Trust as a Competitive Advantage

Why family firms have an edge in the global marketplace

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Family businesses, the most common type of business form world-wide, share characteristics and working styles that can provide strategic advantages.

A few years ago the large Mexican brewery, Cervecería Cuauhtemoc Moctezuma, found itself needing to make a strategic decision. About three-quarters of its exports went to the southwestern United States where its brands - including Tecate, Carta Blanca and Dos Equis - are very popular. The devaluation of the peso in the early 90's meant that the cost of production in U.S. dollars had dropped significantly, providing a nice increase in profits. Furthermore, the implementation of NAFTA provided brewers in any of the three signatory countries the opportunity to sell their beers across national boundaries without major restrictions. It was clear that to stay competitive in this new environment Cuauhtemoc would need to expand its North American franchise as other large breweries were doing.

However, large as it was, Cuauhtemoc needed a partner to be able to do this. Management started conversations with companies that could be a complementary fit. They talked with Coors and Anheuser Busch before selecting Labatt's in Canada. There was something special about these companies with whom they were dealing. All, of course, were breweries. But the interesting point is that all were, historically and culturally, family businesses - as was Cuauhtemoc. At first glance, this may simply seem to say that this industry is dominated by family firms, but breweries are not unique in this regard. In fact, using a broad definition of "family business," Shanker and Astrachan estimated in 1996 that about 22 million businesses in the United States were family-owned or controlled, accounting for approximately 92 percent of all businesses and about half of the gross domestic product.[1]

Neubauer and Lank estimate that in Europe the percentage of businesses that are family businesses ranges from 70 percent in Portugal to more than 95 percent in Italy, with other European countries between 80-95 percent. In the Middle East their figures indicate more than 95 percent of the businesses are family businesses.[2] Excluding government-owned businesses would increase the percentages even more. Williamson's list of the fast-growing new competitors in Asia emphasizes the importance of family-businesses there.[3]

This means that if a family business chooses to enter the global arena it is very likely to be dealing with another family business. Since the owners of family businesses often prefer to deal with others like themselves, and because family control provides some specific advantages in negotiation, this can provide a significant strategic advantage for the family firm that is looking for opportunities abroad. [4]

Family Business Defined

Before elaborating on the strategic advantages, it is important to define what is meant by a "family business." Definitions of family business vary somewhat but, for purposes here, a family business will be defined as one in which the family (broadly defined) either owns the business outright or, if they have gone to the markets for capital, still hold enough of the stock that they can retain management control without fear of being replaced or out-voted. In the current climate of consolidation some may have sold controlling interest to larger holding company while retaining family management. The term is generally reserved for those businesses that have at least two generations of family involved in ownership and management. That is, these companies are past the entrepreneurial stage where the founder(s) are still running the business. The "family" may include cousins, in-laws, and more tangentially-related family members, particularly as ownership and management move to the third generation or beyond.

Family businesses include, of course, local retail and service establishments, but they also include 37 percent of the Fortune 500 companies.[5] In fact, 60 percent of all public companies in the U.S. are still family-controlled.[6] They go to the markets to raise capital, but maintain sufficient shares to operate as a family business.

Strategic Advantages For Global Expansion

A key strategic advantage for the family business is the ability to make long-term decisions. Family businesses can decide to invest in a market, a product, or service that may not be profitable for five or ten years but, in the long run, can be immensely beneficial to the firm. This is often referred to as "patient capital," and it allows management to consider more strategic options than can management in a publicly-owned firm where jobs, and even careers, may depend on regularly meeting quarterly earnings expectations.

In a related theme, the family business can risk unconventional strategies. For example, in public companies, investment in R&D or other kinds of business-building activities is generally related to cash flow. When cash flow is high, investment is high. When it is tight, investment is cut back. The family business can say, "Even though cash flow is down right now, we know the business is cyclical. We are willing to take smaller margins for awhile and keep investing here even though there is not an immediate pay-off because we want to be prepared to catch the next wave." Or, the family business can take time to establish the trust relationship with people in a different country that in the long run can open up an incredibly important market or develop a major supplier. Management in public companies, where turnover is more frequent, may find it difficult to build that personal relationship.

On the other hand, the family business can usually make fast decisions when necessary. There are generally fewer committees, layers of bureaucracy, and other constituencies with which management must deal than is true for a public company. Communications are easier and, if it is necessary or wise to hold a family council about the decision, that is relatively easy to accomplish compared with general shareholder meetings for public companies. When working with family-owned

businesses abroad that are used to operating in this fashion, the family business may have a distinct advantage over less-nimble public companies.

Next, the family business can engage in controlled growth and reasonable diversification in a way that publicly-owned companies often cannot. It can be aggressive without being too adventuresome. There is less pressure to acquire another business simply to be bigger or to increase a manager's span of control so that his or her resume looks better for the next job at the next company. The focus can remain on strategic growth and diversification that builds wealth and strength for the owners. There is a strong alignment of interest between management and owners. This is not to say that some family businesses have not made mistakes in their diversification or acquisition schemes, or grown too greedy, but the dynamics are different.

Finally, family businesses may be more effective at vertical integration than large public companies. While vertical integration is somewhat out of vogue in the larger business community right now, family businesses have often been able to manage those relationships quite well. Again, as the economy becomes increasingly global, there may be effective ways to create a well-managed integrated company that crosses geographical boundaries. That integration may be much easier if both companies are family businesses.

Trust Is The Key

All of this, of course, assumes that the family is functional and in general agreement on things, including how much to pay out to individual shareholders and how much to reinvest. It is the paradox - the ying and yang - of family business that the family can be either a tremendous asset or the kiss of death. If family relationships are divisive, those negative relationships carry over into the business and often are more destructive than they would be between co-workers or managers who have no other relationship.

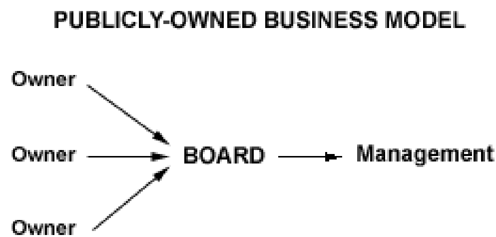
Family businesses, when they function well, function on trust whether located in Boston or Bangkok or Burundi. Much has been written about the "agency problem" in public companies and the need of owners to be sure that management does not manage the company simply for its own benefit rather than that of the shareholders. Family businesses have a different relationship. Management and ownership overlap. Perhaps more importantly, shareholders and family are the same group. Therefore working for the best interests of the family, as most of us want to do, is the same as working for the interests of the owners. The key trust relationships on which family businesses must work are those between generations, between family branches when the firm grows and/or survives long enough that more than the entrepreneurial members are involved, and between key non-family managers and family employees as well as management. Typically, if there is not trust between these segments, the business has to be sold or liquidated. It is extremely difficult to maintain a family business where there is lack of trust among these groups, whether that distrust originates with business issues or from personal aspects of family relationships.

In much of the world outside of the U.S., trust is also very important as an element in the business transaction. It is generally built through face-to-face meetings, shaking

hands, and getting to know the other people. Contracts come later. Family businesses have an advantage here because they understand that dynamic better and because the potential partner is going to better understand them and how they operate. If the business uses the family relationship as a key strategy, the potential partner is more likely to look at the business as "someone like us," and therefore someone we can understand and trust.

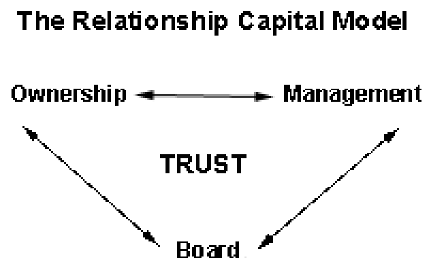
The following figures graphically illustrate some of these differences. As Figure 1 shows, in the publicly-held business model the relationship is linear, with the board expected to represent the best interests of the shareholders and monitor the activities of management as well as to advise management.

Figure 1



The family-business model - the Relationship Capital Model of Family Competitive Advantage - on the other hand, has reciprocal relationships throughout and is cemented together by the key element of trust. (See Figure 2.)

Figure 2



Communication Is Key To Maintaining Trust

One cannot take trust for granted in a family business. The Relationship Capital Model is really built on 5 "C's:" communication, congruence, consistency, competence, and compassion.[7]

Communication: As in other aspects of family relationships, a key factor in building and maintaining trust is communication. In this respect, it is important for members of the family to consciously and deliberately plan how to communicate about the business in addition to whatever informal communication takes place at, say, the dinner table. Informal communication tends to miss some people. Additionally, it is important for the family's health as a family not to always be focused on the business. If there are formal ways to communicate, it helps free people to "be family" at other times.

Most successful family businesses have specific Family Council meetings about the business that include all family members. These are in addition to formal board or committee meetings. They may be annual, if the family is large and scattered around the world, or they may be more frequent. They are formal meetings with an agenda and minutes and they deal strictly with the business, not other family matters. However, if the entire family is getting together only on an annual basis, it is also valuable to have some time just for enjoyment and celebration of the family during that time together.

In addition, family members can be invited to observe board meetings on a regular or periodic basis. To educate the younger generation about the business before they take responsibility for operations, some family businesses institute "Junior Boards" that are briefed by managers in the same way that the real board is briefed, and where the members discuss what they believe should be done while the older generation listens and answers questions.

Congruence and Consistency: The second and third "C's" - congruence and consistency - are also related to communication. Where communication is making sure that everyone knows things, congruence is being sure that they know that they know it. Sometimes information is out there, but people have focused on other things. So later on they may say, "I didn't know that," or "You never told us that." Finding ways to confirm that knowledge is important. It may be through more meetings, through reports and minutes, through videos, or through other communication forms, even if they seem unnatural for families. It reminds people that, "Yes, we did talk about that." And, "I do remember that decision." Consistency means basically to repeat the same thing frequently, and not just assume that, because it was in the minutes once, everyone knows and remembers. Find ways to repeat the message, especially the important ones, and be consistent in what is reported.

Competence: Competence is critically important. Decisions need to be made in ways that truly add value to the business. That does not mean that every decision must have an immediate impact on the bottom line, but it does mean that business decisions should have a business purpose. The fact that Uncle George lost some money on a poor real estate deal and needs extra cash is not a good enough reason to change the dividend policy. It is also important that family members who work in the business be recognized for their competence and not just for their family connections and name. They need ways to prove to themselves and others that they really do have what it takes to run the business. It is, therefore, important that they get the proper training and that they really learn the business.

Compassion: The final "C" is compassion. Sometimes families go too far the other way and forget to be families. If there is a mechanism that allows family members to talk about business and make business decisions, then other occasions can be devoted to activities that keep family ties strong. Families that function well at home and in the workplace, and that maintain an atmosphere of trust, will continue to enjoy a competitive advantage in an expanding global marketplace.

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1 Shanker, M.C. and Astrachan, J.H., "Myths and Realities: Family Businesses' Contribution to the US Economy -- A Framework for Assessing Family Business Statistics," *Family Business Review,* vol. 9, no. 2 (Summer, 1996), pp. 107 -24

2 Neubauer, F., and Lank. A. G., *The Family Business: Its governance for sustainability.* NY: Routledge, 1998

3 Williamson, P., "Asia's Emerging Competitors," *Global Finance,* vol. 13, no. 12, December, 1999

4 The author wishes to acknowledge the influence of John Ward and his work on both the concept of this paper and the illustrations used.

5 Shanker and Astrachan, *op. cit.*

6 ibid.

7 For a general discussions of family business that cover these topics, see, for example, Gersick, K. E., Davis, J.A., Hampton, M.M. and Lansberg, I. *Generation to Generation,* Boston: Harvard Business School Press, 1997; Lansberg, I., *Succeeding Generations: Realizing the dream of families in business,* Boston: Harvard Business School Press, 1999; Koeniz, N. N., *You Can't Fire Me, I'm Your Father;* Washington D.C.: Kiplinger Books, 2000

http://gbr.pepperdine.edu/012/family.html