The Profitability of Corporate Governance in Family Owned Companies

Russell Reynolds Associates

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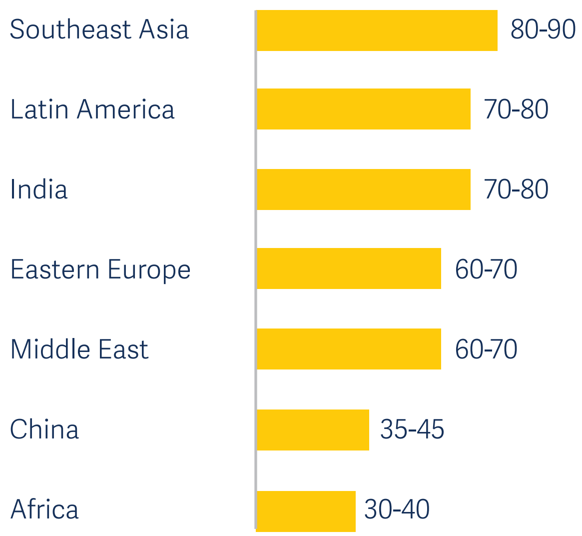
In emerging markets 60% of companies with a turnover of US$ 1Bn and above are family owned. In some cases, such as in Latin America, India and South East Asia, the percentage is 70% or even higher. The high presence of this type of companies in emerging economies means they have a strong responsibility in the development of their regions.

SHARE OF LARGE COMPANIES THAT ARE FAMILY OWNED (%)



However, family owned companies need to overcome many hurdles if they are to compete against other types of companies, such as state owned companies, Multinationals or Private Equity portfolio companies. These obstacles can range from project financing and increasing capital to hiring the best top executives, gaining access to R&D expertise, etc. Implementing an adequate Corporate Governance is perhaps the most important factor and one that is likely to help address the above mentioned issues.

In a recent research study carried out by Russell Reynolds Associates, one of the conclusions reached was that those companies which followed the recommendations to implement a good Corporate Governance practice were the most profitable ones.

WHAT IS GOOD CORPORATE GOVERNANCE?

Although there is no one-size-fits-all solution there are some agreed practices that many Governments are adopting as binding legislation when it comes to listed companies. These laws are aimed not only at protecting shareholders (free float) but also a wider range of stakeholders, including Government itself, from potential fraud and other tax related issues which could affect everyone's pockets. They are also designed to ensure the right environment for businesses to grow.

With regards to non-listed companies, these changes in legislation are still in a preliminary phase and remain mostly as recommendations. Enforcement is difficult for Governments both because of the large number of companies which fall under this category and because the number of affected shareholders is actually limited.

However, depending on the type of risks affecting the different stakeholders and on a company's size these recommendations might become mandatory soon.

Good Corporate Governance is defined as the principles and regulations governing a business operation which must include, amongst others, the following:

- Protect the interests of all shareholders
- Create values that are sustainable in the long-run
- Ensure information reliability and transparency
- Define relationships and responsibilities among shareholders, Board of Directors and Management
- Assess profile suitability of Board Members, CEO and Management
- Ensure the succession of the CEO and top executives
- Define Management compensation
- Supervise the execution of the approved strategy
- Calculate the appetite for risk to be incurred
- Ensure ethics and integrity in the company's management

HOW TO CREATE AN EFFECTIVE BOARD – 3 STEPS TOWARDS GOOD CORPORATE GOVERNANCE

Do we have the best top management for our company? What kind of Board member is the most suitable in order to face future challenges and ensure the best decision making? Although the answer does not always necessarily lie in having non-family members as Board members this action brings in a breath of fresh air in these types of companies. Creating an Advisory Board separate from the owners can be another way of assisting with strategic decision making and creating value for the company. A good starting point to implement changes would be a diagnostic phase in which the objectives to be achieved are identified and set.

At Russell Reynolds Associates we have identified the stages that should be followed in order to achieve a good Corporate Governance.

1 Board Assessment

Once the strategic medium term objectives have been defined, it is necessary to determine whether top management (Board, CEO and Executive Committee) are prepared to achieve them and whether the Board is ready to supervise their progress.

Therefore, companies start with a Board assessment aimed at providing in-depth feedback on how to achieve the objectives set.

The assessment of Board effectiveness should be carried out on two fronts: the suitability of profiles and their working dynamics. Having the right profiles is not enough so group processes and dynamics should be aligned with the objectives set and the environment should be one of trust and transparency, where useful debate can take place.

From this analysis one can usually work out whether there is a need or not to recruit any Independent Advisors (non-family members) with complementary backgrounds that can help achieve the objectives set. Independent Advisors can also provide a number of recommendations to improve processes (number of annual meetings, agenda and length of meetings, information to be shared, quality of the debate and decision making, follow up, etc.)

2 Recruiting Independent Directors or Advisors

Recruiting non-executive external independent advisors is a way of bringing in diverse and invaluable backgrounds and expertise. They can help avoid strategies that have already been proven to be inefficient or warn against outdated technologies. They can also contribute to creating value by developing new digital sales and marketing tools which may pave the way to new channels and markets, for example.

A balance between shareholders' representatives, executives and capable independent advisors will not only lead to innovation in the decision making process but it will also ensure the creation of value.

An attractive project with an appropriate Board culture and dynamics may be a way of attracting and recruiting the right people as Independent Advisors.

3 CEO succession planning

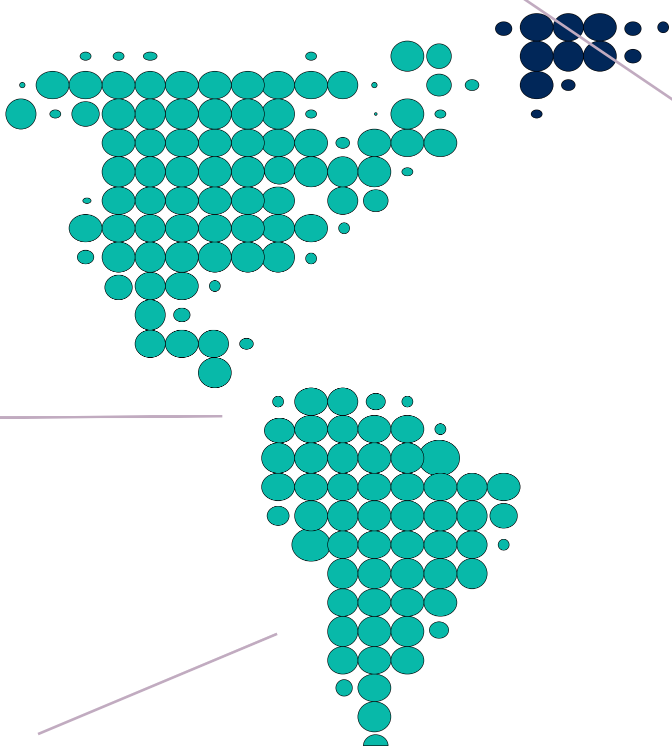
One of the Board's main responsibilities is to ensure the suitability of the company's CEO or top executive, in addition to always having an up to date Succession Plan should the need for it arise – regardless of whether such change is desired or not. Therefore, it is important to carry out an assessment to ascertain the suitability of a company's CEO and to identify who within the management team could be ready to take over this position, should the moment arrive. Alternatively, and if necessary, it would be important to identify the options available in the market.

To this end, it is necessary to describe the qualifications and skills the organization will need in the future, and to carry out an in-depth assessment of potential candidates – both internal and external. This needs to be done without creating false expectations whilst at the same time being careful to keep motivation up and the group united. Additionally, confidentiality about external candidates is a key factor in the success of this type of process.

INTERNATIONAL EXAMPLES OF GOOD CORPORATE GOVERNANCE

SPAIN

When **Desigual's** founder decided to set the basis to sustain the international expansion of his company (specialized in retail apparel) he decided to create a Senior Advisory Board first followed by a formal Board, with the resulting appointment of international NEDs and the optimization of Corporate Governance practices.



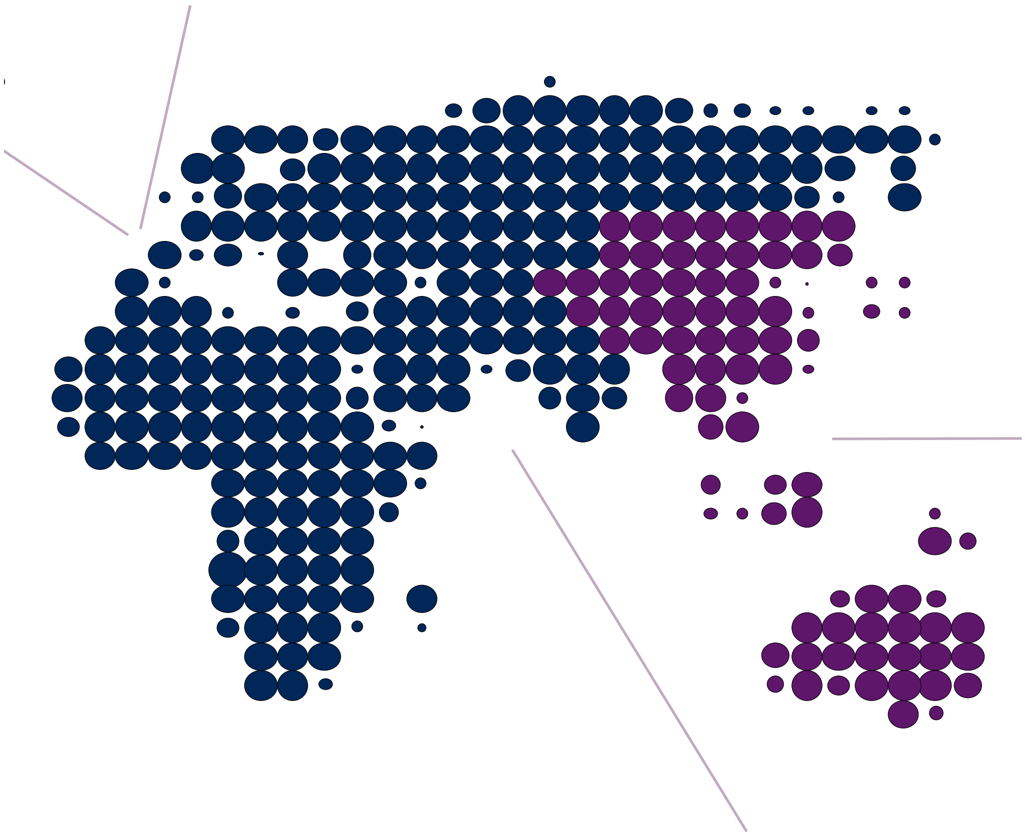
MEXICO

Founded 125 years ago as a brewery, **Femsa** is today one of the largest Coca-Cola bottlers in the world, with presence in 15 countries. In addition, amongst its most prominent businesses we find OXXO, with more than 14,500 convenience stores in Mexico and 14 countries in Latin America, which has made the company the biggest Retailer in the region. The Board of Directors of Femsa, a family run company listed on the Mexican and New York Stock Exchange, has always been characterized by having 25% of Independent Members. The selection of these Directors and its Chairman, a non-executive member of the family, is carried out professionally based on the competencies required in order to achieve the company's strategic objectives.

BRAZIL

Following with probably the most critical responsibility of the Board, the controlling shareholders of Gerdau were planning the succession of the Group CEO and in that process identified some internal potential candidates. In light of the international expansion plan of the group, **Gerdau's** shareholders wanted to make sure they would pick the most suitable person for the job.
This is why, they engaged RRA to perform an independent assessment and benchmark against the market with in depth competence based interviews with 2 specialized Consultants (one with industry knowledge and another with functional expertise).

When the Spanish Real Estate started to decline, **Grupo Gomendio** realized it needed to review its Corporate Governance processes and optimize the Board's composition. Before making a final decision RRA assessed the entire Board, comprised by some family members and Executives. This allowed them to learn about best practices applied in other companies.



INDIA

NIRAV Modi, third generation of 'diamantaires', founded the retail jewelry company bearing his name three years ago. While not publicly traded and still a relatively young business, he very quickly understood the importance of having a high level Senior Advisory Board of four independent CEO level professionals from the luxury and jewelry industry. RRA helped him recruit his Advisory Board that meets five times a year to discuss the development of the business and provides guidance to the executive team.

MIDDLE EAST

The retail specialist **Group Majid Al Futtaim** decided several years ago to implement the majority of the international recommendations for Good Corporate Governance. As a result, they not only improved their decision-making process while recruiting several international advisors to its parent and subsidiary companies, but have continued their successful international expansion to more than 14 countries with 33,000 employees. This policy, along with the transparency in the decisions taken, have led them to be considered by Standard & Poor's and Fitch as the highest rated unquoted group.

WHAT DOES IT TAKE TO ATTRACT THE BEST NON-EXECUTIVE DIRECTORS AND TOP EXECUTIVES TO FAMILY OWNED COMPANIES?

Once the Board's existing shortcomings have been analyzed, it is time to get down to work to resolve them. In addition to improving the Board's processes, it is also necessary to identify those professionals who are going to help in achieving the objectives. The cultural fit of the candidates will ensure their successful integration in these complex organizations.

The importance of cultural integration and understanding emotional profitability

If an external candidate that has undergone and succeeded in a recruitment process (based on his/her profile, credentials, references, interviews with expert consultants and an ad-hoc jury interview process set up by the company) failed to deliver, one ought to analyze the reasons why this candidate has fallen short of expectations. The main variable, which is sometimes the hardest to control, is the integration of a candidate in the company's culture. This factor is especially relevant when dealing with family-owned companies.

Cultural integration involves understanding the concept of "Emotional Profitability", which is a key factor in family owned companies.

Everyone understands profitability in monetary terms but emotional profitability is defined as the satisfaction achieved by every shareholder during a company's life and their participation in it even after selling it. This forces us to consider the Founder's legacy, the company's mission and shared values, as well as more common factors, such as common interests among shareholders, sustainable profitability, and management consensus.

As it happens, one of the main differences between Institutional or Private Investors of any international stock market index and shareholders in a family owned company, regardless of whether it is listed or not, is that the former are driven only by financial profitability. Longstanding shareholders in family owned companies mostly try to find some balance between financial and emotional profitability, especially when the Founder's legacy is close in time, or very strongly rooted. All these issues will be a part of the corporate culture.

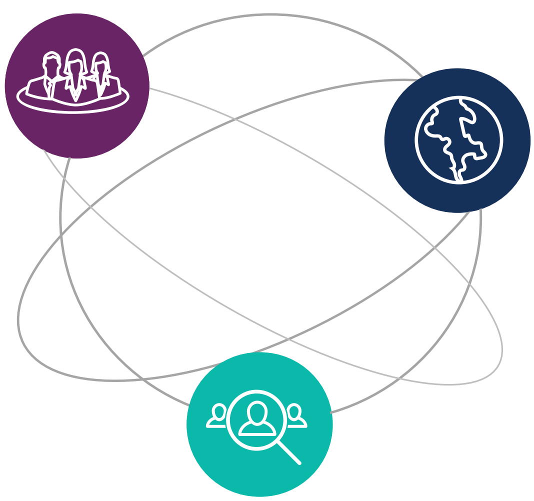
At Russell Reynolds Associates we have developed a tool for Culture Diagnosis to "quantify" an organization's culture. Through an on-line questionnaire, the "guardians" and "evangelizers" of the Culture (Top Management) define the desired culture to be set as an objective.

On the other hand, the organization completes a questionnaire that will provide a diagnosis of the starting point and main efforts needed in order to achieve the desired culture. This feedback is then analyzed by demographic groups (department units and functions, level, seniority, geographical location, etc).

Although sometimes non family owned companies can offer top executives better or easier to achieve compensation packages and career progress, the cultural environment of family owned companies can offset these aspects.

CONCLUSIONS

1. Family owned businesses represent a large portion of the worldwide economy, especially in emerging markets. These kinds of companies are essential as a point of reference and as corporate ambassadors of their domestic markets.
2. The globalization of markets and the current business environment means that decision-making processes need to become more and more sophisticated every day. Good Corporate Governance helps to facilitate decisions about the internationalization of business, the succession of CEOs and Senior Executives or the strategic positioning of companies.
3. The sooner the company owners and its Board address the issue of improving Corporate Governance, the easier it will be to adopt the right strategies, identify the right person to make then happen and increase profitability.
4. The review and modification of the processes by which the Board of Directors is governed, as well as the suitability and complementarity of the profiles that form it, will be key to its correct operation and to the optimization of Corporate Governance.
5. Therefore, they need to rely on other factors such as having an attractive project, an effective Corporate Governance and an open and welcoming culture to newcomers. This is of great relevance when trying to attract or retain a Top Executive.
6. At Russell Reynolds Associates we have learned to identify the real motivation of candidates and, more importantly, to evaluate their fit with the values and culture of an organization. Understanding the objectives a family owned company wants to achieve, and not financial profitability, is what makes it possible to attract the most suitable candidate.



AUTHORS

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Russell Reynolds Associates is a global leader in assessment, recruitment and succession planning for Chief Executive Officers, boards of directors, and key roles within the C-suite. With more than 300 consultants in 45 offices around the world, we work closely with both public and private organizations across all industries and regions. We help our clients build boards and executive teams that can meet the challenges and opportunities presented by the digital, economic, environmental and political trends that are reshaping the global business

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