Who should—and shouldn't—run the **family business**

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Family-owned companies run by eldest sons account for a good deal of the managerial-quality gap between the countries in a study.

Family-owned companies run by outsiders appear to be better managed than other companies, a study finds, while family-owned companies run by eldest sons tend to be managed relatively poorly. Moreover, the prevalence of family-owned companies run by eldest sons in France and the United Kingdom appears to account for a sizable portion of the gap in the effectiveness of management—and perhaps in performance—that we observe in their companies relative to those of Germany and the United States.

These findings come from a study of more than 700 midsize manufacturers in France, Germany, the United Kingdom, and the United States. The study, conducted by McKinsey and researchers at the London School of Economics,[1] looked at the quality of key management practices relative to performance metrics (such as total factor productivity, market share, sales growth, and market valuation) and found that they are strongly correlated.[2] On a scale of one to five, with five being the highest, US and German manufacturers scored best on these metrics (3.37 and 3.32, respectively), while French and UK companies scored worst (3.17 and 3.09).[3]

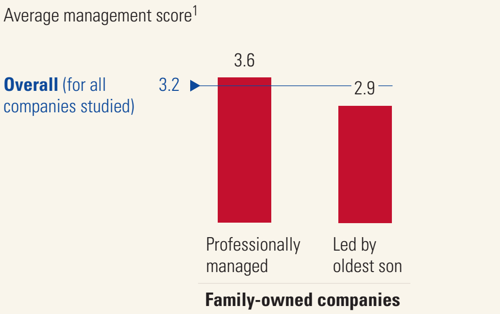
The average management score for family-owned businesses, at 3.2, to that of all companies in our study was essentially identical. The study found, however, that family-owned companies run by outsiders—36 percent of all the family-owned companies in our sample—have management scores that are, on average, more than 12 percent higher than those of other companies (Exhibit 1, on the next page).

One possible explanation is that the combination of family ownership and professional management provides the best of both worlds. Family ownership can enable managers to take a long-term view in decision making, with less pressure to produce quarterly results for investors or to achieve earnings targets. Family members also have a greater direct interest in the outcome of decisions than others do. But recruiting executives from outside the family allows businesses to cast a wide net for talent. What's more, the closely held nature of such a company makes it easier for family owners to take an active part in guiding and managing it and to scrutinize the actions of managers to make them accountable. In this way, a family-owned company can control the conflicts of interest that might otherwise arise between managers and its shareholders—the so-called agency problem.

Not all of the family-owned businesses that we examined are in such good shape. Indeed, the average management score of such companies run by eldest sons—2.9—was more than 10 percent lower than the average for all companies. In our study, eldest sons ran 44 percent of the

EXHIBIT 1

Run better by outsiders



[1] On scale of 1–5, where 5 is best score (controlling for factors such as size and age of company).

Source: Interviews; McKinsey–London School of Economics 2005 study of >700 midsize manufacturing companies in France, Germany, United Kingdom, and United States

family-owned businesses in France and 50 percent of those in the United Kingdom. By contrast, eldest sons ran only 30 percent of the family-owned businesses in the United States and 10 percent of those in Germany (Exhibit 2). We defined a family-owned business as one in which a family owns the single largest block of shares. Most of the companies we examined are privately held.

When we looked more closely at the data, we discovered that family-owned companies run by eldest sons accounted for 43 percent of the gap in managerial quality we identified between companies in France and those in the United States and for 28 percent of the gap between companies in the United Kingdom and those in the United States (Exhibit 3). The strength of the correlation between managerial quality and performance suggests that family-owned businesses run by eldest sons also perform more poorly than their peers.

The prevalence of family-owned enterprises run by eldest sons in France and the United Kingdom can be traced to feudal times. In those countries, the eldest son typically inherited the family property, whereas in Germany it was typically divided equally among the sons. Today, however, tax breaks also play a role. A typical family-owned enterprise with a book value of $10 million or more, for instance, receives an inheritance tax exemption of 100 percent in the United Kingdom and of 50 percent in France but only 33 percent in Germany. The United States has no such tax exemptions.

Automatically handing control of a family-owned company to a designated heir can create several problems. First, any company that considers no one else for the top job automatically excludes better potential candidates in the talent pool. Moreover, someone who expects to lead a company by birthright may put less

EXHIBIT 2

A tax advantage

	Share of family-owned businesses by country, %	**Proportion with oldest son as CEO,** % of total	**Inheritance tax exemption,**[1] %
France	32	44	50
United Kingdom	30	50	100
Germany	30	10	33
United States	10	30	0

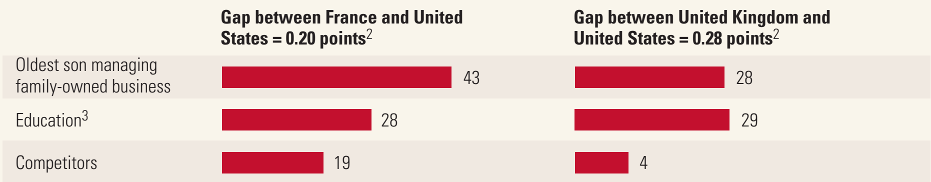
[1] For typical midsize family-owned business valued at >$10 million.

Source: Interviews; McKinsey–London School of Economics 2005 study of >700 midsize manufacturing companies in France, Germany, United Kingdom, and United States

EXHIBIT 3

Gagging on the silver spoon

Known factors[1] contributing to gap in average management practices score, %



[1] All other factors are unaccounted for and could include lower basic skills (eg, shop floor skills) and the relative lack of appeal the manufacturing sector holds for top-quality talent. Researchers are considering these and other possibilities as areas for further investigation.
[2] Measured on scale of 1 to 5, where 5 is best score; on average, US companies scored 3.37; French companies, 3.17; UK companies, 3.09.
[3] % of employees with college degrees.

Source: Interviews; McKinsey–London School of Economics 2005 study of >700 midsize manufacturing companies in France, Germany, United Kingdom, and United States

effort into acquiring the necessary skills and education than do people who expect to compete for their jobs. Indeed, family-owned businesses that select the CEO from among *all* family members, we found, are no worse managed than other companies.

The mandate for family-owned companies, then, is simple: pay particular attention to succession planning. Although family ownership is no worse, and often better, than other forms of ownership, choosing family members—especially the eldest son—to run the business isn't always the best answer.

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[1] Nick Bloom and John Van Reenen, "Measuring and explaining management practices across firms and countries," National Bureau of Economic Research (NBER), working paper 12216, May 2006 (http://papers.nber.org).
[2] Stephen J. Dorgan, John J. Dowdy, and Thomas M. Rippin, "The link between management and productivity," *The McKinsey Quarterly*, Web exclusive, February 2006 (www.mckinseyquarterly.com/links/22294).
[3] To determine the scores, we interviewed as many as two senior managers at each company about 18 topics in three broad areas of management practice: shop floor operations, target setting and performance management, and talent management. We found that an improvement of one point in management scores correlated with an improvement of six percentage points in total factor productivity.