INSEAD on performance

Control, performance and shareholder value

Two leading business school professors compare the strengths and weaknesses of family-run companies versus public companies

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Short-term shareholder value vs. long-term performance

Is there a tension between the popular concept of short-term shareholder value as measured by a company's share price and long-term performance in a family-run business?

Theo Vermaelen: Absolutely not–there is no such thing as short-term shareholder value measured by the stock price. The value of a company is the net present value of all future cash flows from now to infinity. The share price is not the same as shareholder value.

Ludo Van der Heyden: There is no disagreement on that. As an investor, you have to decide whether you're worried or not about short-term stock price variation, and for most investors this is irrelevant because you can't control it, you can't manage it, you have to react very quickly. Eventually the share price will reflect long-term value creation–and if you see opportunities where the share price today is much lower than you think it should be in terms of economic fundamentals, then invest aggressively and conservatively and wait until the market catches up.

Theo: There are opportunities in the short term, however–especially when a company buys back its shares. Because it misses its short-term targets for earnings per share, analysts downgrade it and the share price falls. When the management announces a buyback, the market ignores it completely and people who buy that company's shares can make a lot of money if they hold

on to them long-term. The people that sell because of short-term considerations often sell too cheaply. Every year I give my list of such companies and it has proved to be the best investment strategy today.

'Managerial talent is not an inherited quality'

Theo Vermaelen

So if the market is wrong about your company, you should see it as an opportunity and take advantage of it. Of course, some people will be concerned about short-term share prices–if your company is too cheap, someone may bid for it and buy you out below fair value. That can be a concern if your company is not tightly controlled by a family: it's subject to hostile bids that are not driven by sound, fundamental reasons. An argument could be made that a family-controlled business which is immune to hostile bids is better for the long-term shareholders because they cannot be bought out at the price below fair value.

Ludo: There seems to be a premium for stocks in companies that have some type of dominant shareholder such as a family–so long as they do not have a majority holding. The premium becomes negative if there is a majority shareholder because then the other shareholders will have no voice, whatever happens in the short run. The market likes a reference shareholder such as a family which behaves with the mindset of a conservative investor. They're not going to sell out because they're going to pass the company on to the children.

Even the market recognises that you can't leave the market to the market when it comes to long-term value creation. If you just have shareholders without a relatively strong minority, then some value can be lost because management can do whatever it wants, there is no supervision. That was what led to the adoption of the remuneration approach of Stern Stewart in the 1990s which aimed to tie management incentives to economic value added. But it linked EVA to the share price which is exactly what you don't want for long-term value creation, because it encourages shorter-term animal spirits to do things that force up the share price.

So there are two very different games: to play the market in the short run and play it in the long run. I have visited companies where the CEO would welcome me in the lobby and check the share price, and then check it again after a one-hour meeting.

If you're interested in long-term value creation, it's a waste of time to look at short-term share valuations.

The new manager of a big company has no impact for at least three years. I spent ten years visiting factories and it takes two years minimum to turn round performance if you do everything right–and typically you lose a year because you don't have the right management. And if it takes three years just to improve a factory, it takes much longer to really change the business–to open a new product line, for example. Long-term value creation can take many years.

Ownership for value creation

The two professors then turned to the factors that can undermine long-term performance in a family-run company.

Theo: If the family intends having their children running the company forever, that limits the pool of potential managers and I do not see how that could be optimal for value-creation. Managerial talent is not an inherited quality–if I'm a good manager, my children will not necessarily be good managers too. You can maybe pass on the colour of your eyes and your hair

but not managerial talent. I know of companies where the founding father was a great guy with a great idea, but when he passed the company on to his sons, it brought down the company because they were useless managers. This is the danger if you start limiting your pool of potential managers.

Ludo: It's all about management incentives, understanding how you need to incentivise the managers to create long-term value. And most studies say that family firms which were thought to be inefficient are on average doing that better. Why? Because on average they're more committed to long-term value creation than non-family firms.

'It is easier to train an owner than a CEO'

Ludo Van der Heyden

Theo: You have to incentivise managers, but how do you incentivise them? That's the question. If you keep the company in the hands of the family and they care about the long run, that's fine. But holding on to a business for the long run is not necessarily value creation–sometimes someone else is a better manager than you are and can see better opportunities. In such cases, you should sell your business and this is my main problem with family businesses that don't want to sell their company.

Ludo: I advised a big family company, run by the father who was a genius. My advice was to sell the firm: I told him he was half of the value of the firm, and if he sold the firm now he would cash in on its value. But he was in his eighties and wanted to pass it on to his children–and the problem is that the children of geniuses are typically not geniuses. But families don't sell up often because members of the family say they have been waiting for their chance to run the company.

As a family, you always have to ask

whether we are the best owners. If we are controlling shareholders, are we the right controlling shareholders for the business? Given our interest as family shareholders, is investing in this business still what we want to do? The best way to remain a family firm for 300 years is to keep creating value for the next 20 years: if we as owners provide control and stability that creates value, let's continue it.

It's easier to train an owner than it is to train a CEO. You can't train a CEO who needs animal spirits which is an intangible characteristic, but I can train a good shareholder. So a family should certainly not take the view that a family member should be CEO.

Top: Theo Vermaelen
Above: Ludo Van der Heyden

The family company as incubator

The discussion explored the reasons for the premium commanded by family-controlled companies, and what can undermine it.

Ludo: One of the benefits of family firms is they can have a culture of long-term value creation. That doesn't mean they will never sell the business but that they do not overreact to negative developments. It's continuity, it's the fact that families care and they care about who represents them. But their focus must be to make sure that the family members who are on the board know what they're doing.

> **'As an investor, I want controlling shareholders obsessed with making money'**
> *Theo Vermaelen*

Theo: If the family firm is a public company, it has to raise money from other people who really care about money and are concerned about how much the family cares about making money. As an investor, I want controlling shareholders who are really obsessed with making money–I don't want people who care about family values and other issues. If the company is controlled by family whose goal is not to maximise returns but to make family members happy or do good for the environment or whatever, it should say that in advance to investors so that everybody knows it. Then people like me can avoid such companies and other people who like those goals can invest in them.

Ludo: I think the source of the premium commanded by family firms is not that they're going to maximise family happiness, but that they're more credible when they make a commitment to long-term value creation. Why are they more credible? Because it's part of their culture. In a good family firm, the first school is the family.

There is no question that if you are born a Rothschild, you're going to learn about finance from day one. By the age of 15, the chances are you're already a trader, and you're doing it with cousins and people you trust. And you trust them because you know

what they're good at and that people–including your mother and your aunt–will stop you from doing things if they are not good.

So the premium that family firms command is often that there is more credibility when they make an announcement to the markets because it's not going to change. And they are more credible because they're more careful about training the people who actually manage the commitment to this announcement.

Theo: But the family mission has to be about value creation and there's no way to guarantee that. There's no way that limiting control to a specific group of people is optimal, and there is no theory can justify this. After all, some family members will probably sell their shares. You have to have competition in the jobs market to guarantee that the best people are running the company. I understand there's a desire for commitment to the long run, but you can easily encourage that commitment by paying people with stocks they have to hold for long periods of time.

Does control matter?

Finally, the professors discussed the desire among many families to retain control of their businesses, and the implications for performance.

Ludo: Families are obsessed with control–but if you don't have a project, control is worthless. It's not control that should be the obsession, but the project–and whenever I talk to families about control, my question is control for what? Control by itself has no value unless you use it to execute a long-term project–that's the premium.

For example, if somebody says: let's merge–you're going to lose control but it's going to create a lot of value. Then the family could say, let's go ahead and exercise control together through a pact. That is what the Belgium families behind Interbrew did when they created a long-term pact to merge the business with AmBev of Brazil. They lost sole control of the business, but with the Brazilians they're in control of the biggest beer company in the world.

> **'Companies are not about happiness–they're about doing things'**
> *Ludo Van der Heyden*

Theo: Obsession with control can be dangerous. If people are obsessed with power and refuse to issue stock, they might then have to borrow money and leverage up too much. If you end up with debt in a very risky business, you can go bankrupt.

Ludo: The issue of control is about the psychology of an entrepreneur. Entrepreneurs don't do it for value creation, they do it because of their drive–it's their identity, it's their project. It has nothing to do with value creation, it's psychology, it's an obsession. But it's also good in the sense that our fundamental driver is ourselves. There are people who say they do it for others, but the more they say that the less I believe them–I think they do it for themselves.

Theo: That's why I think a hungry manager leveraged up is my ideal manager, someone that really wants to make money. These are the people I trust–the others have got too rich to care about cash flows.

Ludo: I agree. Companies are social instruments but the overall logic is an economic one. We need others, but we do it for ourselves. Value creation is a very tedious thing and happiness is a very personal thing. Companies are not about happiness, they're about projects, they're about doing things, they're about changing the world. When you have changed the world then you can sit back and do something different. ■

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This is an abstract of the Pictet Report, 'Focus on performance', issued April 2011. For further information please contact Ninja Struye de Swielande, nstruyedeswielande@pictet.com.