

# What every family member needs to know about strategy



By John L Ward and Randel S Carlock



**Family owners, and all major shareholders in the family business, need to understand the strategic planning process of their business to sustain the long-term value of their company**

JAN OWNER IS A NON-EMPLOYED shareholder in his family's business. He tries to keep up with developments in the business by reading the minutes of each board meeting. He is shocked to read in the most recent minutes that management is thinking about changing its strategic direction, borrowing more money, and not increasing annual dividends for the first time in eight years. He immediately calls up the Chairman. "What is going on here?" he asks. The Chairman tells him that the company is faced with a strategic challenge that will require a period of increased investment.

Jan is uncomfortable with this explanation. The business has long benefited him and his family, and he takes great pride in the company. But he does not like the sound of the changes, and he is not sure why they are necessary. He wants to be a competent owner and an appreciative supporter of the business, but he does not know how to begin assessing management's recommendations to the board. Jan needs to understand how business strategy develops and the benefits it creates for all stakeholders.

Like Jan, all family shareholders need a basic understanding of strategy. Usually, their family business holding is their largest investment, and they need to know how strategic decisions will affect their risk, liquidity and return on investment. Many family owners take great pride in their family's reputation and business heirloom. In times of change, however, understanding strategy is essential to sustaining this emotional stake in the business. Management also functions better and can make more effective decisions when it feels it has the informed consent of the owners. For all these reasons, learning the basics of strategy is essential to shareholders like Jan.

## **Understanding business planning**

Jan should begin his education by learning the basic principles of strategic planning. Businesses face constant change. Markets evolve and innovative

competitors are always fighting for greater market share. To stay competitive, businesses must continuously adapt and reinvest. The rate of reinvestment is the most fundamental strategic decision made by all businesses. Reinvestment levels are driven by the industry a business operates in. Much of the strategic planning process focuses on assessing the "opportunities and threats" of the industry and competitors. Many planning tools are used to analyse the

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**Family owners take great pride in their family's reputation and business heirloom; understanding strategy is essential to sustaining this emotional stake**

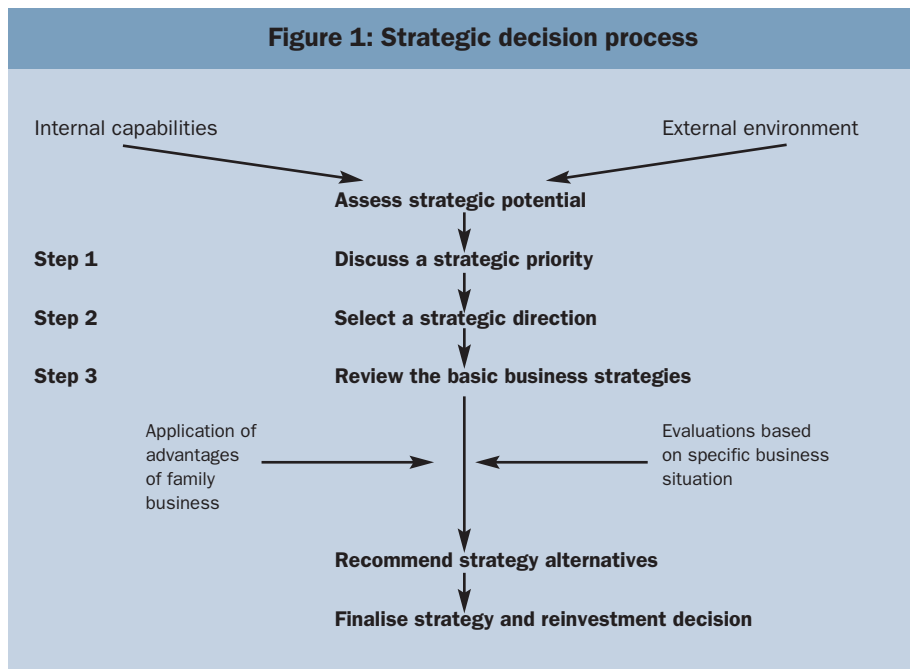
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growth potential of the market and the company's market share relative to competitors. These factors determine the level of investment necessary to remain competitive in the industry.

The second driver of reinvestment levels is the relative competitive position of the company within its market. The strategic planning process assesses the "strengths and weaknesses" of the company, both internally and externally. It looks at market share trends, and the financial and organisational resources of the company. Often, planning seeks to articulate the company's "core competencies" and its "competitive advantage". The assessment of "strengths, weaknesses, opportunities and threats" is often called a SWOT analysis. This analysis seeks to document the strategic potential of the business.

The second stage of the planning process assesses how reinvestment should be targeted to sustain or increase the company's "competitive advantage". In this stage, different strategic priorities and directions are discussed, and a number of basic, business strategies are

**Figure 1: Strategic decision process**



reviewed. In family companies, the impact of different strategies on their family ownership also needs to be assessed. A business strategy can only work if it is consistent with the family's values and vision of ownership, including its expectations for return on investment and income distribution. After these assessments are complete, several appropriate strategies are developed in greater detail for recommendation. From these alternatives, a final strategy is chosen (see Fig. 1) and a reinvestment decision is made.

### **Roles in the strategic planning process**

Generally, in business, management executes the strategic planning process, and the board of directors reviews the process and its outcome. Most planning experts agree that management "ownership" of strategy is an important component in successful planning. Boards, however, serve the vital function of

questioning management's assumptions, and providing rigorous, independent assessment of recommended strategies. Boards also serve to assure that management's strategies reflect the best interests of the shareholders and will maximise value creation while minimising risk.

Shareholders rarely have direct input into strategy selection. However, underlying all strategic decisions is the value proposition made by the company to its shareholders. In the case of family businesses, this value proposition can be more highly developed, particularly with the use of parallel planning, which links business strategic planning to family continuity planning. In family companies, the board serves the vital role of assuring the proper alignment of business strategy and ownership expectations (see Fig. 2).

### **The key to alignment**

All businesses go through lifecycles and

need reinvestment. As businesses age and grow their strategic potentials change as do necessary reinvestment rates. In family businesses, ownership also goes through lifecycles as the family ages and generations succeed. With time, ownership becomes increasingly dispersed, and the investment objectives of shareholders often change. Over time, strategically aligning business and ownership objectives becomes more challenging and critical.

Family shareholders like Jan need to understand how the natural lifecycles of their business or its industry will impact needed reinvestment levels over time. All businesses have limited capital to deploy. Public companies compete for capital, and their cost of capital can vary considerably over time. Industries fall in and out of favour with investors, and markets move up and down. Privately held family businesses with owners like Jan typically have lower, more stable costs of capital, which can give them a significant advantage over other companies.

This family business advantage depends upon balancing the trade-off between strategic business investment and current shareholder distributions. Privately held family companies tend to grow capital internally, through retained earnings. As the proportion of earnings paid out to shareholders increases the rate of internal capital growth decreases, leading to lower levels of capital for strategic reinvestment. Because of this relationship, family businesses can rationally adjust their capital growth rates over time to match their strategic need.

The simple formula illustrated in Figures 3 and 4 shows the direct relationship between the percentage of profits paid out to ownership, and the sustainable growth rate a business can achieve. Family businesses outperform public companies because their closely held ownership groups are more willing to adjust their reinvestment levels for the long-term strategic benefit of their businesses. This is particularly true when the family ownership is actively engaged through a parallel planning process.

### **Building long-term value**

Family owners like Jan need to understand the strategic factors that drive the long-term value of their business (see Fig. 5). They should learn the basics of their industry, and get to know its general size, customer

**Figure 2: Fundamental strategic principles for family owners**

- Continuity requires continuous adaptation, innovation and reinvestment
- Owners and the board should measure and monitor each other
- The amount of reinvestment depends on industry opportunity and relative company strength
- Reinvestment competes with shareholder liquidity for resources
- Management sets strategy: the board reviews it, the owners determine the levels of reinvestment and liquidity

## FAMILY BUSINESS KNOW-HOW: *Planning processes*

**Figure 3: Calculating sustainable growth rate with bonus and dividend payments**

Estimated sustainable growth rate	= Retained earnings Beginning owners' equity	= \$90,000 \$1,000,000	= 9%
<b>Net income after tax (\$)</b>	<b>Dividends (\$)</b>	<b>Retained earnings (\$) *</b>	
500,000 Operating profit			
– 100,000 Consulting expense			
400,000 Pre-tax income			
– 160,000 Taxes (40%)	150,000		
<hr/> 240,000	<hr/> – 150,000	<hr/> = 90,000	

\* Assumes no change in proportion of assets (inventory, receivables) or in operation efficiency

**Figure 4: Calculating sustainable growth rate without family payments**

Estimated sustainable growth rate	= Retained earnings Beginning owners' equity	= \$360,000 \$1,000,000	= 36%
<b>Net income after tax (\$)</b>	<b>Dividends (\$)</b>	<b>Retained earnings (\$) *</b>	
600,000 Operating profit			
600,000 Pre-tax income			
– 240,000 Taxes (40%)			
<hr/> 360,000	<hr/> Nil	<hr/> = 360,000	

\* Assumes no change in proportion of assets (inventory, receivables) or in operation efficiency

reinvestment are mutually dependent and often can only grow in tandem. Family owners should not only track growth in net income but should know how efficiently their business produces profits. Return on investment (ROI) measures are important for tracking this and economic value added (EVA) is the best of these. EVA measures profit performance against a calculated cost of capital, which includes a cost for debt and equity. Economic Value Added tells you how efficiently the business produces profits, and whether increased investment is continuing to produce profits as efficiently over time.

One more factor that drives long-term value creation is innovation. Businesses that stay the same eventually fall behind. Arguably, nothing has greater potential to impact long-term value creation than successful, strategic innovation. Family owners should be aware of key strategic initiatives and why they are being undertaken.

### Conclusion

Understanding strategy can be challenging for family owners like Jan. As businesses and their owning families grow larger, generating mutually beneficial strategic thinking takes careful planning and a shared process. Family owners like Jan need to understand the strategic planning process of their business. They need to know the roles of management, the board, and ownership in generating strategy. In addition, they need to understand the balance between profits, shareholder distributions and reinvestment levels.

Finally, family owners like Jan need to understand the “strategic story” of their business, and what the future may hold in the way of challenges and opportunities. When owners like Jan know what it will take to create long-term value, they tend to support reinvestment at appropriate levels, giving their companies the key strategic family business advantage. ■

characteristics, and growth trends. They should know about market share in the industry, and their company's position relative to key competitors over time. Family owners need to know the “strategic story” of their business, including the potential for growth in their market and the lifecycle stage of their business.

Family owners should also learn about the internal capabilities of their company. They should understand the core competencies and underlying values

that drive the historic success of the business. They should know about the general organisational structure of the company, its governance, and how roles and responsibilities are defined. They should know the current competitive goals of the company, and the business strategy for accomplishing these goals in the future.

Reinvestment rates and profitability levels are two very important strategic factors that drive long-term value creation. In family businesses, profit and

**Figure 5: Six key factors to monitor in long-term value creation**

- Industry growth
- Market share trends
- Organisational and cultural strengths of the business
- Reinvestment level
- Strategic innovation
- Economic value added

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