

## Family businesses are central to the global economy

Region	2010	2025 <sup>1</sup>
Southeast Asia	7,941	15,003
Latin America	1,266	5,608
India	858	1,338
Eastern Europe	5,797	8,057
Middle East	-	-
China	-	-
Africa	-	-

Region	Share (%)
Southeast Asia	80-90
Latin America	70-80
India	70-80
Eastern Europe	60-70
Middle East	60-70
China	35-45
Africa	30-40

- Makeup 35% of the companies in the Fortune Global 500 firms
- There are 5.5 million family businesses in the US
- Family-owned businesses contribute 57% of the US GDP, employ 63% of the workforce, and are responsible for 78% of all new job creation.

<sup>1</sup> Projection based on city GDP forecasts.  
<sup>2</sup> As of 2013 or closest available year, captured at headquarters location.

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## Family Business Definitions

- **Structural definitions** focus on the firm's ownership or management arrangements, e.g., "51% or more ownership by family members." *ownership*
- **Process definitions** stress on how the family is involved in the business – its influence on company policy, its desire to perpetuate family control of the business. *Control. Succession. Chairman. Board. family*

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## Why is the Industry Family Controlled?

- In the 1950s, over 70% of the 1785 daily newspapers in the US were family-owned
- All except one of the 12 largest newspapers in the US family controlled in 2006
- The 12 newspapers account for 50% of the circulation
- The desire to shape the news and hence public opinion
- "Preserving journalistic integrity"

Private Benefit of Control  
Or  
Competitive Advantage

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## Why is the Industry Family Controlled?

- Firms and industries are more likely to remain under family control when:
  - Their efficient scale and capital requirements are smaller
  - The environment is noisier *VUCA*
  - The investment horizons are longer

(Villalonga & Amit, 2010)

In a time of crises is family ownership good or bad?

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## How is Family Control Achieved?

**1. Disproportionate board representation**

- 80%  
55%: Representation on the board exceeding the voting stake

**2. Dual class stock**

- Board control through voting rights

**3. Voting agreements**

- Agreement between family & institutional owners

**4. Pyramids**

- Indirect ownership or cross-holding of stock ✓

**5. Trusts**

- Pool the family's voting power and reduce taxes in intergenerational transfers

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## How is Family Control Achieved?

- Role of the Board** 51% CPO
  - Appoint, monitor and set compensation for top management
  - As part of monitoring, it reviews and approves major corporate initiatives
- Shareholder Voting** 51%
  - Major corporate initiatives that involve a structural or strategic change
    - Appointment of Board Members
    - Mergers and amalgamations;
    - Sales of undertakings;
    - Variations of shareholder rights;
    - Alterations in memoranda of association or articles of association;
    - Approval of audited financials and boards reports;
    - Declarations of dividends;
    - Reduction in capital;
    - Liquidation of the company.

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## How is Family Control Achieved?

- Majority Voting System**
  - Nominees need more than half the votes cast to be elected
  - VS. Withholding a vote for a Director equivalent to voting against
- Plurality Voting System**
  - India: Nominees with the most "for" votes are elected.
  - In contested elections, withheld votes do not count
- Withhold but not be identified ✓
  - Fear of management retaliation

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## Morgan Stanley's Assault

**Overspending** NYT

- M&A: Boston Globe - \$1.1 Bn in 1993
- New HQ - \$600 Mn

**Stock repurchase** \$5 Bn

- \$3 Bn between 1997 & 2004 at Avg price of \$37

**Corporate Governance**

- Dual Class shares
- Excessive management compensation
- Entrenchment of management
- Conflict of Interest (Publisher vs Owner)

**Sulzberger's inaccessibility**

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## Morgan Stanley's Assault

- Company Perquisites
- Board, Family Council or Advisory Compensation
- Family Business Dividends
- Income from Job (inside or outside)
- Income from Investments outside the family business
- Inheritance & family gifts

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## Sulzberger's Choices

- **Business:** Responsibility to readers for journalistic integrity
- **Owner:** Fiduciary duty to shareholders
- **Family:** Preserving the Socio-emotional wealth of the family

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## Sulzberger's Choices

In order to endure for generations in a sustainable manner, families need to grow their financial assets while maintaining unity and building talent. The three factors, Growth of Family Assets, Family Unity, and Family Talent, are vital for ongoing family success

*3 generations. 50%*

JOHN A. DAVIS, 2014

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## Evolution of Family Business Governance System

- Family firms start as **controlling owner**
  - Full ownership & control
  - Remains for one or two generations
  - Small advisory board instead of BoD
  - Paper Board with family members
  - Family council to prepare plans, policies, rules & agreements
- Intense family relationships
- The founder is impressive, builds a lot of value and is typically at the center of activity, often regarded as indispensable.

OWNERSHIP STAGES

Controlling Owner → Sibling Partnership → Cousin Consortium

BERSICK, ET AL, GENERATION TO GENERATION, 1997

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## Evolution of Family Business Governance System

- **Sibling Partnership** stage
  - Usually lasts for one generation
  - Two or more siblings share ownership & control
  - Formalisation process starts
  - Historical rivalries due to lopsided distribution of power
  - Family relationships less connected as siblings create their own nuclear families
  - Sibling tension around power and fairness, balancing dividends with reinvestment, and building professional systems in the business are common issues at this stage.
  - Role of independent advisors critical

OWNERSHIP STAGES

Cousin Consortium

Sibling Partnership

Controlling Owner

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## Evolution of Family Business Governance System

- **Cousin Consortium** stage
  - The family is larger, diverse, and the business is larger and more complex
  - Bloated highly political boards
  - Annual family assembly of the entire family
  - Non-family members often manage the business, while the family gravitates to board roles

OWNERSHIP STAGES

Cousin Consortium

Sibling Partnership

Controlling Owner

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## Family Wealth Paths

- **Path 1: It declines.**  
This is called the Three-Generation Rule Path, which follows the three-generation axiom.
- Wealth travels this path typically for two reasons:
  - The family consumes its assets faster than it generates assets; and
  - The business is in a maturing or declining stage in its industry, is not keeping pace with technological advancements and is not regenerated.

FAMILY WEALTH PATHS

Quick Descent

Three-Generation Rule Path

Regeneration

1st Generation 2nd Generation 3rd Generation

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## Family Wealth Paths

- **Path 2: It declines faster.**  
This is called the *Quick Descent Path*, which happens for the same reasons as the *Three-Generation Rule Path*, and in addition:
  - The family makes a bad bet (or two) in overly risky investments that do not turn out well; and/or
  - Financial assets are divided due to family conflict, perhaps costly lawsuits, or divorce.
  - On this path, families lose a lot of money quickly.

FAMILY WEALTH PATHS

Quick Descent

Three-Generation Rule Path

Regeneration

1st Generation 2nd Generation 3rd Generation

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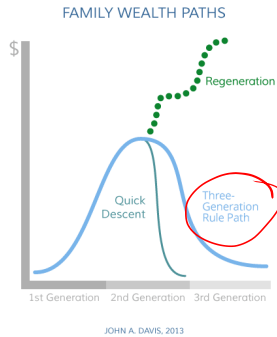
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## Family Wealth Paths

### • Path 3: It grows.

Families that do well financially over generations are on the *Regeneration Path*. These families follow several philosophies and practices to grow their wealth, such as:

- Have strong management talent running their operations
- Stay united as a family
- Stay focused on their family mission
- Control their lifestyle expenses
- Diversify at the right time
- Develop family talent, including—in every generation—grooming *wealth creators* who know how to make money for the family.



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## Tradeoff between Control, Liquidity, & Growth

• Control is essential for founders and their families for:

### • Economic Reasons

- Which business to enter or exit
- What to acquire or sell
- How much to invest
- Whom to hire and how much to pay them, Whom to fire
- Dividends

### • Psychological Reasons

- Power, pride & prestige
- Emotional attachment

*Socio Emotional.*

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## Tradeoff between Control, Liquidity, & Growth

### • Public Equity

- Powerful incentive for employees
- Visibility to consumers
- Required to disclose information
- Underpricing problem

### • Private Equity

- Contacts
- Quality certifications
- Managerial expertise
- Better board supervision
- Professionalisation pressure
- Accountability

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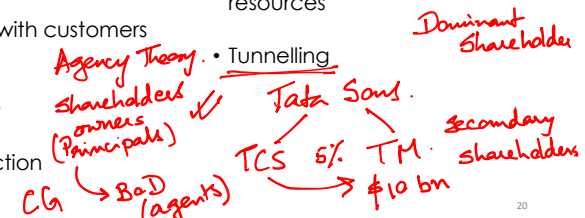
## Tradeoff between Control, Liquidity, & Growth

### • Strategic Investor

- Operational Know-how
- Reputational rub-off
- Ability to attract & retain talent
- Relationships with customers & suppliers
- Learning race
- Hold-up
- Adverse Selection
- Moral Hazard

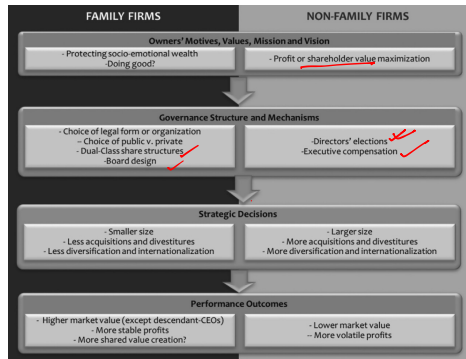
### • Internal Capital Market

- Tax savings
- Lower cost of capital
- Efficient redeployment of resources



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## Family vs non-family Firms



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## The House of Tata

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## Was Ratan Tata the right choice?

*Right.  
Ethical  
Family.  
Improved Business.*

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## Was Cyrus Mistry the right choice?

*Labour unrest.*

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## Tata Saga

- In Oct 2016, Cyrus Mistry was abruptly removed as Chairman by the Board of Tata Sons and later removed from the Board by the shareholders
  - In 2018, the National Company Law Tribunal (NCLT) upheld the decisions
  - In Dec 2019, the National Company Law Appellate Tribunal (NCLAT) reinstated Cyrus Mistry as Executive Chairman of Tata Sons
  - Tata Sons filed an appeal in the Supreme Court of India, which stayed the NCLAT orders

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## Tata Group

- Started by Jametji N Tata in 1868
- His sons Dorabji, Ratan and brother Ratanji set up Tata Sons as the family's investment arm
  - The family stake in various Tata firms was routed through Tata Sons
- Both Dorabji and Ratan bequeathed most of their inheritance and wealth, including shares in Tata Sons, to philanthropic charitable trusts.

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## Tata Group

- JRD, the son of Ratan took control in 1938
- In the sixties, there was infighting among the siblings of JRD
- The Shapoorji Pallonji group took advantage and bought the shares of Tata Sons from the siblings.
  - Pallonji Mistry, the father of Cyrus Mistry had good relations with JRD as well as Ratan Tata
  - He was invited to the board on condition that he would not transfer his shares without board consent

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## JRD

- Under JRD, the managers had total freedom
  - The Tata Group was like a commonwealth of enterprises, not an empire
  - Senior managers in the Tata Group were very powerful – Durbari Seth, Russi Modi, Nani Palkhivala
  - RNT was appointed as successor in 1992, coinciding with reforms

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## RNT

- RNT set the retirement age for executive directors at 65 and non-executive directors at 75
  - Capex in TISCO and TELCO to make them cost-competitive
  - TELCO forayed into the passenger car (risk appetite)
- Institutionalised group cohesion
  - Progressively increased Tata Sons' stake in group companies
  - Tata Sons undertook a rights issue - the group companies subscribed, using the money Tata Sons bought shares of group companies
  - Tata Brand Equity and Business Promotion Agreement (BEBP)

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## RNT

- Group Executive Office
  - Restructured the business into seven sectors
  - Set up a Business Review Committee
  - Implemented the Tata Code of Conduct
  - Implemented the Tata Business Excellence Model
- In August 2010, Tata Sons announced the formation of a selection committee for next leader
  - In Nov 2011 Cyrus Mistry was announced as next Chairman

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## CM

- 60% of revenues from international business with overall PAT @ 10% and debt of \$26 billion
  - CM closed plants, divested businesses, shelved capex
  - Plans to turn around Tata Motors, Corus Steel and Telecom business backfired
  - In 2016, the Economist in a scathing review termed Mistry's performance as 'listless'

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## October Shock

- On 24 Oct 2016, Nitin Nohria, Dean of HBS offered CM the choice to either resign voluntarily or be voted out by the board
  - CM refused, was kicked out, RNT returned
- CM counterclaims
  - He inherited a sick company
  - RNT acted as a super director
  - Shareholder democracy vs Corporate Governance

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Do they have similar jobs?

Mr Sanjiv Puri  
Chairman ITC

Mr N Chandrashekhara  
Chairman Tata Sons

M-form ← BG.

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### Understanding Business Group

Diversified (M-Form) Corporation vs. Business Group (G-Form) Organization

*M-form*      *G-form*

Diversified company

Corporate Board and HQ (CHQ)

SBU 1, SBU 2, SBU 3

Family/Group Holding Company

Company 1, Company 2

Board/CHQ - Affiliate 1, Board/CHQ - Affiliate 2

SBU 1, SBU 2, SBU 3 (under each affiliate)

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### Understanding Business Group

Shareholding Structure

Corporate board and HQ

SBU - 1, SBU - 2, SBU - 3

M-form

Company -1, Company -2, Company -3

CM, TS, TB, TS

G-form

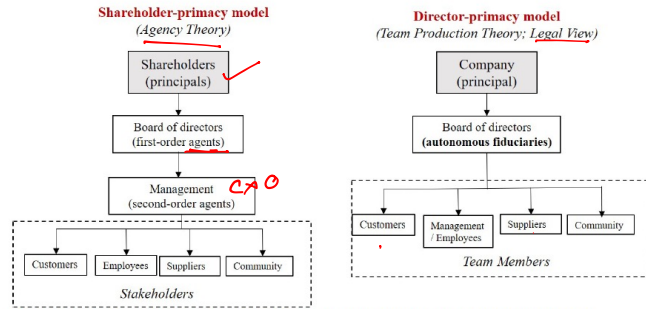
○ Shareholders      ● Business group common shareholder

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### Understanding Business Group

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## Models of Corporate Governance



(Adapted from Lan, L. L., & Heracleous, L. (2010). Rethinking agency theory: The view from law. *Academy of Management Review*, 35(2), 294-314)

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## Models of Corporate Governance

	Agency theory	Team Production Theory; Legal view of corporations
<u>Conception of the company</u>	Companies are legal fiction representing a nexus of contracts.	Legal entity representing a nexus of firm-specific investments.  Companies are legal constructs but are also economic and social organisms.  A complex team production activity which involves the inputs of various stakeholders and the resulting output is neither separable nor attributable to contributions of individual stakeholders.

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## Models of Corporate Governance

	Agency theory	Team Production Theory; Legal view of corporations
<u>Origins of the company</u>	Private agreement among property owners to pool and increase capital.	Created with the sanction of the lawmakers to encourage investment in long-term, large-scale projects needed by the society.

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## Models of Corporate Governance

	Agency theory	Team Production Theory; Legal view of corporations
<u>Functions of company</u>	Maximize shareholder value. All corporations have this same objective function.	Multiple objectives – serve a need in the society; provide employment; drive innovation.  The purpose of each company is determined by the company's board independently.

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## Models of Corporate Governance

	Agency theory	Team Production Theory; Legal view of corporations
<u>Shareholders</u>	<p>Shareholders 'own' the corporation.</p> <p>Shareholders are principals who have authority over the conduct of the company.</p> <p>Shareholders are homogeneous. All shareholders are self-interested wealth maximizers</p>	<p>Shareholders are one of the stakeholders whose support is essential for team production in the company.</p> <p>Shareholders own the "equity shares" of the company with defined rights and obligations.</p>

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## Models of Corporate Governance

	Agency theory	Team Production Theory; Legal view of corporations
<u>Board of Directors</u>	<p>Appointed by the shareholders as their 'agents'.</p> <p>Monitor conduct of the management with the objective of protecting shareholder interests. Agents of shareholders. Monitors management to protect the interests of shareholders.</p>	<p>Autonomous entity with fiduciary responsibility to the 'company'.</p> <p>Acts as a mediating hierarch—balances the often competing claims and interests of the various stakeholders who contribute to the team production process, makes decisions on the allocation of team surpluses, and is legally ultimately in control of a company's assets and key strategic decisions.</p>

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