Ushering in CHANGE

Serious challenges loom for the family businesses that power Europe's economy, say Brunswick's **CARL GRAF VON HOHENTHAL, FIONA CLAIRE LITTIG** and **ALESSANDRO IOZZIA**

Family businesses make up as much as 80 percent of all European enterprises, account for roughly 50 percent of the region's GDP and provide about half of its jobs, according to estimates from European Family Businesses, the EU federation representing long-term family-owned enterprises.

The majority of these family businesses are small- and medium-sized, yet all face the same modern pressures as their larger competitors – from globalization to rapidly changing technologies to mercurial markets. But if their smaller size offers potentially greater agility to adapt, the need to stay true to their founding principles makes any restructuring process potentially more intimidating for owners and unsettling for their employees, customers and the public.

Looming especially large on the horizon for family businesses is the question of leadership succession. In their 2015 report, "European Family Business Trends," KPMG found that one out of every four family business owners was thinking about passing the day-to-day management of the business to the next generation in the coming year, while one out of five was thinking of handing over ownership of the business.

Though they have vastly different economies and cultures, Germany and Italy are case studies in the critical role family businesses play in Europe for national economies. They also illustrate the challenges family businesses face from increasingly fast-paced technological innovation and impending leadership transitions.

THE SMALL BUSINESSES POWERING A BIG ECONOMY

Germany's "Mittelstand" is a class of companies forming the backbone of the world's fourth-largest economy and consisting of roughly 3.5 million small- and medium-sized businesses. They accounted for nearly 99 percent of all German businesses in 2011, and were frequently invoked as a reason why Germany fared better than its neighbors through the 2008 financial crisis.

However Mittelstand is as much a business philosophy as it is a descriptive category. These businesses are highly specialized and often family-owned. Owners and managers tend to be the same people or from the same family and thus share equally in liability and risk. The businesses are marked by a focus on long-term goals and a strong sense of regional solidarity, loyal customers, high quality goods and services, and an emotional bond with their employees. While annual employee turnover at some big US companies can be 30 percent, it is only 2.7 percent at these smaller German businesses, according to *The Economist*. The Mittelstand culture was described by the *Harvard Business Review* as "the forefront of a modern management model that builds flatter, more innovative and more networked enterprises."

But this family ownership can also bring negative effects: strained human resources, discrimination against non-family minority shareholders, internal conflicts that can arise in even the best of families, and the murky question of leadership succession.

This last point, succession, is set to become an especially pressing concern for the Mittelstand. According to KfW Development Bank, CEOs at 580,000 small and medium-sized German enterprises will announce a change in leadership by next year. Roughly four million jobs depend on the success of that process.

Studies show that the transfer of power from founder to other family members often results in a loss of value. The practice of primogeniture – appointing the first-born son regardless of management qualities – can be particularly damaging to the company's reputation.

In the absence of a clear succession plan, innovation tends to slow and competitiveness suffers as the owner gets closer to retirement. The successor needs to develop the company's strengths in line with rapidly changing technology. Automation presents technological challenges but also threatens product and service quality and employee loyalty – the very things that define the family business experience. Globalization is also increasing demand for executives with experience in international markets, potentially leading a company further from its geographical base.

RINGING IN 1,000 YEARS

In Italy, family businesses comprise 85 percent of the country's companies and 70 percent of its workforce. But more so than other EU

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countries, Italy's family businesses are marked by longevity. Of the 100 oldest businesses in the world, 15 are Italian; the country is also home to a full half of the world's oldest family businesses. The oldest is bell-maker Pontificia Fonderia Marinelli, which traces its roots to craftsmen active around the year 1000.

Even such long-running businesses are finding succession to be a challenge, as the younger generations are more inclined to move away from traditional businesses to make better use of their technological expertise or pursue their own business venture. "For them, the family business is not as attractive as it was years ago," says Guido Corbetta, the AIdAF-EY Professor at Bocconi University in Milan.

For those that are interested in taking over the family business, their time may soon be at hand. According to the Italian Association of Family Businesses, 22 percent of business leaders are over 70 years old and 24 percent are over 60. And if age isn't inspiring change, perhaps poor performance might: between 2007 and 2014, Italian companies with older leaders recorded poorer performances in terms of return on investment and on equity.

Nearly half of small- and medium-sized businesses in Italy have boards of directors completely made up of family-related members. These pure-family models often perform better than mixed boards, or ones comprised solely of outsiders, regardless of whether the company is led by the first or the second generation. About 66 percent of Italian family-owned businesses are fully managed by family members, compared with 26 percent in France and 10 percent in the UK.

However, that close-knit culture is shifting, according to Corbetta. "The number of family-owned businesses moving toward external managers is increasing, partly because of a need for technical skills, but also because of commercial and management pressures," Corbetta says. "Families are conscious of the value a third party can bring in new contacts and networking opportunities."

INVENTING THE FUTURE

Pressured by market and generational shifts, family businesses in both Germany and Italy are actively looking to innovation and international perspectives as the road forward.

The Italian government, through its "Industria 4.0" program, is encouraging small and medium-sized manufacturers to embrace advances including 3-D printing, augmented reality, and process optimization and analysis. For 2017, it hopes to expand private investments by €10 billion to €90 billion ($10.4 billion to $93.7 billion), launch academic programs and research centers, and build high-capacity networks across the country.

Similarly the EU is looking to reduce regulatory pressures on small- to medium-sized business that could hamper innovation. Globalization pressures and increasingly fierce competition could cause such businesses to back off their commitments to invest in innovation.

As family businesses operate in an increasingly global marketplace, international experience seems a prerequisite for the next generation of leaders. This is reinforced by a growing appetite for international trade among all stakeholders. A Brunswick Insight global survey (Page 17) found that 58 percent of all age groups had a positive view of international trade; among those aged 18 to 29, that number rose to 65 percent.

Above all, family owners should be looking for leaders with vision – able not merely to continue the business, but to transform it.

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