Relative returns: why you should seek out family-run firms

Studies show that shares in family-owned companies tend to outperform the wider market. But how do you identify the ones most likely to succeed? Matthew Partridge investigates

When it comes to family-run firms, we tend to think of small companies serving a market niche. In fact, several of the world's corporate behemoths are in family hands. About 30% of the S&P 500 and 40% of continental companies with sales over $1bn meet the standard definition of family ownership: at least 20% of the shares are controlled by a single family. Family ownership is less common in the FTSE, although examples include Hikma Pharmaceuticals and AG Barr. But how do they perform? And how can investors identify the best bets in this field?

What the research tells us

There are two major studies on how family ownership affects stock returns. Investment bank UBS found that listed family-owned firms have raced ahead of the overall market over the last decade. Specifically, the UBS Small & Midcap Family-Owned Global List has returned 17% per year in the past 15 years, against 6% for the MSCI global large-caps and 8% for the MSCI global small-caps. Family-owned technology companies have vastly outperformed the Nasdaq, even though family-controlled businesses are often associated with the old economy. The shares of family-owned companies also tend to be less volatile than shares in comparable firms.

Of course, there are a few caveats. Shares in the UBS Family index have been hit harder than most small caps by the decline of the stockmarket over the past few months, falling by just under 20% since the start of the year. It is also important to note that their outperformance is not constant over time, with strong returns only continuing for as long as the family have a large stake and remain actively involved in what's going on. Once families start drastically reducing their stake, with a view to exiting completely, the relative outperformance of the family firms usually starts to peter out.

A study by Credit Suisse looking at the world's 1,000 largest global family firms also found that their shares outperformed – by around 4% a year since 2006. This outperformance was consistent in Asia, Europe and the US, though it was strongest in continental Europe, where it was around 5% a year. The companies boasted superior revenue and earnings growth. While this was more pronounced among first and second-generation family firms, third-generation ones also did better than average, suggesting that they were still decent investments.

The advantages of family firms

So what's behind the numbers? "Having spent a lot of time in boardrooms, advising family firms, and from my own research, it's clear that family control brings two main benefits", says Heinz-Peter Elstrodt, an executive fellow of organisational behaviour at London Business School. Firstly, "they bring concentrated ownership". This is important in overcoming what is known as the principal agent problem: if share ownership is widely dispersed, the average shareholder owns only a small stake and therefore doesn't have a large incentive to hold managers to account. That allows them to get away with poor performance.

Long-termism is another hallmark of solid family-owned companies. Joe Bauernfreund of the British Empire Trust notes that family firms are more likely to have a vision about where they want their company to go. Instead of just looking to make a quick buck, family members "are usually long-term investors who are prepared to favour profits being reinvested in order to grow the business for the future".

They can also act as a counterweight to the tendency of professional managers, whose compensation may be linked to short-term performance, to focus on the next few quarters. Family members also tend "to make sure that their companies are run in a sustainable, conservative manner", which should bolster long-term returns.

Avoiding leverage

Taking on too much debt can foster profligacy and means that even minor setbacks can have serious implications. So it's encouraging to note that "family firms are known for a more prudent use of leverage", says Quaero Capital's Jean Keller.

They are also better at dealing with the other problems that trouble modern companies as "they tend to have lower executive remuneration". Family control is also bad news for investment bankers desperate to generate a large number of fees in mergers and acquisitions activity – families typically avoid overdiversification and unnecessary acquisitions.

Of course, not all the returns from shares in family firms are down to the superior performance of the underlying companies. Some are due to the market consistently undervaluing them, which provides scope for healthy long-term share price growth. Many family-owned companies have done well in recent years, yet their stocks still trade at a substantial discount to sector peers, "making them particularly attractive to investors looking for quality at a reasonable price", reckons Bauernfreund.

Where family firms can go wrong

Even the supporters of family firms can admit that things can sometimes go wrong. These problems can be summed up in three words: "emotion, succession and nepotism", says Frans Jurgens of Juno Capital, a fund that invests in a lot of continental family firms. While the emotional attachment "means that the owners are emotionally connected to the business", it also means that "change can be too slow... people want to keep doing it the way dad or grandad did it, even though market conditions may have dramatically changed". Conversely, sometimes a new generation arrives and goes on a takeover spree "to make a point to the elders".

A clash of generations

The replacement of one generation with another can be a particularly trying time, says Elstrodt. His research suggests that succession problems trigger the sale of many family firms to outsiders, "with

"Sometimes a new generation will go on a takeover spree to make a point to the elders"

Succession problems can throw a company off course

only 30% of family firms surviving into the third generation". Perhaps the most trying transition is the changeover from the founder to the second generation, "which involves particularly complicated changes". While companies "tend to be a one-man show" in the first generation, the second "needs to learn to do things very differently" if the firm is to endure. Unfortunately, in some cases, the older generation is loath to ditch the current business model, even when it is clearly necessary.

The transition between the generations is also complicated by the fact that family members may have different objectives. While many family members will want profits to be channelled back into future growth, other members may "lose interest in the firm, or just want to receive a steady stream of dividends", which can lead to missed opportunities. Throw in emotions, "and by the time you get to conflict it may be too late", Elstrodt warns.

The danger of nepotism

Professor John Van Reenen of the Massachusetts Institute of Technology thinks nepotism is a key risk. A 2011 study authored by Reenen, with Nicholas Bloom and Raffaella Sadun, found that those family firms overseen by professional managers tended to be well run, since the outside family members kept the managers on their toes.

However, handing the reins to the eldest son led to shoddy management practices and hit both the share price and profits. Firms led by eldest sons were conspicuously "weak on people management practices, such as merit-based promotion, pay, hiring and firing". Nepotism at the top can lead to "merit taking second place to other things such as connections or tenure" elsewhere.

Still, it's important not to overestimate the impact of these disadvantages. "People are always nervous about the impact of family feuds or other issues", says Keller. Indeed, the likelihood is that fear of poor governance is part of the reason family firms boast such impressive returns: they are often available on the cheap. However, non-family firms also have their fair share of management turmoil and governance problems. Indeed, "the risk of a CEO in a conventional firm pillaging their company by issuing themselves cheap options" is bigger than any problems typically associated with family outfits.

How to spot the good ones

In order to maximise your chances of success, there are four main things to consider before deciding to invest in a family firm. Elstrodt suggests that the amount of shares that a family should control is a balancing act. Too small a stake "is not a good thing" because they have little incentive to make sure that the firm is properly managed.

However, "if they have more than 70% then the firm is effectively a private company", and may neglect the interests of outside shareholders. So, what you want is for "the stake to be low enough for the

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"The ideal family stake in the business is between 40% and 70%"

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family to be forced to accept outside feedback, but high enough to give them an incentive to care", ideally "between 40% and 70%" of the company.

Even if the family control is in this "sweet spot" it's also vital to have strong corporate governance, with outside directors who are willing and able to make a contribution. Fund managers can gauge how robust the board is quite easily by approaching senior management directly. It's harder for ordinary investors. But they can look at the background of the non-executive directors to see how much experience they have and any connections they may have to the family. "If they are school mates and golfing buddies of the CEO, they are not going to provide independent advice," says Jurgens.

Do they have a plan?

Jurgens also thinks that you need to consider the family's vision for the future. Part of the reason family firms outperform on the continent is because continental European firms "see public listings as a necessary evil to raise cash for long term investment", notes Jurgens. By contrast, British family firms tend to float on the stock exchange "in order to enable the family to exit the business and convert their stake into cash". One question to determine which of the two camps a firm falls into is to ask the management "whether they have a three- to five-year plan for where the company is going".

In this context, rising dividends as a proportion of earnings can actually be a warning sign, especially if they are accompanied by falling returns on invested capital, a key gauge of profitability. Based on his experience, Jurgens thinks that is inevitably a sign "that management is running out of good ideas". Of course, management shovelling money into unprofitable ventures is hardly auspicious either, since is it important that they "are able to allocate capital efficiently". Overall, "I'd rather see a firm maintain high returns on capital, even if that meant that the dividend stayed the same, or even fell, in the short run", says Jurgens. While family ownership may provide an additional boost to both performance and returns, Jurgens' experience has taught him that the most successful family firms and the most successful non-family firms have much in common.

Indeed, his decision to specialise in family firms came about "because I looked for the firms with certain criteria and discovered that they were mostly family-run". Qualities conducive to strong long-term returns are often intrinsic to family-run outfits, notably low levels of debt, high margins, long-termism, and "a management with skin in the game".

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Golfing buddies don't provide independent advice

"Continental firms see public listings as a necessary evil to raise cash for investment"

The family-run firms to buy now

The Wacker family has been involved with German construction equipment manufacturer **Wacker Neuson SE (Frankfurt: WAC)** for over 150 years. Johann Christian Wacker set it up as a blacksmith's in the mid-19th century. Although construction is a highly cyclical industry, it has managed to grow by an average of 7% a year over the past five years, and shows scant sign of slowing down.

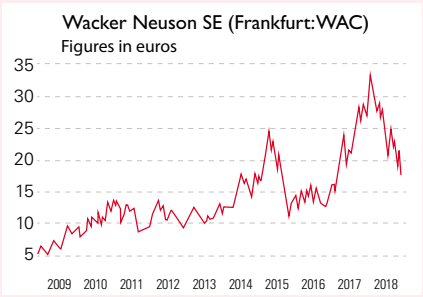
In addition to robust growth, it has maintained impressive returns on invested capital of just under 10%. It has an attractive valuation, trading on a 2019 price-earnings (p/e) ratio of 10.3 and only a slight premium to the book value of its assets.

Brembo (Milan: BRE), one of the acknowledged leaders in the development of braking systems in cars, is owned by the Bombassei family, who have a 53% stake in the firm through a holding company. Its systems are focused on the high end of the market and are used in Formula 1 cars. Unlike most of its competitors, its brakes use aluminium calipers, making them 20-30% lighter than the competition. Over the past five years sales have grown by over 11% a year, and it has ambitious plans for global expansion. Despite this, it trades at only 10.5 times 2019 earnings.

The Thorpe family own a majority stake in **FW Thorpe (LSE: TFW)**, which manufactures several different brands of professional lighting systems sold around the world. The company trades on a 2019 p/e ratio of 21, a hefty premium to the overall market.

However, this is more than compensated for by breakneck growth, which has seen revenue nearly double since 2013. This growth hasn't come at the expense of margins either: FW Thorpe boasts a 15% return on invested capital.

Jardine Strategic Holdings (LSE: JDS) owns large stakes in several companies in Hong Kong and Singapore, including convenience story group Dairy Farm, property group Hongkong Land, and the Mandarin Oriental group of luxury hotels. It also owns part of the overall Jardine Matheson conglomerate. Despite the current turbulence in Asian markets, the region's growth prospects remain solid. It also looks attractive from a valuation perspective since it trades at 11.4 times 2019 earnings and a 30% discount to the value of its net assets.



One of the largest family firms in the world is **Exor (MILAN: EXO)**. This is the holding company for the Agnelli family (which owns just over half the shares). It owns PartnerRe and football club Juventus as well as major stakes in Fiat Chrysler, Ferrari and the Economist.

While there are concerns about the amount of debt that it has recently taken on, the management has outlined a programme that should allow leverage to be reduced to a more sustainable level. It currently trades at bargain basement levels – a mere 6.6 times 2019 earnings.

While several companies, such as Solactive and Euronext, have developed indices that track the performance of family firms, no company has yet introduced an exchange-traded fund. However, the **British Empire Trust (LSE: BTEM)** has a large number of family firms in its portfolio, with four out of the top ten holdings (Exor, Pargesa, Aker SA and Wendel) owned by a family or the founder. Despite the fact that markets have been focused on growth companies for the last 15 years, BTEM, skewed towards value stocks, has managed to outperform the FTSE All-Share returning 9.9%, against 7.6% for the FTSE. What's more, BTEM trades at a discount of 9% to net asset value.