<u>Jobs vs. Wealth:</u>

Choices for a Sustainable Family Business Legacy

(This article was first published in Gulf News on April 11, 2019)

Recently we were asked a very interesting question by a senior Family Advisor for a very large family group in the UAE. His query to us: “When you work with family businesses, is it about jobs or wealth?” We asked him to elaborate so we could understand the full nature of his question. He gave us some context highlighting that he was advising the family group to implement governance structures which would lay the foundation for a sustainable legacy passing from generation to generation. During this journey they found themselves stuck on a fundamental question: “what is the purpose of a sustainable family legacy- is it to provide jobs for family members, or is it to secure and generate wealth for family members?”

The context of his question was rooted in their collective experience of observing numerous family legacies in the region fall into decline. The statistics on this speak for themselves- globally, 97% of family legacies collapse before they reach the fourth generation – commonly referred to as the third-generation curse. Put another way, only 3% of family businesses around the world successfully transition the legacy past the third generation. In the Middle East, this family group along with many others are fast approaching this generational cliff. Most have 2G family members actively working and integrated into the operating businesses, and many others have incorporated some 3G members.

<u>Family Business Decline</u>

There are generally two models of decline in a family business- fast and slow. A rapid descent happens when a confluence of issues in the family sphere, the ownership sphere and the business sphere (from the famous 3-Circle Model for family businesses developed at HBS by Renato Tagiuri and John Davis) take down the legacy in the span of a decade. As an example, family unity and values may not be deeply embedded, exacerbated by the fact that the ownership is unstructured with future succession undefined, and to top it off, the legacy business is up against a challenging economic environment. Families facing an onslaught on all three fronts collapse quickly under the pressure, affecting all areas of the family, the business and the wealth, with tremendous value destruction along the way.

Such tragic stories are all around for people to see, and not just in the region but around the world. That said, most family legacies go through a more sustained descent when the issues are not as pervasive across all three spheres. Most of these are propped up by a good business model which keeps any underlying issues at the family and ownership level at bay. However, there too the infection will spread and ultimately overwhelm the system.

Recognizing the odds are stacked up against them, some families have started to act. In a 2016 survey conducted by our firm we found that one in four families in the Middle East and South Asia have started implementing some level of governance mechanisms, e.g., family constitutions (also referred to as family charters), family councils and assemblies, business boards, shareholder agreements and so on. However, 75% of these went on to admit that the systems were not properly implemented or were not functioning well. This means that only 5% of family businesses from our survey had satisfactory and effective governance mechanisms.

So, what was the secret sauce for these 5% of families? Upon closer examination we found a fundamental truth at the heart of sound family governance- simply put, family governance is not about the policies, systems and structures alone; it must be accompanied by creating a healthy environment at the family level (and we mean the *entire* family, not just its leaders) to embed the governance culture in the family's DNA. This is a larger topic for another day, and we will come back to this in a later article.

Getting back to the original question posed at the start – jobs vs. wealth – we must first point out that these two paths are not entirely exclusive of each other; following one path could mean that the family will also receive "some" fruits from the trees along the other. Still, family leaders most often find in their governance journey that there is no middle ground between these two, at least not a good one. As in the case of the family group in question, they realize that it is important for them to clearly define what path they want to be on and what culture they want to instill, and to push forward on that path with the entire family in tow. So which path should they choose? Well the answer comes down to one of mindset.

Start with Jobs

If the mindset of the family is geared towards creating a lasting legacy, one that continues across generations, then the answer in our viewpoint and from our experience is *jobs, jobs, jobs*. Put another way, sustainable job creation is a required aim within the governance framework for any family that seeks to achieve a sustainable multi-generational family legacy. Wealth in this case becomes an outcome of this journey, not the focus of it. Such a legacy avoids the perils of stagnation and in fact grows due to the sustained contribution of its members.

To use an analogy, think about the governments around the world. It is not hard before you find examples of where extreme wealth has been created with the primary purpose of the leaders being to secure the wealth, and the power that comes with it. The result is that the society bifurcates into the haves ("chosen ones") and have-nots, with growing income and wealth gaps, finally leading to an implosion and revolution. In contrast, there are other nations which do an effective job of harnessing their resources to ensure their citizens are contributing members of society. These nations have historically achieved greater wealth and prosperity than the others, and all because of their citizenry, not despite it.

Family leaders face a similar mindset challenge as the family citizenry matures and as they undertake the responsibility of supporting and managing the growing numbers. Those who choose sustainable job creation as a goal and then implement it well, ensure that family members for generations are incentivized to develop and make their own contributions, thereby growing the legacy while also preparing them for future ownership. Some will further drive the diversification of the family portfolio into other sectors and geographies thus reducing overall portfolio risk. Others will drive a regeneration of the legacy business to bring it up to mark with the times.

Doing this right requires the family sphere and the business sphere to work closely to assess and develop family members, to plan and encourage their participation, to set and communicate clear expectations, and finally to support and be vested in their success. This process is not linear but circular, as in these modern times development is continuous, and success is not guaranteed. Policies in the Family Constitution dealing with Education, Employment and Welfare will need to be developed and carefully integrated, and the Family Council and Board of Directors will have to work closely together to implement these policies. We will have more on this in a future article.

What about Wealth?

When we shared this viewpoint with the advisor, there was an obvious counter: Is it not possible for family leaders to also focus on wealth preservation and wealth creation policies at the same time? The answer is absolutely yes, they can and should; however not as the foremost priority. With wealth as the primary concern, the likely scenario is that the family legacy will not survive past the current generation, and if it does, it will be a legacy of the individual and not of the family.

To illustrate this, we will share a fictional story which serves as a common example of what we have witnessed across families: In 1970, Henry Smith had a very innovative idea in the automotive industry and proceeded to amass a significant amount of wealth as a result of this. He is coming on in years and looking at his family he finds no capable successors for the future- no one worthy of taking the legacy to the next level. He also senses a lot of resentment towards him and underlying issues between family members preparing for the succession challenge that is coming. Henry decides that it is time to secure the wealth, most importantly to safe-guard it from the family. He puts in place the appropriate legal and financial structures with trusts and wills to ensure that everything is protected by professionals. He also decides to “professionalize” the business by putting in place a business board and an executive team with little to no involvement from family members.

What results of course is that the legacy continues, led by professionals who manage the businesses, the investments, and the foundations long after Henry has passed. Family members draw dividends and support their lifestyle and continue on their individual journeys. Some remain part of the original family companies, while others become successful entrepreneurs or go into the professional sphere, and the rest struggle to make ends meet. All share a loose connection of being descendants of the great Henry Smith, but apart from this, the family members are all on their own.

At this moment, it is easy to be sympathetic to Henry and his actions given the circumstances. There is no right and wrong in such complex matters- we all base our actions on our own perceptions of the current situation and our own biased prediction of the future. However, it is important to note the consequence of his mindset. In effect, by keeping his family on the sidelines, the legacy which Henry safe-guarded was that of his own – the Henry Smith legacy, and not the Smith family legacy. This is an all too common approach among family leaders once significant wealth has been created- to ensure that future family and ownership issues do not disrupt the wealth. Like Henry, most do not consider about what would happen to that family and their wealth when the current batch of leaders are no longer there.

Looking Forward

A different approach towards inclusion and support may have yielded different results. It is possible no one from the second generation would have succeeded Henry, but he might have found his heirs apparent among the third generation to take over and grow the legacy. Next generation family members who became successful businessmen could have supported diversification of the family group portfolio if the structures were in place to encourage participation.

That said, it is not easy for family leaders to step back and come upon this answer. In this region, there are several such leaders we have spoken with who have similar perspectives as Henry. They see limited options for the future, and possibly no one capable in their family to take over the mantle from them. Most of these leaders have gone forward and implemented policies to secure the wealth and professionalize the business. The challenge they face now is to ensure that their legacy does not become one for the professionals to inherit- where their founding vision, values and stories are now lost and relegated to the pages of a Wikipedia article. To succeed in this, family leaders must have the courage and stamina to create an inclusive, participative and results-driven culture in the family and business, supported by the right policies and systems. Such a foundation will set the stage for a family legacy which both sustains across multiple future generations, and also grows along the way with each group driving growth and diversification and making its own mark.

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