in retaining such qualified professionals. The relationship between family/managers and non-family professionals must be carefully crafted to maintain a well-functioning management team and to lead the company to success.

Relations between the family as shareholders and non-family investors also present challenges. Non-family external investors often have significant influence over the shaping of the family business' governance. Their views on corporate governance are converging due to economic globalization and emergence of global investors.

Despite convergence of governance patterns in the competition for capital, differences are likely to remain, from country to country and from industry to industry.

There is also a trend toward standardizing understanding of good governance for investors and international capital markets. Notes one institutional investor in response to a 2006 global study of institutional investors:[71]

> *"Global capital markets have become more integrated. Corporate governance becomes a common theme in the global investment community. It can serve as a screening tool to nail down the portfolio candidates. Moreover, it can also serve as a benchmark for our investment portfolio." —Institutional investor 2006*

69 PEREZ-GONZALEZ, F. (2001). Does inherited control hurt firm performance? *Working paper Columbia University.*

70 AMIT, R., & VILLALONGA, B. (2006). Benefits and costs of control—enhancing mechanisms in U.S. family firms. *SSRN Working Paper.*

71 2006 ISS Global Institutional Investor Study, by RiskMetrics' wholly owned subsidiary, Institutional Shareholder Services (ISS), 2006. Reproduced by permission of RiskMetrics Group, Inc. . ©2006-2009 RiskMetrics Group, Inc. All rights reserved.

This study, from RiskMetrics' subsidiary, also finds that the majority of investors say that corporate governance is more important today than it was three years ago. They also say that it will become even more important in the next three years—including for family businesses. Investors place a strong value on corporate governance, minority shareholder protection and transparency. As a result, they want family businesses to have structures and processes that are globally recognized as good practices without necessarily considering the family business governance specifics.

In addition, family-controlled firms often face a difficult choice as they confront the need to fund growth by attracting equity: do they cede partial control to external shareholders and change their old habits and ways of running the business, promoting tangible improvements in corporate governance in exchange for capital for growth?

This discussion shows that family companies must consider a variety of sometimes conflicting issues when competing for resources alongside global companies, particularly in countries with institutions, regulatory frameworks and enforcement mechanisms that do not inspire the confidence of investors. There are additional challenges as well:

- Quite often, especially during the early, start-up stages of the family business, the company and family relationships are not clearly distinguished. This is particularly true with respect to financial relations and accounts—the company's and family's assets are not legally separated. This causes problems in distinguishing company-owned assets, and how company-owned assets can be used by the family as a shareholder.
- Existing governance-related policies are informal, as a general rule. This can lead to reliance on key people rather than on structures and processes. Such "common" understandings may not be as universally-held or understood when situations change. As a result, there could be some uncertainty on the part of external investors and non-family employees.
- Weaknesses in governance systems of family businesses are most evident in internal controls, internal audit and risk management. Since many family businesses are managed by the founders or their children, the control environment is largely tailored to their needs. The problem: the controls do not grow along with the company, as the business becomes more complex. This gap is a primary area of concern for external investors.
- Governance challenges only increase as the family and business grow more complex with each succeeding generation.

3 Governance Solutions to Family Business Challenges

This section looks at various governance solutions to the challenges unique to family-owned businesses, and covers a variety of topics:

- Distinguishing governance solutions in different ownership stages of the family business
- Family governance institutions
- Family governance documents
- Specific solutions to some family governance challenges
- Succession planning in family-owned business
- Case study: Ultrapar

To address the challenges detailed in the previous section, family businesses have come up with many governance solutions that are specific to their ownership structures.

Research published by IBGC in 2006 analyzed 15 family-controlled companies and found that these companies had five main motivations for seeking improvements in their governance policies and practices:[72]

- To institutionalize and perpetuate the business model
- To provide the means to implement the defined strategic plan
- To add value for shareholders
- To enhance the potential for attracting debt financing, resources and shareholders
- To improve the company's image abroad, facilitating globalization and reaching a base of foreign investors

The study provides clear evidence of the value of good governance to such companies. The study sample was comprised of listed companies with certain liquidity levels. They also met a certain standard of relatively advanced corporate governance practice. The research found a relevant and meaningful positive correlation between the quality of corporate governance at these companies and their operational and market success.

The analyzed companies are on average larger and are worth more. They have higher market multiples. They are operationally more profitable, with more liquidity. They pay higher dividends. And they are more solvent in the short term and more leveraged than the average of all listed companies on BM&FBOVESPA. The study also concluded that the analyzed companies typically follow better corporate governance practices than an average company listed with BM&FBOVESPA.

Family-owned members of the Companies Circle have faced a similar set of motivations. The stories that follow provide concrete illustrations of the reasons to initiate corporate governance improvements in family companies and the benefits they afford to the controlling family, the family business and outside investors.

"I don't know cases of families in Latin America that had become more united because of money, but I do know of many cases where families have destroyed companies because of money. The lesson to be learned here is that company value is what unites shareholders, irrespective of whether these are family members, institutional shareholders or investors who are external to the controlling groups."

—Roque Benavides, *Buenaventura, CEO*

[72] IBGC, BRAZILIAN INSTITUTE OF CORPORATE GOVERNANCE (2006). Corporate governance in family cotrolled companies: relevant cases in Brazil. *São Paulo: Saint Paul Institute of Finance.* The companies analyzed include Gerdau, Gol, Itaú, Klabin, Localiza, Marcopolo, Natura, NET, Pão de Açúcar, Randon, Sadia, Saraiva, Suzano, Ultrapar and Weg..

Buenaventura transforms from family-run firm to professionally-managed company

In Latin America, as elsewhere, family fights have destroyed value and companies to the detriment of all. **Buenaventura** set out on the corporate governance improvement path as a way to avoid this situation, transforming the company from a family-run business to a professionally-managed firm. With a focus on aligning the family's objectives with those of long-term shareholders and ultimately maximizing value for all shareholders and implementing good corporate governance, the company's founders and their successors believe they have avoided the kinds of family disagreements that could have harmed or destroyed the company.

As a listed company on both the NYSE and the Lima Stock Exchange, company leaders have seen that investors really care about corporate governance, and adopting such practices truly pays off. The company underwent an entire culture shift, affecting all shareholders, including family members, to focus on the benefits for the company as a whole. The family's objectives with respect to the company and non-family shareholders' objectives are the same, as all are interested in enhancing shareholder value.

Generational shift at Ferreyros

This company's significant change in the pattern of ownership and control over time is rooted in family factors. The first generation of founding partners passed on their ownership to the second. But not every second generation family member wanted to participate in the business, since the heirs had other interests for their careers and lives. So the owners opted to turn over the company's management to professional non-family managers and to create a broad and diverse base of shareholders. To facilitate the transfer of the company's stakes to new owners, **Ferreyros** registered its shares on the Lima Stock Exchange, an initiative that required the implementation of corporate governance improvements to attract investment and enhance the company's controls and performance.

3.1 Distinguishing Governance Solutions in Different Ownership Stages of the Family Business

Corporate governance solutions that family businesses can adopt will vary depending on the stage of the controlling family's ownership. Some structures and processes are adapted to situations in which there is a single person, the founder/patriarch of the company, in charge of the company. Other solutions are better suited when the next generation takes over the business. And a third set of governance solutions are appropriate for companies controlled by family members of later generations.

Harvard professor John Davis developed a model to help understand the three-phased evolution of family companies, shown in Figure 5.3.[73] The initial phase, in which all dimensions are concentrated in one family, groups of families or the individual founder is known as the "founders stage." As time goes by, the company grows and transitions ownership to the next generation, a stage called the "siblings' partnership." As more time passes, the company transitions to future generations, reaching maturity—a stage Davis calls the "cousins' confederation". When the firm reaches maturity, according to the model, the challenge is to renew and recycle in order for the company to continue.

[73] GERSICK, K. E., DAVIS, J. A., HAMPTON, M. M., & LANSBERG, I. (1997). Generation to generation: life cycles of the family business. *Boston: Harvard Business School Press.*

Figure 5.3 Development and Transition of Family Businesses Over Time

Source: Better Governance, based on GERSICK, Kelin E., DAVIS, John A., HAMPTON, Marion M., and LANSBERG, Ivan I. Generation to Generation: Life Cycles of the Family Business. (1997)

For Your Consideration

Remember that what works at one stage of this ownership cycle usually does not work well at other stages. So controlling families should take a careful look at the governance solutions recommended for their particular stage of development.

The governance solution you choose for your family business should depend on the ownership stage your company is in.

3.2 Family Governance Institutions

Transferring the values and business knowledge of the founders to future generations becomes more difficult as the family grows. The challenge is to keep the generations and all family members united and their interests aligned over the years. When families reach the third and fourth generations, their members may barely know each other. It becomes more difficult to maintain aligned interests within a large family, especially given that the demand for creation of wealth for future generations increases as time passes.

As the competition for resources and power within the family intensifies, it becomes increasingly difficult to maintain a common purpose. How does a family maintain a shared vision about the company? All sorts of diverging views can arise: on ownership, on the degree of control that the family intends to retain, on the family's involvement in the company's governance either through the board of directors or executive management.

The good news: help is available. Family business consultants and groups focused on governance say that several easily accessible publications can help families and their business with finding answers to these and other relevant questions. The IFC Family Business GovernanceHandbook,[74] published by the International Finance Corporation, recommends the

[74] IFC, INTERNATIONAL FINANCE CORPORATION (2008). Family Business Governance Handbook, *http://www.ifc.org/*

establishment of family governance institutions that can help strengthen family harmony and its relationship with the business.

The handbook, aimed at guiding families as they initiate best governance practices on the corporate and family levels, suggests that allowing family members to gather under one or more organized structures, strengthens communication links between the family and its business. This approach also provides opportunities for family members to network and discuss issues related to the business and the family. Table 5.4 highlights the types of governance structures families might establish, depending on the stages of the family company's development. In addition to governance-related structures presented in the table below, families might consider establishing other structures, such as family office, education committee, share redemption committee and career planning committee.

Table 5.4 Family Governance Institutions

	Family Meeting	Family Assembly	Family Council
Stage	Founder	Sibling partnership/ cousin confederation	Sibling partnership/ cousin confederation
Status	Usually informal	Formal	Formal
Membership	Usually open to all family members. Additional membership criteria might be set by the founder	Usually open to all family members. Additional membership criteria might be set by the family	Family members elected by the family assembly. Selection criteria defined by the family
Size	Small size since family still at founder stage. Usually 6–12 family members	Depends on the size of the family and membership criteria	Depends on criteria set up for the membership. Ideally 6–12 members
Number of meetings	Depends on the stage of the business' development. When business is growing rapidly, can be as frequent as once a week	1-2 times a year	2-6 times a year
Main Activities	› Communication of family values and vision › Discussion and generation of new business ideas › Preparation of the next generation of business leaders	› Discussion and communication of ideas, disagreements, and vision › Approval of major family related policies and procedures › Education of family members on business issues › Election of family council and other committees' members	› Conflict resolution › Development of the major family-related policies and procedures › Planning › Education › Coordination of the work with management and the board and balancing the business and the family

Source: IFC Family Business Governance Handbook

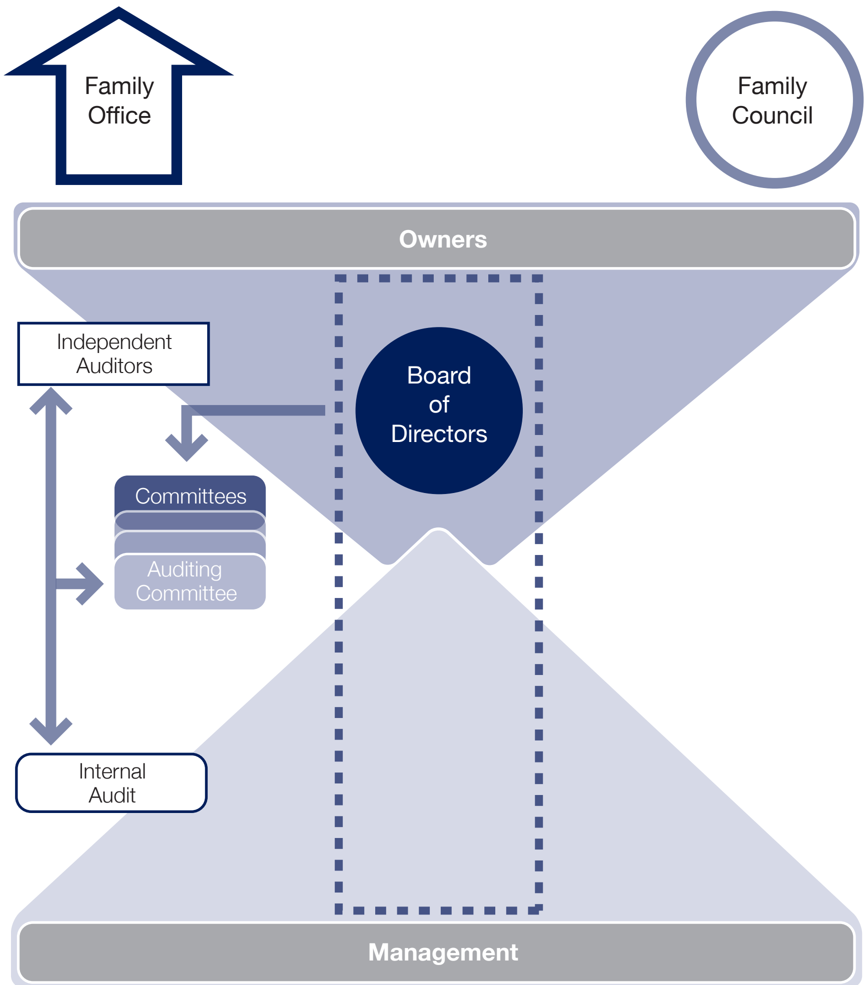
Figure 5.5 shows that once the "cousins' confederation" stage is reached and the company opts for renewal and recycling, the company adopts good governance practices for the company and the family with the creation of the family office and the family council.[75] This action

ifcext/corporategovernance.nsf/AttachmentsByTitle/Family+Business_Second_Edition_English+/$FILE/Englilsh_Family_Business_Final_2008.pdf, pp. 31-32.

75 The family office is an investment and administrative center that is organized and overseen by the family council commonly in large and wealthy families. The office is the mechanism through which advice on personal investment planning, taxes, insurance coverage, estate planning, career counseling and other topics of interest is provided to individual family members. For more detail, see IFC, INTERNATIONAL FINANCE CORPORATION (2008). Family Business Governance Handbook, *<http://www.ifc.org/*

separates the various dimensions and establishes practices that generate greater transparency and the trust of outsiders. This stage involves the most extensive family governance institutions and business governance structures. Good communication between the two sets of structures is key to business success and family peace.

Figure 5.5 The Governance Structure of Family-Controlled Companies with Good Practices



Source: Better Governance

3.3 Family Governance Documents

Family governance structures and institutions require a certain degree of formalization if they are to function well. As families adopt policies on the family's approach to the business and on governing the business, they will formalize these efforts with documents that will differ depending on their ownership stage.

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ifcext/corporategovernance.nsf/AttachmentsByTitle/Family+Business_Second_Edition_English+/$FILE/Englilsh_Family_Business_Final_2008.pdf>, pp. 32-33.

Typically, in the earlier stages when the company is governed by the founder or his/her children, many aspects of family and business governance are informal. Any efforts to formalize relate mostly to the business itself. First attempts at written policies usually are brief documents that state a general family vision and mission with respect to the company.

The next level of formalization comes with the need to develop a family employment policy. This becomes more apparent when the company reaches the sibling partnership stage. The family employment policy sets clear rules on terms and conditions of family employment within the firm. For some families, these rules stipulate conditions of entry, retention and exit from the business. The policy also should cover the treatment of family member employees vis-a-vis non-family employees.[76]

In third, fourth and succeeding generations, family businesses can barely survive unless full family governance policies are written and communicated within the family and the business, as well as to other outside stakeholders. The document covering all of these policies is commonly called a family constitution. This document expresses the family's principles regarding the family commitment to core values, vision, and mission of the business. It often defines the roles, compositions, and functions of family governance institutions and the company's own governance bodies, such as the shareholders' meeting, the board of directors and senior management.[77]

For Your Consideration

Creating a family constitution will codify all of your family-related governance policies.

3.4 Specific Solutions to Some Family Governance Challenges

As companies focus on maintaining all the benefits afforded by family ownership and supplementing them with good governance processes and structures to enhance competitiveness and foster growth, they will face challenges.

Solutions used will include mechanisms to:

- Separate functions of ownership, control and management
- Create family offices to clarify the boundaries between the family's and company's accounts
- Develop the skills and knowledge of heirs so they can become responsible owners, as they can assume various roles as an owner, director or an employee

Processes and structures for decision-making will vary: it is one thing to decide on family matters and quite another to tackle company business, with issues such as division of equity and the like. The family council, created to address family issues should remain completely separate from the board of directors and from shareholders meetings, both of which focus on company-related decisions.

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76 IFC, INTERNATIONAL FINANCE CORPORATION (2008). Family Business Governance Handbook, <http://www.ifc.org/ifcext/corporategovernance.nsf/AttachmentsByTitle/Family+Business_Second_Edition_English+/$FILE/Englilsh_Family_Business_Final_2008.pdf>, pp. 23-27.

77 For more information on family constitutions, see IFC, INTERNATIONAL FINANCE CORPORATION (2008). Family Business Governance Handbook, *<http://www.ifc.org/ifcext/corporategovernance.nsf/AttachmentsByTitle/Family+Business_Second_Edition_English+/$FILE/Englilsh_Family_Business_Final_2008.pdf>*, pp. 24-25.

It is true that introducing governance measures will not resolve every investor concern about family-owned or controlled firms. Still, instituting structures and processes for the family and the business can address some key challenges.

Keeping peace in the family: Keeping peace in the family is important for inter-personal, social and business reasons.

The problem

Conflicts among the siblings who run the business or misunderstandings between different family branches may spill over to the company's domain and create problems for other shareholders.

- How to manage relations between family members who work for the family business and those who are only owners and rely on dividend income from the success of the company: These two groups may have diverging interests and varying degrees of access to company information, which may lead to an atmosphere of distrust in the family.
- How to manage situations in which some family members want to work for the company, and others want to pursue their own interests, possibly leaving the family business entirely.

Suggested solutions

Family governance institutions can play an important role as places where sensitive issues can be discussed and solutions found.

- A family assembly or family council can mull over the issues and develop policies on how dividends are determined and distributed to make sure that the family is satisfied in ways that are not detrimental to the success of the business. Putting things on the table and openly discussing contentious issues is often the fastest way toward finding a solution acceptable to all concerned parties.
- The family can create a liquidity fund, which could be used by the family to redeem the shares of family members who wish to pursue their own interests outside of the family business. Some companies even establish special committees with oversight for the redemption policies.

Presence of outside, non-family shareholders: This situation poses its own set of challenges.

The problem

- How can the company ensure that these external investors are fairly treated? These investors might have interests and views on the role and results of the business that diverge from the controlling family's point of view. Investors also might have different levels of access to company information. In some cases, external investors have even less information than non-management, family shareholders.

Suggested solution

Corporate governance improvements may help.

- Empower the board of directors to arbitrate between the family and outside shareholders. A board that performs classic functions of management oversight and helps management define and pursue the company's strategic direction is capable of aligning the interests of all types of investors.

- The presence of independent directors can reinforce the board's mediating role. Independent directors can provide an outside, objective perspective for business decision-making. They can act independently to resolve conflicts of interest and family governance problems, such as employment issues.

3.5 Succession Planning in Family-Owned Business

Succession planning is a sensitive issue and involves such dilemmas as:

- How to maintain objectivity when family feelings are involved.
- How to make objective judgments unimpaired by emotions.

Some useful steps for dealing with executive succession are presented in the checklist in Table 5.6.

Table 5.6 Checklist: Ensuring Strong Senior Management for the Family-Owned Company[78]

- ☑ Analyze the organizational structure and contrast the current and optimal roles and responsibilities (compared to peer companies) of each senior manager.
- ☑ Design a formal organizational structure that clearly defines the roles and responsibilities of all senior managers. This should be based on the company's current and future business operations' needs.
- ☑ Evaluate the skills and qualifications of the current senior management based on the new organizational structure.
- ☑ Replace and/or hire senior managers.
- ☑ Decentralize the decision-making process and approval levels as necessary. Decision-making powers should be linked to the roles/responsibilities of managers and not to their ties to the family.
- ☑ Establish a clear family employment policy and make its content available to all family members.
- ☑ Develop an internal training program that allows skilled employees to be prepared for taking on senior management assignments in the future.
- ☑ Establish a remuneration system that provides the right incentives to all managers depending on their performance and not on their ties to the family..

Over the years, the Companies Circle members have confronted the succession issues head-on. Here is a sampling of their approaches to resolving the problems.

[78] IFC, INTERNATIONAL FINANCE CORPORATION (2008). Family Business Governance Handbook, *<http://www.ifc.org/ifcext/corporategovernance.nsf/AttachmentsByTitle/Family+Business_Second_Edition_English+/$FILE/Englilsh_Family_Business_Final_2008.pdf>, p. 47.*

"…The times we live in, where competition for capital is fierce and globalization forces us to compete globally, the international competitive scenario requires companies to be experts in adapting to ever-changing scenarios. The preparation of an advance succession plan will allow for the transition from one stage to another to be carried out smoothly, avoiding interruptions."

—Roque Benavides, *Buenaventura, CEO*

Buenaventura separates board and management

This firm's initial succession process involved separating the position of chairperson of the board from that of general manager. This was a controlled and natural process, approved by most shareholders.

The next stage—succession planning at the general manager and other senior management levels—is a topic of frequent discussion at **Buenaventura**'s board meetings. Now, the company is in the preliminary process of identifying and evaluating potential in-house candidates, with the idea of developing new capabilities. The search also will extend to consider outside candidates.

As a company and as a family, Buenaventura seeks to ensure continuity of the corporate vision. The executives who are appointed to manage the business in the future must be the candidates best equipped to continue generating growth and increasing value for the shareholders and stakeholders. The board is playing an essential role in this succession process, ensuring that competent professionals are involved in the selection process and that the decision criteria fit with the company's vision, mission, values, and strategic choices. The board also can exercise its full powers to resolve any internal conflicts that might arise during the process.

Non-family professionals take the helm at Marcopolo

Non-family professionals took the management helm for the first time at **Marcopolo** in 1995, with the appointment of a team of executive directors who were not shareholders. Ten years later, although this executive team was still young, it became apparent that the company needed a succession plan. Since 2005, the company has focused on managing succession.

Currently, Marcopolo's senior executive succession plan looks like this:

- Retirement policy: At age 60, with possibility of a five-year extension period in special cases
- Retirement preparation plan: Policies for potential continued relations between the company and the retired executives, such as consultancy, or appointment as a board member in controlled companies

- Board role: Regular follow-up on the succession plan, mainly through the company's human resources committee

In addition to the succession of business leadership positions, family businesses should pay close attention to ownership succession and preparing future generations of owners.

For Marcopolo this meant developing a formal ownership succession plan. Currently, the two potential candidates for succession attend in-house and external training programs. The main theme of these courses is the enhancement of knowledge, skills and technical know-how to become competent company shareholders—the successors at Marcopolo decided that they would only assume the role of shareholders, with seats on the board. They leave the role of managing company operations to external management professionals.

Elements of Marcopolo's Training for Family Ownership Succession Candidates

- In-house training: Lectures on specific characteristics of industrial, engineering and manufacturing areas
  - commercial knowledge-building emphasizes sales and marketing strategies
  - administrative and financial knowledge-building focuses on strategic planning, budgets, accounting, cash management and company finance
- External training: Courses and seminars given by institutions that are highly regarded in the academic world and the corporate community

"This was an outstanding process, brilliantly planned and executed accordingly. Succession was successful and created room for new executives to join our group."

Ana Maria Igel, wife of Pery Igel, son of Ultrapar's founder

Succession process for Ultrapar

At **Ultrapar**, Pery Igel, the son of the company's founder, viewed some of his hired executives as allies who could help protect the company from the uncertainties that a business dependent on family management and capital could face. In the 1980s, Igel drew up a process for his succession based on two key elements:

- Professionalization of Ultra Group's management
- Shared control of the company between heirs and key executives

To carry out this plan, Igel distributed beneficiary shares to his heirs and transferred shares to executives. A shareholders agreement, formalized in the mid-1980s provided for reciprocal rights of first refusal in the event of sale of controlling shares. It established two separate holding companies with a defined life span of twenty years and control over the umbrella firm, Ultra S.A:

- Igel Participações: held by the heirs of the family
- Avaré Participações: held by Ultrapar executives

During this period, new management leaders were trained to prepare them to lead the company's growth. These executives who were now also owners had their interests aligned with those of the family. In the transition stage, a new group of executives received shares, but with a shorter time horizon in which to dispose of the shares.

In late 2004, the two holding companies were dissolved, and the corresponding shares were passed on directly to Ultrapar's heirs and executives.

Two years later, in 2006, a new succession process took place. This time the CEO—one of the executives who received shares from Igel as part of the original 1980s share transfer—was replaced by a professional groomed internally by the company. The former CEO retained his position as chairman of the board of directors—yet another step in the company's evolution towards better governance.

Suzano Restructuring

In 2002, as the Feffer family's third generation began to assume more leadership, the company initiated a thorough restructuring process. The goal: to ensure that the businesses in which the Group had decided to invest—pulp and paper and petrochemicals—would be sufficiently capitalized for long term sustainability, able to grow, with competitive costs of capital through its partnerships with the capital markets. Efforts also were designed so that the businesses did not depend excessively on the controlling shareholder's capital.

Case Study: Suzano and 83 Years in a Family-Controlled Company

The path to good governance requires a tailor-made approach that addresses the particular challenges, vision and purpose of each company. It also must be understood in the context of the level of maturity of the controlling family, its shareholders and the controlled companies.

Working with strangers who are managing your company and sitting in your boardroom for the first time might be an uncomfortable experience at first, especially when you are not sure of its value. This challenge was experienced thirty years ago at Suzano by Max Feffer, son of founder Leon Feffer and father of current board chairman David Feffer. The different stages experienced through the years helped make it possible for the organization to react in a fast and effective way when Max Feffer died, creating a model to survive family uncertainties.

The Suzano Group designed a structure based on family control and on maintaining a close relationship with capital markets. The arrangement allows heirs of the founders to exercise control through the board of directors, while management is comprised of non-family executives. The family acknowledges that this move has enabled more potential development and expansion of the company, and protects the business from possible intra-family conflicts.

Of course, the extent of governance processes and structures that the company follows depends on the development stage of the company and the controlling family. It requires careful and gradual introduction and implementation of governance measures, which can be improved and enhanced over time.

A big picture of the phases of Suzano's company development as shareholders' involvement in the company evolved is shown in Table 5.7.

Table 5.7 Suzano´s Development Phases

Phase	Benchmarking Process
First phase (1920s-1970s)	› Founded by Leon Feffer at the age of 20. He maintains leadership until his death in 1999. › Management highlighted by his entrepreneurial style and centralization
Second phase (1970s-2001)	› Max Feffer joins executive management in the 1970s › Development of executive managers and heirs › First executive president and first non-family board director
Third phase (2001-present)	› Max Feffer dies › New model of governance and management › David Feffer presides over the board with executives in management

The timeline in Figure 5.8 shows the milestones in each phase of company development, the impact and next steps. On the right-hand side one can see the most recent phases of the process, culminating in the installation of a new governance structure and the sale of one of the units, generating significant value for the shareholders

Details of the Restructuring. In 2002, as the Feffer family's third generation began to assume more leadership, the company initiated a thorough restructuring process. The goal: to ensure that the businesses in which the Group had decided to invest—pulp and paper and petrochemicals—would be sufficiently capitalized for long-term sustainability, able to grow with competitive costs of capital through its partnerships with the capital markets. Efforts also were designed so that the businesses did not depend excessively on the controlling shareholder's capital.

For this to happen, the two companies, Suzano Papel e Celulose and Suzano Petroquímica, had to comply with corporate governance standards consistent with best market practices.

In 2003, the Group implemented a new business model based on three pillars:

- Family control: For the Group's long-term vision, reputation and values

- Professional management: For capital discipline and a fast decision-making process
- Partnership with the capital markets: To assess company performance on a permanent basis, promote the continuous practice and enhancement of corporate governance standards and ensure business growth and development

A first step in the Group's restructuring process: Suzano Holding began to run Suzano Papel e Celulose and Suzano Petroquímica subsidiaries through a professional management team, recruited in a search that considered internal and external candidates from the marketplace.

The new professional management team, comprised of highly-qualified executives, streamlined corporate operations spread among the subsidiaries. Their efforts have resulted in 30 percent cost reduction, improved management performance, implementation of appropriate subsidiary control mechanisms, and management accountability for results. The team also implemented a new monitoring model allowing for improved monitoring of and reporting for subsidiaries.

These successes have enabled members of the controlling family to step aside from their executive role in these subsidiaries and assume a more strategic position, minimizing succession-associated risks to the continuity of the Group's businesses. Some members of the family began to participate in the strategic management of Suzano Papel e Celulose and Suzano Petroquímica through appointments to the boards and related management and strategy committees, along with other Suzano Holding executives. So, the Group created processes to ensure a better balance between greater management independence for the subsidiaries and long-term strategy for the controlling shareholders.

These improvements have marked an important change in the behavior of the controlling shareholders. After decades of a hands-on approach to the businesses, the controlling family withdrew from day-to-day management, delegating to professionals and assuming a more strategic role. For members of the family who had truly grown up in and with the company, this represented a huge paradigm shift.

In the Words of the Entrepreneur: David Feffer Tells the Suzano Story [79]

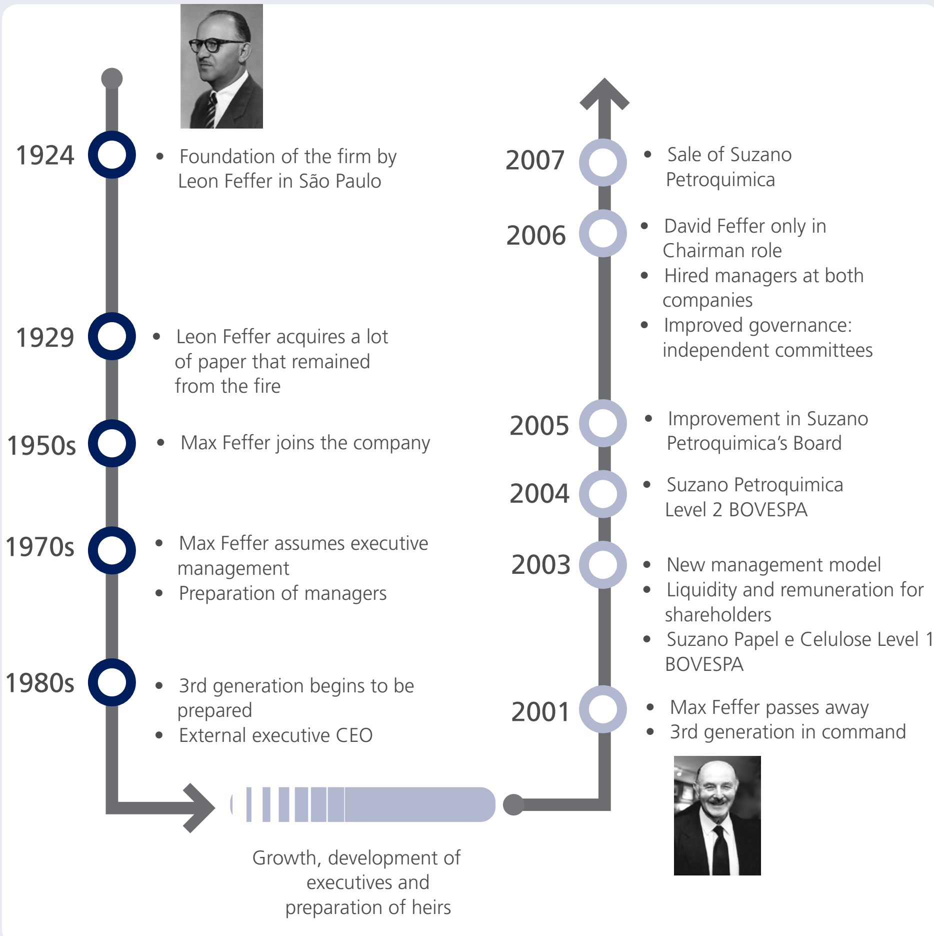
Understanding the enhancement of corporate governance practices in Suzano Group demands, at first, the rebuilding of the path since its foundation in 1924 by my grandfather, Leon Feffer.

The implementation of the Brazilian industry in the early 1950's, more concentrated in the state of São Paulo, was the scenario of the beginning of our industrial activities. This movement was led by important entrepreneurs, who set up family-owned conglomerates strongly responsible for the development of Brazilian industry.

The beginning of our activities was in the pulp and paper industry. In the 1950's, we developed the technology for the production of pulp from eucalyptus and became the first company in the world to produce it on an industrial scale. For that,

[79] Written for UPsides, FMO quarterly magazine, Number 2, Netherlands, April 2007.

Figure 5.8 **Progression of Suzano´s Leadership Succession and New Governance Model**



Source: Better Governance with Suzano data

my father, Max Feffer, and a group of Brazilian scientists spent some months at the University of Gainesville, Florida (USA), studying alternatives for pulp production using native Brazilian trees, since all the pulp produced at that time was based on pine trees, common in European countries.

In the 1970's we diversified our activities towards the petrochemical industry since we identified an important growth trend in the use of plastic in the packaging segment, an important market for the paper industry, thus seeking to keep our presence in that segment.

My grandfather's management ended with his death in 1999, at the age of 96, leaving behind entrepreneurship as his legacy, which enabled the substantial growth of our business.

Then, my father, Max Feffer, assumed command and marked his management by preparing the Group for the strategy towards the capital market. Under his command, the Suzano Group defined its growth platform, divested from non-core assets and focused investment on our main businesses, which were separated into two different companies, Suzano Papel e Celulose and Suzano Petroquímica.

With my father's unexpected death in 2001, after little more than two years leading the group, the controlling shareholders—my brothers, my aunt and my mother—unanimously invited me to assume command of the Group. I accepted and we discussed how we would face the future. I said: "We have two options; there is no right or wrong decision, nor one that is better than the other. But whatever is to be done will be definitive. There is no turning back."

We could continue being a family business, like in my grandfather's and father's days, or become a professional company with a strong and clear capital market strategy. In the first case, I explained, Suzano could perfectly serve the current generation of our family, but the future would be uncertain because it would probably be difficult to access the necessary resources for modernization and growth of the businesses. We need to always keep in mind that we participate in two capital intensive companies. Therefore, we could begin to face serious difficulties to invest, reinvest and compete in the marketplace.

On the other hand, professionalizing the companies and reinforcing the partnership with the capital market, would allow us to leave the 21st century better than how we started it, also having access to competitive funding to successfully face future investment challenges.

Both options were correct. The second one, however, presented another advantage: the perspective of solid value generation, business sustainability and the maintenance of the values and beliefs of the founders, who did not just think about the present, but also the generations to come. Everybody was conscious that taking the capital market route would entail having to live from the results of the businesses rather than directly from them. Between the two options, the second one prevailed.

Despite all the changes this process has brought, the transitional phase was very smooth and, in fact, represented an enhancement of our way of doing business. We had very sincere and realistic conversations. We closed the door to the past and opened the gates to the future. The basic foundation was that Suzano should belong to all shareholders, including the Feffer family. When we made that decision, the difficulties started to be felt. First, we requested to be dismissed from our positions. We needed to create a meritocracy criteria in the Group, paving the way to promote *stronger development, to reformulate assessment parameters and, particularly, to treat all shareholders equally.*

All these changes were very challenging. I had grown up getting ready to be the president of the Group one day. Suddenly, I was forced to commit a kind of hara-kiri. I left management's front line to take over as chairman of the board of directors of both companies, which are responsible for defining business policies, long-term global strategy and for the supervision and management of executive directors. It was not easy. The process progressed. We hired executives from the marketplace. We began to define and align strategic actions for the pulp and paper and petrochemical businesses counting on the support of a professional senior management.

In 2003, we implemented the new management model with the adoption of high standards of corporate governance practices, based on three pillars: family control, professional management and partnership with the capital market.

Independent members are also part of the board of directors of both companies, transforming them into an important place for debates focused on adding value for the businesses. Suzano Papel e Celulose and Suzano Petroquímica are listed in BOVESPA's special of corporate governance segments, which ensure a fair, transparent and reliable relationship with the shareholders and the capital market. We created the Audit, Sustainability and Strategy, and Management committees, which are responsible for discussing these subjects in depth, with the goal of better support for the board of directors in its decision making. The boards of directors at the Suzano companies have internal rules defining their operating procedures and guidelines for performance, qualification and assessment of their members.

We launched our code of conduct based on the ethical principles that always guided our activities: integrity, equality, transparency, professional recognition, corporate governance and sustainable development.

The benefits of better corporate governance and the capital market strategy became evident when we realized that the access to capital was bigger and easier, coupled with lower sensitivity to market volatility. The capital market has an additional important role of permanently evaluating the performance of the company and its management. If the results do not meet expectations, they are criticized by analysts, and investors tend to step back. It is a matter of coherence between what is promised and what is done. If there is good management, what was promised is delivered and the capital flows. Otherwise, the market penalizes the company. There is no way to hide this reality. Management is either positive or negative. The capital market, naturally, is practical, very clear and pragmatic.

When a company adopts high standards of corporate governance, it should have greater responsibility for results. The balance between right and wrong has a higher importance since the control systems acquire a wider perspective, with respect to detailed and clear rules. For Suzano Group, corporate governance is a guarantee of the sustainability of what the founders created. It is the evolution of a dream. We may face difficulties along the way, which are natural. But good corporate governance practices contribute to the continuity of the Suzano companies, and make its foundations resistant to this irreversible movement called globalization. And, thanks to these good governance principles and the good performance of our businesses, the capital markets have learned to value and respect our controlling position.

—David Feffer, *Suzano, Chairman of the Board*

Suzano Group sold its petrochemical operation to Petrobrás in 2007, creating value for its shareholders. This would have not been possible without key improvements in corporate governance.

This chapter addressed the unique corporate governance challenges facing family businesses.

For Further Thought and Discussion

- Are you a member of a family that owns a company? If so, identify some of the main challenges facing your company and your family.
- Are you a non-family senior executive in a family-owned company? List some of the main challenges facing the firm.
- Based on the discussions in this chapter, name some specific steps towards resolving these challenges, using suggested corporate governance practices. Remember to first identify the company's ownership stage—still led by the original founder? Are direct heirs in control? Effective actions will depend on pegging them to the right phase in the company's lifecycle.