Patterns of Family Enterprise's Growth

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1 The Phenomenon

In the year of 1668, the Merck family had a small pharmacy with three employees. After a pioneering invention in the field of Alkaloid by Emmanuel Merck, the pharmacy started growing 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 has developed into a multinational, well-established business group.

The Merck Story is one narrative of an almost 350-year-old German Family-Owned Business. There are many more old companies who can look back on a colorful past, starting with a small craftsman's 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 of the cases, the second generation started to establish organizational structures, after the pioneering innovation of the founder. We would like to explore the challenges of the second generation from a practical/action-orientated perspective. What are the development requirements of the next generation concerning the business growth in the different stages of the enterprise? In order to understand these requirements, our team has conducted comprehensive studies of the 350 biggest industrial family-owned businesses in Germany with a special focus on the transition from the first to the second generation.

We found patterns facilitating successful long-term growth as described below.

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2 The Rare No-Growth-Requirement

Of course, as we focus on the determinants of growth as a development need of the second generation, we have to acknowledge that in certain businesses, growth is irrelevant (or at least not essential). Growing is optional for a business if it has a monopolistic position such as a downtown hotel, a rare vineyard, or a luxury brand. The need to grow is also not given if the business operates in a highly fragmented industry (e.g., food and beverage industry). But, in all other conditions, growth is needed for sustainability. As our research reveals for the German businesses, the conditions of sustainable growth are:

3 An Upper Growth Limit After the First Generation

We found that all old family businesses which still survive have one important point in common. After the first generation, the growth rate was at a maximum not higher than 1.5 times the overall growth rate of the respective industry. We also found that the average growth rate over a period of 30 years did not exceed 10%.

4 A Lower Growth Limit

The growth rates of the family businesses studied were also not lower than 0.8 times the overall growth rate of the respective industry or some 2.5–3% annual growth rate (assuming an industry growth of 3–4 in mature economies such as Germany—and respectively higher in China).

As this 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 a full-blown enterprise early in the second generation is fundamental.

5 Four Factors Are Essential for Supporting Sustainable Growth

For an understanding of the reasons for successful cross-generational growth, we need to look at four requirements as shown in Fig. 1: Need, Options, Capabilities, and Willingness.

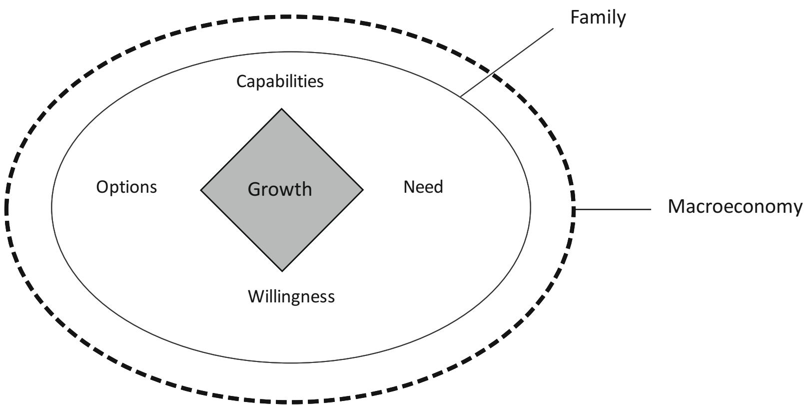

Fig. 1 Growth Diamond. Source: Author's own figure

5.1 Need

The necessity of growth has an organizational as well as an individual dimension. At the organizational level, the growth of the whole industry plays an important role and drives the need to grow the business. As mentioned, the overall industry growth is an important benchmark for the thresholds for growth. Another driver of the necessity of growth 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 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 divisions, i.e., diversified activities, survived over these 70 years.

On an individual level (family level), the necessity of growth is driven by family-specific issues such as the inheritance mode 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 need comprises financial compensation in the form of dividends, etc. and 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 the family a job opportunity. The increased demand for dividends can increase the need for growth but this demand could also be a threat to the company as it depletes the financial resources which are dedicated to financing the aspired growth.

The mode of inheritance is a further driver of the necessity of growth, 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 of several, then shares of the other heirs generally must be financially compensated, which indeed reduces the financial scope of potential growth opportunities for the business.

Therefore, transferring the business to one child only significantly curbs the desired growth. But it is a fact that there is no old and large company in the sole ownership of a fourth-generation owner. Those companies which are still in the sole ownership of one person, such as Faber Castell, many traditional hotels or famous vineyards, are comparatively small. Concentrated ownership requires cash outflow to compensate those heirs excluded from the inheritance of the business shares. According to German law, in case a descendant is excluded as heir by the will, he or she is nevertheless entitled to a minimum participation in the wealth of half the amount of the normal share. The challenge is that this half is to be paid in cash without delay. Such cash comes from the company's after-tax retained profit. This cash outflow reduces the growth potential by one half or two-thirds.

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

5.2 Options

Following the growth needs of the family business, the growth options of the business, which arise in the second or subsequent generations are of equal importance. A distinction can be made between internal and external opportunities. The internal opportunities to grow are defined by 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. In addition, the reduction of the time-to-market process and the contraction of the innovation—(substitutions)—curve open new growth opportunities. Also, 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.

The practical implication requires that one should search constantly for internal and external opportunities for growth, deploying your own strengths as well as the opportunities arising from the macroeconomic surroundings as this is the starting point for any growth. Maintaining contact with an external network and building up partnerships could help to overcome any weaknesses.

5.3 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. The willingness to take risks and a proactive orientation, especially of the top management team, are key drivers of growth. Also important is the ability to communicate and implement the decisions derived from the entrepreneurial orientation to the employees—the leadership style. Besides talent, organizational capabilities play an important role in the growth process, such as the time of adaption to external and internal changes as well as the financial stability.

One favored and commonly used step to enhance the financial capabilities for growth is an IPO. But our research reveals that an IPO is not needed in order to grow into a large company. Empirical evidence shows that in Germany there are three times more non-listed Family-Owned Businesses with more than one billion EUR sales than listed ones. Furthermore, the growth rate of non-listed Family-Owned Businesses is higher than the growth rate of listed Family-Owned Businesses and Public Companies. It is a fact that the higher dividend quota of listed companies reduces the sustainable growth rate. Therefore, the absolute amount of retained earnings in a non-listed Family-Owned Business is generally higher than in a listed Family-Owned Business. Further, the profit pressure by non-family shareholders might reduce the opportunity for innovative and risky projects.

Further, we found that no listed company older than 60 years with more than 600 million EUR revenues is still under the dominating influence of the original owner family. This is a frightening finding as already 100 years ago family enterprises such as Siemens and many, many others made IPOs. They either disappeared, were sold or collapsed, or survived with the original owner family's participation reduced to a negligible portion.

Practical considerations require that you respect your own given resources. For a medium-sized family company, the commandment applies: "Don't play where the elephants dance!" Restrict your growth aspirations to an evolutionary path in line with your financial strength. Strengthen your financial basis initially by retained profits.

5.4 Willingness

The final point to discuss is the willingness to grow which stems from personal experience, characteristics, and the surroundings, all of which 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 as well as improved reputation based on the size and market position. Personal experience in other growth-orientated companies can facilitate the decision-making in the family business as well as the personal experience of mentors and of members within networks. Characteristics such as entrepreneurial orientation (innovative, proactive, risk-taking) are important drivers of growth in the 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 founders' 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. One reason for these strong convictions is the desire to maintain the goal of double-digit growth in subsequent generations.

Having analyzed 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. In fact, with the exception of the American oil companies—which had the 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. In Germany, the closest case is Robert Bosch with some 9% average growth rate over 125 years. Equivalents in the USA are Koch Industries and Mars.

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

Another reason is the financing mechanics of growth. The first generation lived frugally and invested the full cash flow into the expansion of 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 developed 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. Furthermore, the second generation might follow a more cautious business strategy.

From the third generation onward, the growth is achieved to a large extent via Mergers and Acquisitions. Whereas organic growth can be financed at book value of the assets, growth via M&A implies purchase prices of two or three times of the book value.

The practical conclusion implies that one should be careful when setting quantitative goals, specifically one should be cautious with basing targets on the high targets from the high growth record of the first generation. Rather shape the growth orientation in qualitative terms. Growth is an evolutionary development.

6 From Enterprise to Entrepreneurship: Reintegrating Entrepreneurship

Matching these development needs is quite an achievement. Successfully doing so can result in a well-established, sizable, multinational enterprise. 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 even in this stage of the life cycle. Through our examination of the 100 biggest Family-Owned Companies in Germany, we see that 20% of them showed growth spurts even in later generations, primarily in the third generations, but some even in later generations.

Up until now, we have only preliminary indications on the causes enabling such mature companies to experience growth spurts. 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 know-how base and innovation of new business models. We can also observe opportunistic acquisitions of available unrelated companies that can open up new routes of further development.

Pursuing such growth initiatives is a long-term effort. This needs to be supported by a long-term perspective of the top management. For a non-family executive, the expectation of a long tenure is necessary to create a long-term perspective. Combining the long tenure with an appropriate incentive system and virtual share options might 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 engagement and entrepreneurial attitude can be vital to promote the renewal.

Besides willingness, another important factor in promoting growth spurts is financial resources. Therefore, freedom from shareholder value pressure by financial markets is necessary.

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

All these trends and initiatives could be interpreted as efforts to integrate entrepreneurship at the management level.

In conclusion, the demanding challenge in the long-term strategy of a Family-Owned Business is developing the growth path. There is not a simple key success factor enabling a family and its company to pursue a growth path. It requires a particular mindset and a fit in four major dimensions: Willingness, Need, Options, and Capabilities as well as their realization on the management and employee level. It is worthwhile exploring the interplay of these influences.

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