5 Growth Path of Family Enterprises

Having examined the 500 biggest family enterprises regarding their longitudinal growth process, this chapter analyses the growth process along the generational development and tries to develop practical implications for the sequence of generations.

One of the interdependent research projects dealt with the exploration of the complexities of the family businesses' growth process. Seibold (2017a, 2017b) has developed a phase theorem to analyse the growth paths of family businesses.

5.1 Phase Theorem

This phase theorem was derived from different examples of family business growth. All studied companies were older than 100 years, had sales of more than EUR 10 billon (2014) and are still family controlled. The data gathered from the cases studies reflect the generational influence on the growth phases. These findings were supplemented by overall economic as well as political factors and embedded in the life cycle theory (Table 5.1).

The first phase covers the company's establishment up to the beginning of the First World War in 1914. In 1914, the period of high industrialization ended in Germany.

The second phase covers the time between the outbreak of the First World War and the beginning of the post-war period of the Second World War in 1952. In this phase, the difficult reconstruction time of wars is covered. At this time, important company archives were destroyed.

The third phase (1952–1974) includes the post-war period, the time of the economic miracle and the beginning of the recession in the wake of the oil crisis.

The fourth phase covers the period from 1974 to 1991: the markets are increasingly networked and commercial and market entry barriers are steadily reduced. In

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Table 5.1 Phase theorem

Phase I	Phase II	Phase III	Phase IV	Phase V
Pre-industrialization	World Wars I + II	Post War boom	Globalization	Eastern expansion
Phase I (foundation-1914)	Phase II (1914–1952)	Phase III (1952–1974)	Phase IV (1974–1991)	Phase V (1991–2014)

Source: Authors' own table

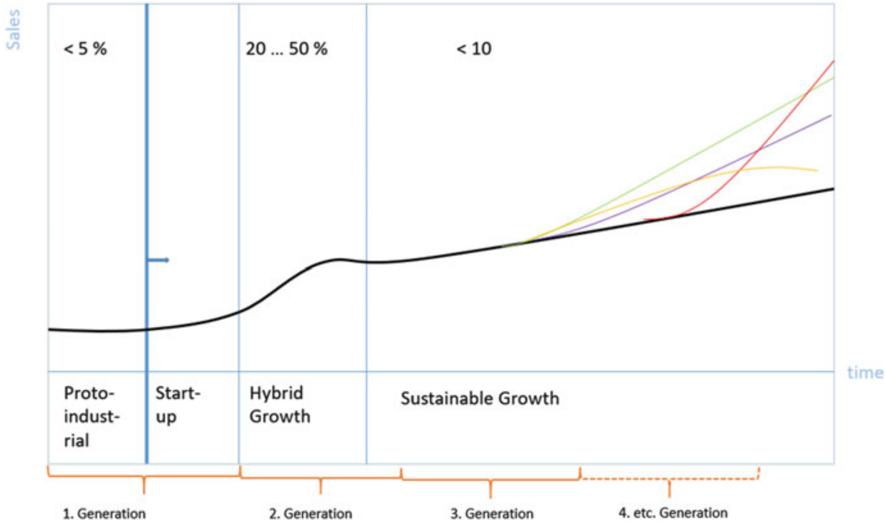

Fig. 5.1 Life cycle. Source: Authors' own figure

1991, the Soviet Republic was finally dissolved and the Eastern markets were opened.

The fifth phase covers the period from 1991 to 2014. In the 1990s, the European economy weakened. At first, Germany could compensate for this downturn with the reunification boom. Subsequently, the economic situation in Germany also weakened.

Considering all the political as well as generational factors and referring back to the life cycle theory, the following phase model could be proposed (Fig. 5.1).

To illustrate the phase theorem, the example of the company Merck is used:

In the year 1668, the Merck family had a small pharmacy with three employees. After a pioneering invention in the field of Alkaloids by Emmanuel Merck, the pharmacy started to grow, and during the second generation the pharmacy developed into an enterprise with an industrial production of pharmaceuticals and chemicals. Over the years, the enterprise expanded and developed into a multinational, well-established business group.

The Merck Story is the narrative of a nearly 350-year-old German family-owned business. There are several more old companies that can look back on a colorful past, starting with a small craftsman shop, a pharmacy or as a self-employed merchant. All of these stories have one thing in common, they all started small and have developed into a long-lasting family business. In most cases, the second generation started to establish organizational structures after the pioneering innovation of the founder.

5.2 First Generation's Willingness to Grow

The first generation has a higher entrepreneurial orientation[1] than the later generations, and thus the first generation has a higher capacity for growth (Cromie, Stevenson, & Monteith, 1995; Dunn, 1995) and correspondingly a higher growth rate (Reid, Dunn, Cromie, & Adams, 1999).

The centralized authority of the founder (Gedajlovic, Lubatkin, & Schulze, 2004) characterizes the strategic decisions of the first generation. This is followed either by excessive risk-taking or by a strong aversion to risk in order to keep the company's assets (Casillas, Moreno, & Acedo, 2010).

In the first generation a reluctance of the founder to give away his/her "power" can be detected (Gedajlovic et al., 2004; Gersick, Davis, Hampton, & Lansberg, 1997). In this context, the resistance/dislike of succession plans of the founder's generation should be named (Davis & Harveston, 1998; Sonfield & Lussier, 2004).

Davidsson (1991), Westhead and Cowling (1997), Delmar and Davidsson (1999), and Delmar and Wiklund (2003) (SME Managers) particularly address the growth willingness of the founding generation. Not all entrepreneurs have growth as a corporate goal (Ambrose, 1985; Wiklund, Davidsson, & Delmar, 2003). The profit maximization is not the only goal of family entrepreneurs (Chrisman, Chua, & Sharma, 2005; Westhead & Cowling, 1997; Westhead & Howorth, 2006). The latter study shows that companies in the first generation and businesses where few managers are part of the family prefer "rational" objectives rather than family goals. As the number of shareholders rises, the focus shifts to family-specific objectives (Dyer & Handler, 1994). In the earlier literature, there is a distinction between the business-first and family-first mentality (Singer & Donahu, 1992; Ward, 1987). Dunn (1995) states that having the characteristics that are important for growth is more likely for the business-first company. Donckels and Fröhlich (1991) point out that family-first companies are resistant/persistent and have a more conservative attitude towards growth than business-first businesses. Subsequent literature reveals that the terms family-first and business-first are not static concepts, but can change within the company over time (e.g. Martin & Lumpkin, 2003; Reid et al., 1999).

[1]See Casillas and Moreno (2010) for an overview of the relationship between the entrepreneurial orientation and growth of family firms. The authors conclude that family involvement has a positive influence on the innovation capabilities (Moreno & Casillas, 2008) and the competitive aggressivity, but has a negative impact on risk propensity.

Note: Profit maximization as a target does not promote growth as any growth strategy has the tendency to reduce short-term profitability. Further profit maximization tentatively leads to an increasing risk assumption that might jeopardize longevity.

So far there have been few studies that deal with the impact of the objectives on the company's performance (Frese, Krauss, & Friedrick, 2000; Seijts, Latham, Tasa, & Latham, 2004). Lee and Marshall (2013) examine how the goal orientation of family entrepreneurs affects the company's performance. The authors note that the goals "good reputation" and "growth" have a positive effect on the company's performance.

The transition from the first to the second generation can promote growth and strategic innovations (Zahra, 2005). However, during generational transitions (first to second), negative effects on strategic planning can occur (Cater & Schwab, 2008; Chrisman, Steier, & Chua, 2006).

5.3 Second Generation's Developmental Needs

Having described the first generation's willingness to grow, the developmental needs of the second generation are explained in terms of: Need, Willingness, Capabilities and Options (Fig. 5.2).

5.3.1 Need

The necessity to grow has an organizational as well as an individual dimension. On the organizational level, the growth of the whole industry plays an important role (McGrath, 2012) and drives the need to grow the business. The industry growth is an important benchmark for the thresholds for growth. Thus, the need to grow is determined by the threshold of 0.8 of the respective industry growth. Another driver

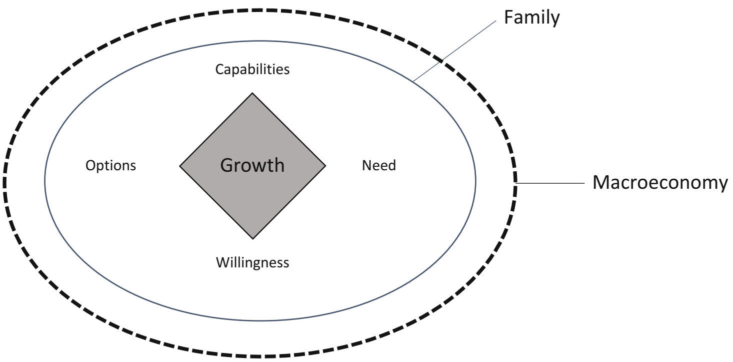

Fig. 5.2 Growth diamond. Source: Authors' own figure

of the necessity to grow are the geographical dynamics of the respective industries. The overall macroeconomic situation determines the need to grow continuously.

From the business perspective, the most important benefit of growth is the gain of stability and thereby sustainability. These can be based either on a larger market share in a product-market-sector or—even more importantly—on a diversification into several business activities. A long-term analysis of companies in the state of Baden–Württemberg between 1940 and 2010 shows that all companies with more than three subsidiaries, i.e. diversified activities, survived over these 70 years (Ehrhardt & Nowak, 2011).

On an individual level (family level), the necessity to grow is driven by family-specific issues such as mode of inheritance (Fittko & Kormann, 2014) and shareholder expansion. As the number of family members increases, there is a greater need for the business to grow in order to satisfy the demands of all family members. On the one hand, this is financial compensation in form of dividends etc., on the other hand this is the opportunity of an active career in the family business. As the business grows and develops further business divisions, it can offer any suitable member of family a job opportunity. The increased demand for dividends can increase the need to grow, but this demand could also be a threat to the company as it depletes the financial resources that are dedicated to financing the aspired growth.

The mode of inheritance is a further driver of the necessity to grow, as an increased shareholder base or the payout of shareholders can be the outcome. If the business is transferred to all heirs, the shareholder base expands and the issues stated above arise: The increased demand for dividends and the possibility of an active career in the family business. If it is the case that the business is bequeathed to one child, the shares of the other heirs must be financially compensated, which indeed reduces the financial scope of the business's potential growth opportunities.

Therefore, transferring the business to one child only significantly curbs the desired growth. It is a fact that there is no old and large company in the sole ownership of a fourth-generation owner (Fittko & Kormann, 2014). Those companies that are in the sole ownership of one person are comparatively small, such as Faber Castell, traditional hotels or the famous vineyards. Concentrated ownership requires cash outflow to compensate the heirs excluded from the inheritance of the business shares. According to German laws, this is half the value of the estate compared to the state of intestacy. But this half is to be paid in cash. This cash comes from the after tax profit retained in the company. This cash outflow reduces the growth potential by one-half or two-thirds.

Practical Implications

As a consequence, the founder should anticipate the succession management as it can have a tremendous impact on the second generation's need to grow. The second generation should align its growth to the industry situation using the above-mentioned corridor as a potential guideline.

5.3.2 Options

Following this elaboration on the growth needs of the family business, this section will focus on the growth options of the business that arise in the second or subsequent generations. A distinction can be made between internal and external opportunities. The internal opportunities to grow are the innovation potential as well as the amount of and access to financial resources such as reinvestment potential. External growth opportunities arise from changes in the market/product or the macroeconomic cycles and trends. During the last 40 years, German industrial companies have found their growth almost exclusively in export markets (Conrad, 2013). The reduction of the time-to-market process and the contraction of the innovation—substitutions-curve open new growth opportunities. Taking over the market shares of declined firms in the respective industry enables new growth opportunities. Joint ventures, alliances and networks, especially in an international context, yield opportunities for growth.

Practical Implications

Search constantly for internal and external opportunities for growth, consider your own strengths and weaknesses, as well as the macroeconomic surroundings as these are the starting points for any growth. Maintaining contact with an external network and building up partnerships could help to overcome any weaknesses.

5.3.3 Capabilities

To pursue the above-mentioned options, special capabilities are needed. One of the most important factors influencing the capabilities for growth are the human resources (Penrose, 1959). The willingness to take risks and a proactive orientation, especially of the top management team, are key drivers of growth. Additionally, it is important to have the capability to communicate and implement the decisions derived from the entrepreneurial orientation to the employees—the leadership style. Besides human resources, organizational capabilities play an important role in the growth process, such as the time of adaption to external and internal changes, as well as financial stability.

One favored and commonly-used step to enhance the financial capabilities for growth is an IPO. Our research reveals that an IPO is not needed to grow into a large company. Empirical evidence shows that there are three times more non-listed family-owned businesses with sales of more than EUR 1 billion than listed ones. Furthermore, the growth rate of non-listed family-owned business is higher than that of listed family-owned businesses and public companies. It is a fact that the higher dividend quota of listed companies reduces a sustainable growth rate. Therefore, the absolute amount of retained earnings in a non-listed family-owned business is higher than in a listed family-owned business—all other parameters being equal. Further, the profit pressure by non-family shareholders might reduce the capability for innovative and risky projects.

Practical Implications

Ensure financial liquidity and the realization of proactive, innovative and risk oriented behavior.

5.3.4 Willingness

The last point to discuss is the willingness to grow, arising from personal experience, characteristics and the surroundings that shape the goal-setting concerning growth.

Expected outcomes of growth strategies influence the growth willingness. The motivating forces are the monetary reward and increased independence (Davidsson, 1989). Personal experience in other growth-orientated companies, as well as the personal experience of mentors and within networks can facilitate the decision-making in one's own business. Characteristics such as entrepreneurial orientation (innovative, proactive, risk taking) are important drivers of growth in business. The personal experience and the characteristics are shaped by the family and their goals, needs and concerns. Especially for the second generation the goals of the founder' generation are still strongly prevalent. Many founders decisively convey and assert their attitudes, strategies and goals to the offspring who succeed them. Due to the strong presence of the founder, it is challenging for the successor to establish his/her own attitudes and goals in the business strategy. This is one of the reasons why they prefer the sole ruler principle also for the next generation. Another reason for these strong convictions is the wish to continue the goal of double-digit growth in subsequent generations.

Having analysed the 350 largest and oldest German family businesses, we have not found one company that was able to achieve double-digit growth over two generations or more. With the exception of the American oil companies—which had their sales growth based on rising oil prices and mergers—there are hardly any companies at all which were able to achieve a double-digit rate over 100 years (Chap. 4). In Germany, Robert Bosch comes closest to this with some 9% average growth rate over 125 years. In the USA, Koch Industries and Mars might be a case in point.

Potential causes of this observed phenomenon could be the problem of overstretching the organization, as a real growth rate beyond 10% or more requires increasing the management at least by a factor of two each decade.

Another reason are the financing mechanics of growth. The first generation lived frugally and invested the full cash flow into expanding the business. In the second and subsequent generation, the growth is reduced (compared to first generation growth). In the second generation, the factories and business assets invested by the first generation have to be renewed, refurbished and so forth. Therefore, the cash flow has to be split between renewal without growth and growth investments.[2] Furthermore, the second generation might follow a more cautious business strategy. This is very justified to avoid the high exit rates based on the "Liability of newness" (Stinchcombe, 1965).

Practical Implications

Gain experience from other growth-orientated companies by working there as an employee or on the advisory board.

Be careful in setting quantitative goals, specifically be aware of basing targets on the high targets of the high growth record of the first generation. Rather shape the growth orientation in qualitative terms. Growth is an evolutionary development.

5.4 Viable Growth Path: The Seibold–Lantelme–Kormann-Formula (SLK-Formula)

5.4.1 Growth Corridor

More than 20% of German family-owned enterprises are older than 120 years. Achieving such an age requires different stages of development as outlined in the previous chapter. Passing through the thresholds of the first and second generation and having developed into a mature business is a remarkable effort for a company. Combining the findings from the growth rates of the 500 biggest family-owned companies and the results of the analyses of the growth history (Seibold, 2017a, 2017b) with an extensive data analysis of the 10,000 German family enterprises, a sustainable growth path could be suggested for third and onward generations.

The upper limit for the second and onward generation ranges between 8 and 10% or 1.5 times the overall growth rate of the respective industry. According to an analysis by Seibold (2017b), examining the 100 biggest German family enterprises, 20% of the analysed businesses show a CAGR of more than 10% over a period of 11 years. The preconditions and roots of this growth spurts are examined in a different research project.

The lower limit of the viable growth corridor is determined by the market-influenced productivity-improvement that is itself dependent on the respective industry and know-how. This is the logical prerequisite for survival as otherwise the company would shrink due to rising labor costs. Undoubtedly, there are businesses that survive without growth and remain small.

The following reasons could be assumed examining over 1000 small (<60 Million) and old (>125 years) businesses:

[2]Empirical observation in action research as Board Member. This effect is similar to the famous Lohman–Ruchti-Effect explaining the capacity extension by immediately reinvesting the cash flow from depreciation which levels off in subsequent periods (Ruchti, 1953).

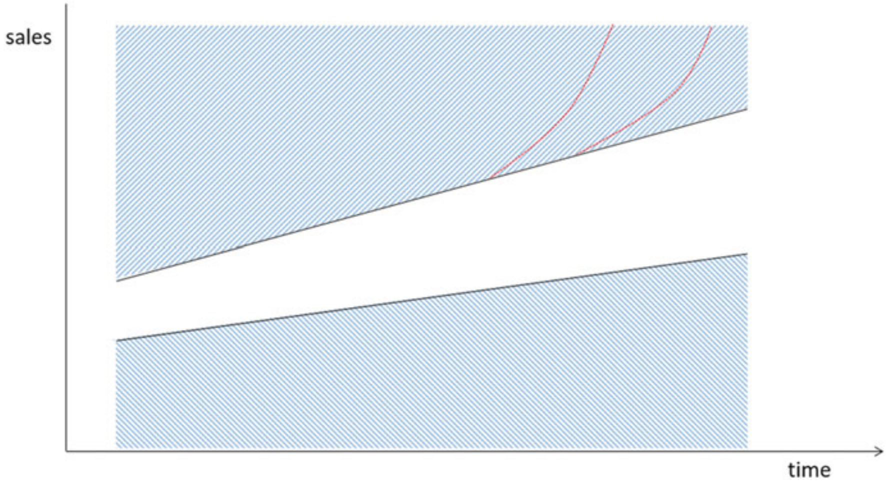

Fig. 5.3 The long-term viable growth corridor. Source: Authors' own figure

1. Price increase
2. Owner-dependence
3. Regional focus
4. Niche market

In the first case the business can raise its price due to a unique location or unique product, as some hotels or luxury brands have done. Zoos, luxury wineries and breweries could also survive without growth but by rising prices. Considering case two, one can think of an owner managed craftsman business which has strong regional focus. Porcelain manufacturers can also survive as they operate in a niche market, although the porcelain industry is almost non-existent in Germany today.

As the long-term growth corridor has an upper limit, the achievable size of a family-owned business is to a larger extent determined by the size achieved during the first generation or early in the second generation at the latest. Unless the founder-entrepreneur emerges from the stage of self-employed or small-shop activity to the size and organization of an enterprise, the ongoing development of the business is not assured. Thus, reaching the stage of an enterprise early in the second generation is fundamental (Flamholtz, 1986).

As the company matures, organizational routines are established, and markets are saturated. In this life cycle phase, growth rates often stagnate or decline. However, some mature and well-established firms show growth spurts (red dotted line in Fig. 5.3) in this stage of the life cycle. Examining the 100 biggest family-owned companies we see that 20% of them showed growth spurts even in later generations, primarily in the third generations, but some even in later generations (Seibold, 2017a, 2017b).

Up until now, we have only preliminary indications on the causes enabling such mature companies to spurt in terms of growth. One must assume that later acceleration of the growth development requires an increased entrepreneurial effort. Typically, it implies reaching out to "new" areas—which include new knowledge bases and the innovation of new business models. We can also observe opportunistic acquisitions of available unrelated companies—thereby opening up new routes towards further development.

Pursuing such growth initiatives is a long-term effort. A long-term perspective by the top management supports this.

For non-family executives the expectation of a long tenure is necessary to create the long-term perspective. Combining the long tenure with an appropriate incentive system and virtual share options would lead to higher commitment and support the realization of entrepreneurial orientation.

The long tenure is equally important when employing family members. Family members in management or on the Board with emotional commitment and entrepreneurial attitude can be vital to promote the renewal.

Besides willingness, financial resources are important to promote growth spurts. Therefore, freedom from shareholder value pressure by financial markets is supportive.

The search for growth opportunities is an emerging field with intensified focus in practice and science. Research and consulting topics such as innovation strategy, design thinking, intrapreneurship, reorganizing the innovative potential of organization (Laloux, 2014) are indicators of an increased emphasis on strategy.

All these trends and initiatives could be interpreted as efforts to integrate entrepreneurship on the management level. These hypotheses will be further explored in our research.

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