INDIA CORPORATE SOLUTIONS GROUP

FAMILY BUSINESSES IN INDIA

TRANSFORMING ORGANIZATIONS TO UNLOCK UNREALIZED POTENTIAL

ALVAREZ & MARSAL

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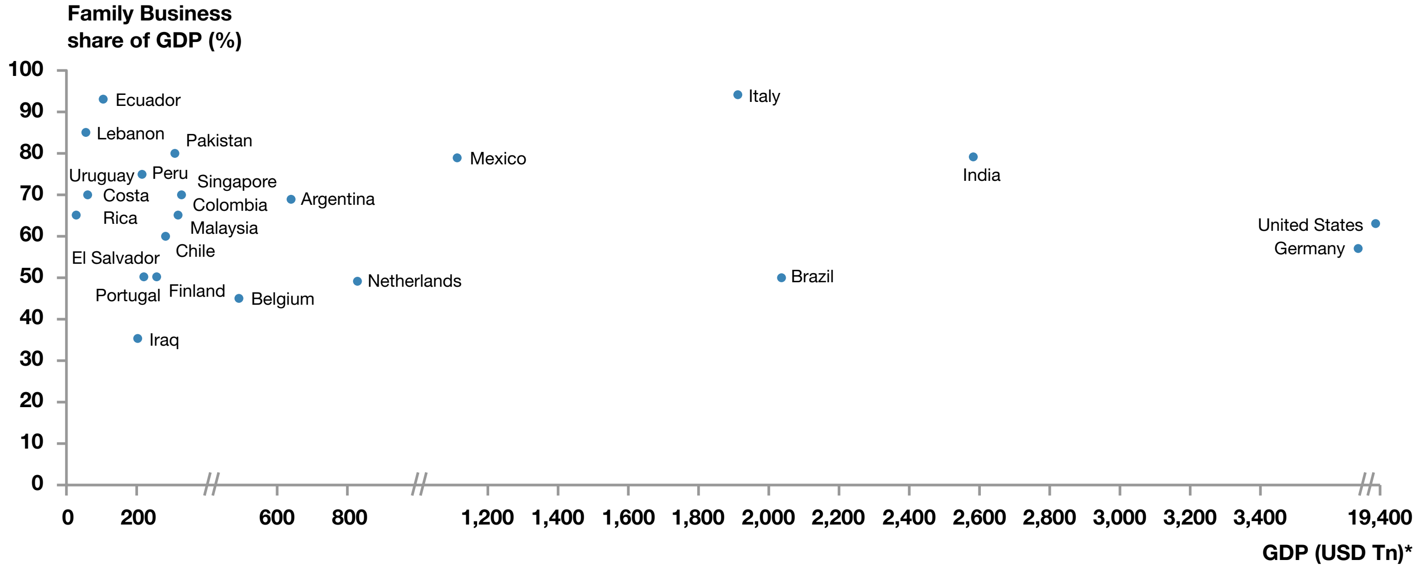
FAMILY-RUN BUSINESSES – SIGNIFICANCE TO INDIAN ECONOMY

Family-held businesses are the oldest and most prevalent form of business ownership. Even though professionally managed companies have been around for nearly a century, family businesses form the backbone of a country's prosperity, representing an important and growing part of the economy, be it mature or emergent. In India, family businesses contribute around 79 percent of national GDP annually[1]. India has 108 publicly-listed, family-owned businesses, making it the third-highest in the world behind China at 167 and the United States at 121 (as of 2015).

FIGURE 1 | NATIONAL GDP SHARE OF FAMILY BUSINESS[1]



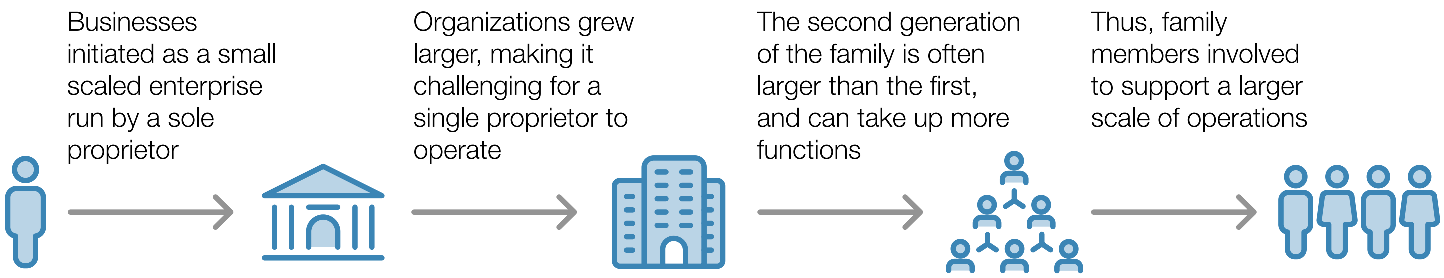
In India, keeping business ownership within a family is a deeply-rooted practice that surfaced after 1900 with their share of total capital growing consistently, while that of the British declined concurrently from 1900 to 1947. Today, India boasts a rich and illustrious list of family-owned businesses. This model of enterprise has survived through the British Raj and the post-Independence controlled-economy phase, and has flourished in the post-liberalization stage since 1991.

In the controlled economy phase (prior to 1990), family businesses had faced relatively less competition from external organizations and received government backing in the form of subsidies or other similar forms of aid that played a major role in their significant growth trajectory.

This, in addition to the ability of family businesses to indigenize products and services to suit Indian markets enabled them to grow and earn attractive returns.

Following the liberalization of the Indian economy post-1990, the influx of Multinational Corporations (MNCs) in India was expected to initiate the downfall of these family set-ups. On the contrary, family businesses have competed strongly and have continued to remain relevant, predominantly due to certain inherent synergies such as faster decision-making and greater focus on relationship-building. Family businesses in India have demonstrated the ability to grow rapidly from small beginnings, achieve scale and to make a significant contribution to national and global economies.

FIGURE 2 | EVOLUTION OF FAMILY BUSINESSES



[2] Economic Impact of Family Businesses – A Compilation of Facts, Tharawat Magazine, Issue 22, 01 May 2014

LIFECYCLE OF FAMILY-RUN BUSINESSES

Early growth in promoter-driven companies is driven by the founder's enterprise, management, decision-making, and appetite for risk. Companies at this stage are flexible and agile, allowing them to move faster than competition. Typically, these businesses have a limited product, customer and geographic focus. This enables promoters to dedicate effort directly to all aspects of the business, enabling cohesion in all functional areas.

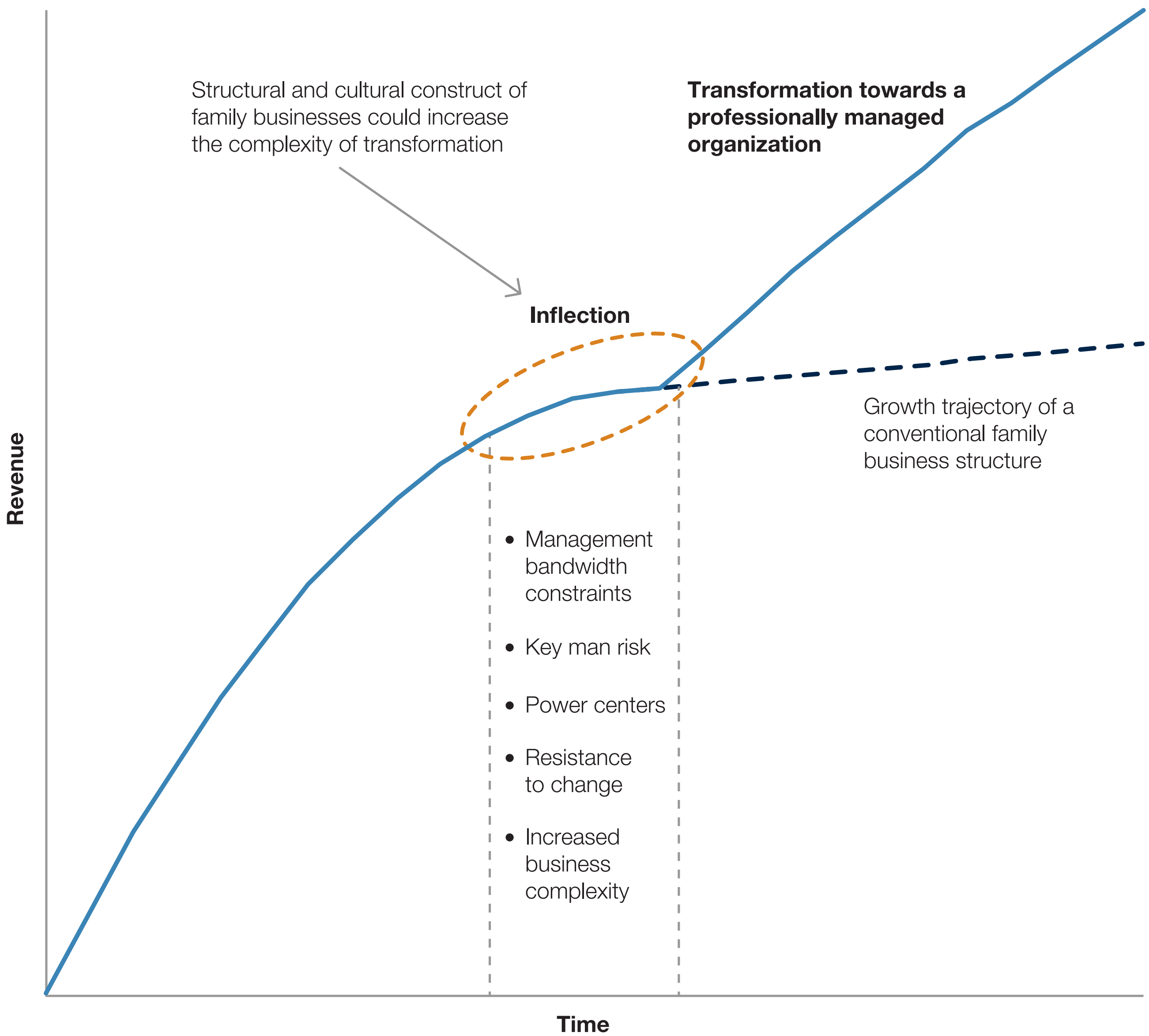
Relationships are key drivers for growth, with the promoter directly managing associations with key stakeholders such as vendors, customers, partners and employees. Additionally, with the structure of the business being relatively simple, individual functions can be addressed on a first principle basis.

As the organization grows larger, it begins widening its product range, geographical reach and customer base. At a larger scale, some of the factors that previously supported its rapid growth may no longer be an enabler for growth. Inherent structural challenges could surface and impact business performance. The promoters' inability to dedicate sufficient time to all functions could become a constraint.

In addition, relationship management across a greater number of stakeholders could prove to be challenge for the promoter. Further, individual functional areas, such as sales, marketing, procurement, supply chain management and production potentially become significantly more complex, requiring function-specific expertise.

All organizations face a period of stabilization after a period of growth, requiring a certain degree of business reorganization and transformation. However, for family businesses, the inherent structural and cultural construct of increases the level of complexity of the transformation process.

FIGURE 3 | TYPICAL LIFECYCLE OF FAMILY BUSINESSES



EARLY GROWTH AND SUCCESS IN FAMILY-RUN BUSINESSES

In the early stages, family businesses often experience a strong growth phase predominantly due to the focus, drive and efforts of the promoter. With direct personal efforts of the promoter, a smaller set up and focused approach, they can operate more efficiently than established organizations. They are often able to make faster decisions, manage relationships more effectively and control costs better, enabling them to gain a competitive edge within a niche market segment.

KEY DIFFERENTIATORS AND DRIVERS OF EARLY GROWTH

DANCING IN THE SHADOWS OF ELEPHANTS

Often, during the initial stages of growth, family organizations operate and grow within smaller market segments or geographies without significant resistance from larger, established corporates. Larger organizations often do not notice the emergence of the business, or do not perceive them to be a significant enough threat to warrant a reaction, until these businesses become significant enough to begin impacting their performance.

LIMITED FOCUS

During the early stages, family businesses are typically focused on specific products, markets and customers. At this point in the growth story, businesses can concentrate efforts and resources, and find it easier to develop and manage these limited segments. business owners are also able to dedicate direct time and efforts to the business, which enables faster and smoother functioning.

RELATIONSHIP MANAGEMENT

Business owners in smaller family set-ups typically devote direct efforts to manage relationships across stakeholders including suppliers, employees, channel partners and customers. It results in a higher quality of engagement with stakeholders, faster resolution of issues, and efficient client servicing, all of which can potentially increase stickiness of stakeholders. This can prove to be an important competitive edge for smaller businesses.

FASTER AND MORE FLEXIBLE

Decision-making in early stage family businesses with relatively flat organizational structures is typically faster and more flexible than that in larger, organized businesses. They typically have a relatively flat organizational structure with a smaller employee base. As a result, information flows more effectively across the organization. Critical decisions can thus be made and implemented faster compared to larger, hierarchical structures.

NO PRINCIPAL AGENT CONFLICTS

As organizations grow larger, decisions are made by a wider group of employees. Employees are often driven by individual goals, which at times could result in decisions and actions that may not work in the best interest of the company. However, in a small family business setup, the promoter typically has control over most decisions, which prompts faster growth and increased likelihood for success.

MORE COMPETITIVE

Agility in decision-making, higher risk-taking ability and better customer service provide smaller businesses with a competitive edge and enable them to compete against more established companies. Direct promoter involvement in day-to-day operations of the business helps to increase the success of the organization. Additionally, overhead costs tend to be relatively low, enabling the business to spend more on staying competitive in the market.

KEY CHALLENGES IN THE PATH OF SUCCESS

While a 'hands-on' approach by the promoter serves the business well in an early growth stage, it can be a constraint once the business attains a certain scale. Family businesses often do not possess the organization-wide capabilities or sufficient promoter bandwidth to successfully scale up. While some family businesses have successfully evolved into professional organizations, many face headwinds at this "inflection" point and stage of development.

FIGURE 4 | IDENTIFYING KEY MAN RISK

ASK

- Effects of prolonged absence on business decisions
- Are daily business decisions solely dependent on one person

ANALYZE

- Are all decision routed through one person?
- Are lost opportunities attributed to delayed decision making by one person

RISK

- Clear dependence on one person indicates key man risk exists
- The organization must have backup plans in place to ensure survival

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Practices that previously delivered significant gains, such as high promoter involvement and a lean organization structure, could now potentially be impediments to growth. Conflicts between family members and resistance to change across the organization often pose further challenges. Some of the more critical challenges include:

1. Management Bandwidth

Family businesses typically evolve into relatively flat organizations, with a small group of top managers, often promoters and a few trusted personnel, managing a wide base of 'executors'. Decision-making across functions is often concentrated with the top managers while middle management is often not developed.

As operations expand to a larger scale, the business begins dealing with a wider geographic reach, product range, organization breadth and customer base. However, in a family business setup, decisions and operations typically continue to be centralized. Dependence on a few individuals could hinder timely and effective decision-making, which constrains business performance. Additionally, one of the core strengths of family businesses during the early years is strong relationships between the management and various stakeholders; at a larger scale, it could become challenging for a small group of managers to maintain relationships across all stakeholders.

2. Key Man Risk

In smaller family businesses, critical tasks and knowledge is often concentrated with a few individuals. Often, companies find it challenging to develop back-ups to these individuals. Unexpected absence of these individuals, whether temporary or permanent, could disrupt the functioning of the business.

3. Development of Power Centers

In legacy structures, individual family members are often entrusted with managing important functions and different business units. Departments within companies tend to develop into independently functioning units. Communication between departments are often conducted predominantly at the management level, with limited interaction between lower level personnel.

At a smaller scale, this facilitates smoother and faster decision-making. However, at a larger scale, the bandwidth of management could potentially increase bureaucracy and reduce the efficiency of the organization. Conflicts between management personnel at different departments could further reduce inter-department interactions.

Power centers could also could reduce operational efficiency and add to costs; as different departments grow, it could potentially result in duplication of organizational roles and functions such as finance, human resources, sales, data management, among others, that could potentially be more efficiently served through shared teams.

4. Resistance to Change

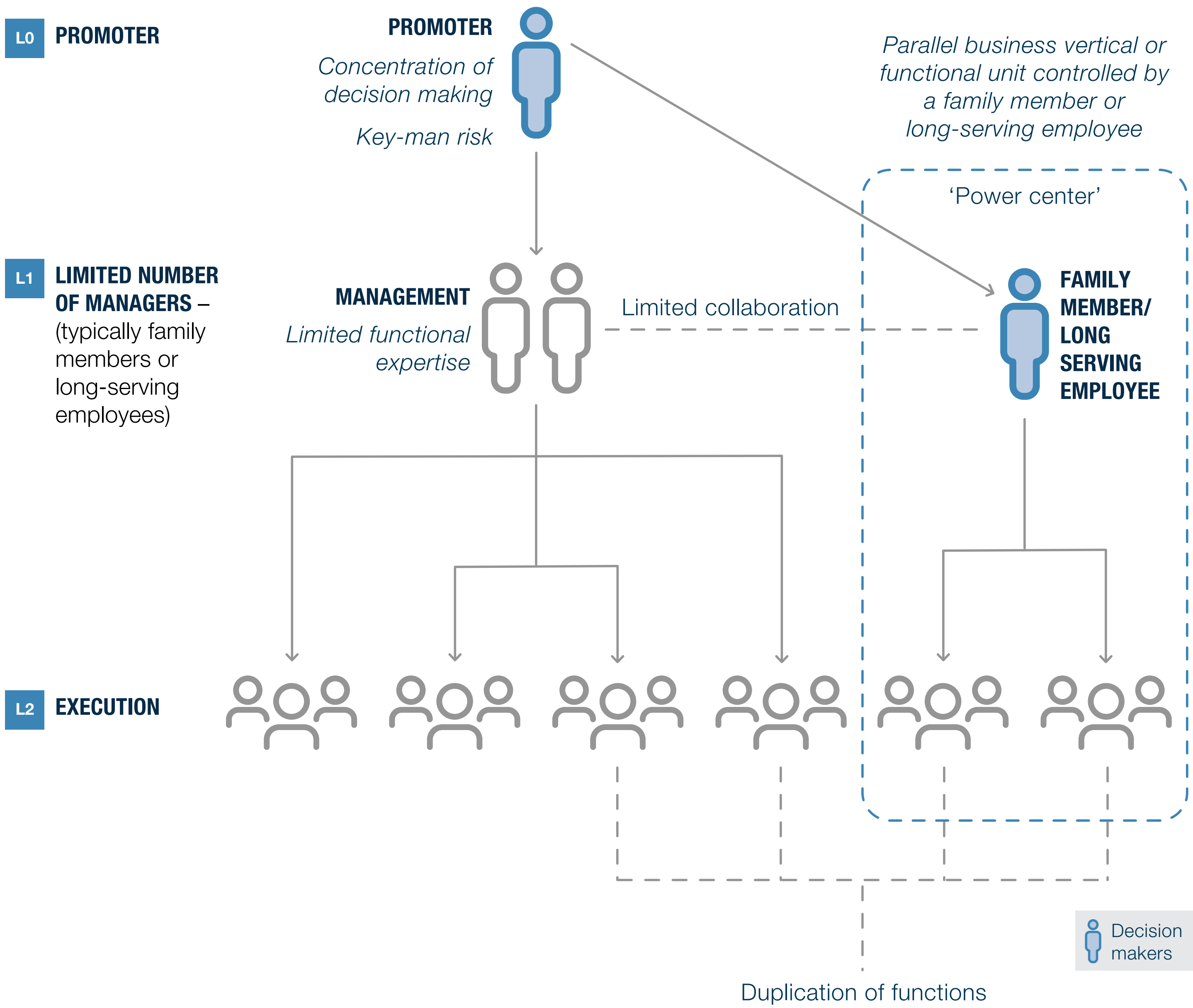
With the ever-changing market environment of today, business and internal business dynamics are increasingly prompted to evolve and to cater to change. After achieving a certain level of success, family businesses develop a comfort zone, often with the view that actions that led to success in the past will continue to bear fruit going forward. As a result, there employees experience discomfort and confusion. These challenges can be exacerbated when younger, second generation business owners join the business and propose new ideas and practices.

5. Increased Complexity – Functional Expertise Becomes More Relevant

During the early years, family businesses often lack well-defined departments. Operations and decisions across various functions are typically managed on a 'first-principal' basis by a small group of promoters and a few long-serving employees. In businesses of limited scale, this approach enables quick decision-making and flexibility.

However, as the company grows, and operations become increasingly more complex; sales teams need to cater to a wider group of customers with increasingly varied demands, financial management becomes more intricate, marketing activities need to be more evolved and supply chains need to deliver a wider range of products over a wider geographic area. At this stage, conventional unstructured decision-making and limited functional proficiency family businesses could potentially hinder business performance.

FIGURE 5 | TYPICAL LIFECYCLE OF FAMILY BUSINESSES



POTENTIAL ENABLERS TO GROWTH

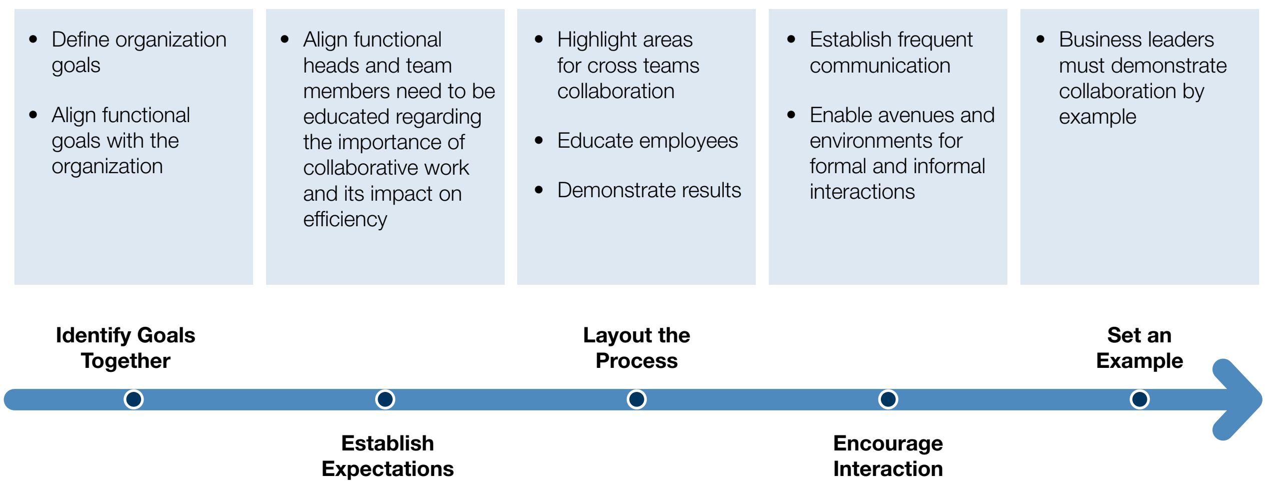
When a company reached the maturity stage of its lifecycle, overcoming obstacles and ensuring a base for long-term success of the business necessitates a transformation.

Challenges faced by at this stage are often structural and cultural, and overcoming them can be enabled through organizational capability enhancement, better communication and conflict resolution mechanisms:

1. Break Down Walls – Build Cross-Team Collaboration

Developing avenues for formal and informal interaction between personnel across departments and levels could potentially reduce some of the inefficiencies in the organization and enable department to move towards commonly-held, identifiable goals. Cross-functional collaboration is an important building block in building a successful organization.

FIGURE 6 | ESTABLISH CROSS-TEAM COLLABORATION

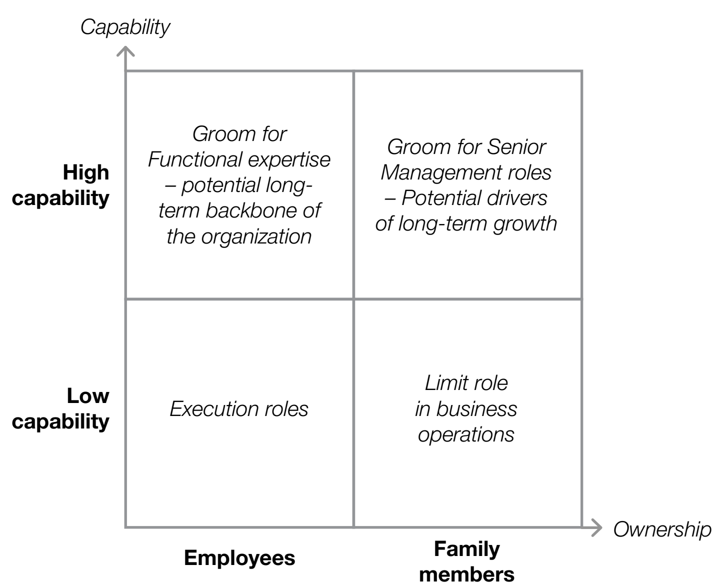


2. Find the Right People for the Right Roles

Conventionally, family businesses were passed on to the next kin, when organizations are relatively smaller, family members or long-serving employees are typically entrusted with key roles across functional departments. As businesses become larger and more complex, expertise across individual functions becomes increasingly important.

There could be a strong case for family members to limit involvement in business operations, particularly in areas where they may not have the requisite capabilities or expertise. Businesses could benefit from hiring personnel with professional competence across divisions and functions.

FIGURE 7 | SELECTING THE RIGHT PEOPLE FROM INTERNAL EMPLOYEE POOL



3. Develop Middle Management

While ensuring the right personnel are leading the right functions, it is also important to ensure that the right support teams are developed. With more complexity, execution across functions becomes more challenging. Businesses require capable teams to ensure effective implementation.

At a larger scale, top management personnel could find it difficult to handle day-to-day activities such as managing external relations and overseeing employee performance. Developing a competent middle management team frees up the bandwidth of top management to focus on directional and strategic aspects of the business. Additionally, developing an adept second rung can ensure business continuity in the absence of senior management personnel.

4. Define Roles of Family Members

Larger businesses often involve multiple family members in various capacities in the organization. Differences in opinion or disagreements on various issues could result in conflicts arising between family members, which could potentially affect business performance. Clear definition of roles of different family members could potentially reduce the potential for such conflicts. Role definition also could enable businesses to ensure that various roles are occupied by the most suitable family members. Role definition could also take on a longer-term view, and could enable smoother succession planning across roles, allowing sufficient time for successors to be trained and developed.

While clearly defining roles could significantly reduce conflicts and increase efficient functioning of the business, implementing can be complicated, requiring buy-ins from all relevant family members. Further, without formal documentation, ensuring the sanctity of an agreed-upon structure could be challenging.

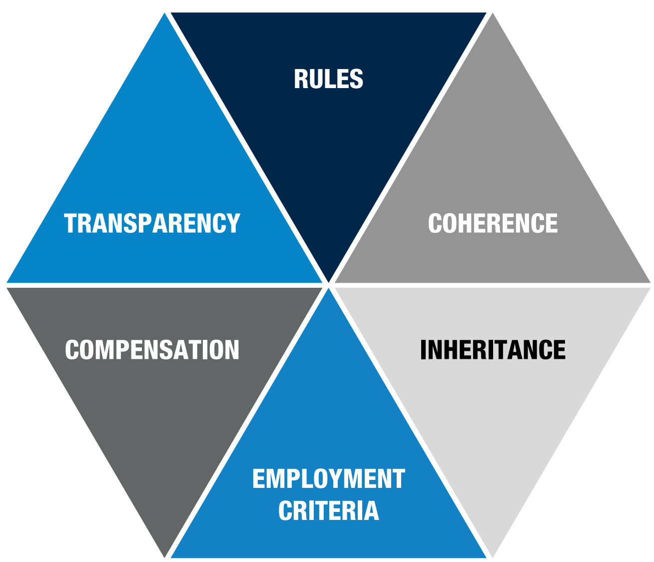
A family business constitution could be an excellent tool to ensure alignment between family members regarding business, and at times, personal matters. The family business constitution is a written agreement, often legally binding, between family members defining various matters relating to management and governance of the business, including roles of family members, processes for managing conflict and values of the family. It details aspects of the business such as compensation for family members, inheritance details and succession plans, and could potentially significantly reduce for the volume of disputes.

FIGURE 8 | COMPONENTS OF FAMILY BUSINESS CONSTITUTION

Rules
In case of family conflicts or any ambiguous situations

Transparency
Lays explicit guidelines to ensure clarity

Compensation
Compensation disbursement policies are explicitly laid out to prevent future disputes

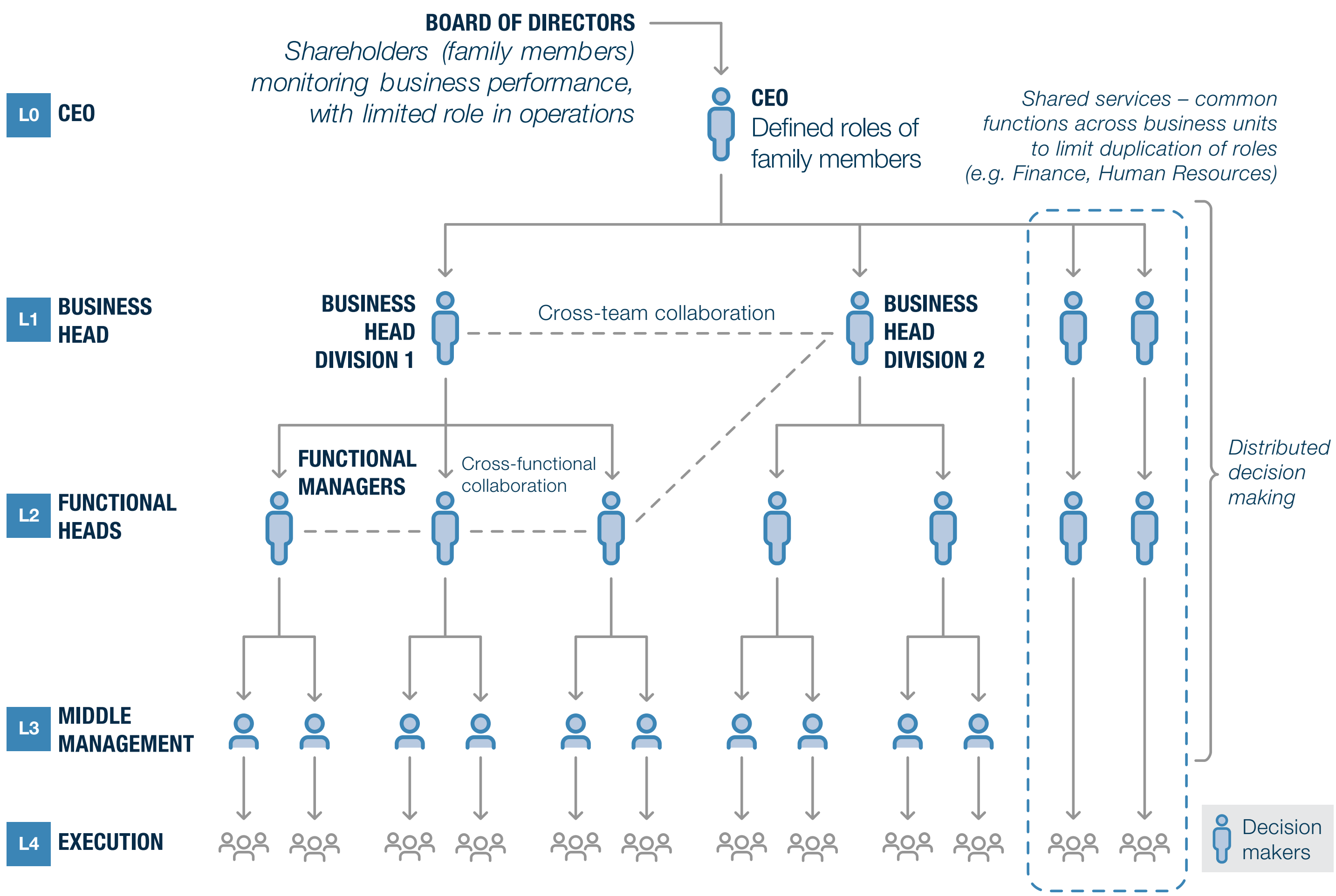


Coherence
Since all actions are guided as per these rules, it ensures increased family coherence

Inheritance
Each family member's stake in the business in pre-decided

Employment Criteria
Ensures that family members are employed based solely on merit or other criteria as needed

FIGURE 9 | ORGANIZATIONAL STRUCTURE OF A PROFESSIONALLY MANAGED BUSINESS



Augmentation of the business structure and processes at this stage is critical for the long-term development of the business. However, implementing change can be tricky; it often faces resistance across levels in an organization. Hasty implementation could impact business performance and employee morale in the short run. Implementation needs to be carefully planned and executed. A collaborative approach that brings all employees and business owners on board and is supported by adequate and effective communication throughout the process is critical for success. Successfully managing change at this stage could enable the company to resume its path towards growth and unlock latent value for promoters and investors.

CONCLUSION

While India boasts a large and ever-growing list of family-owned businesses, none are spared from the many arduous tasks needed in order to grow. Throughout each business' particular growth story, there are several phases that present unique challenges. If the business wishes to maintain the family-oriented business structure, they must navigate these phases with great care and precision.

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