
Succession: Challenges & Opportunities

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The Family Firm Project

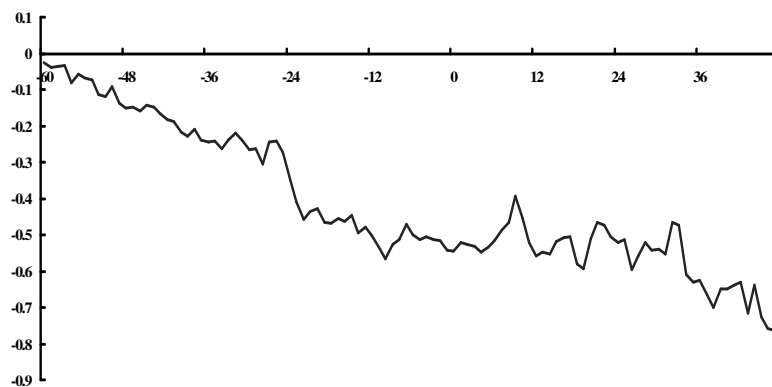
- A research on 220 succession cases in Hong Kong, Singapore, and Taiwan
 - “Succession: the Role of Specialized Assets and Transfer Costs” (available upon request)
- Key issues
 - How successful are firm leadership successions in Asia?
 - What are the key challenges?
 - What determine the choice between an heir and an unrelated successor, and the preparation of a succession process?
 - How do governance structures and corporate policies evolve around succession?

The Succession Sample

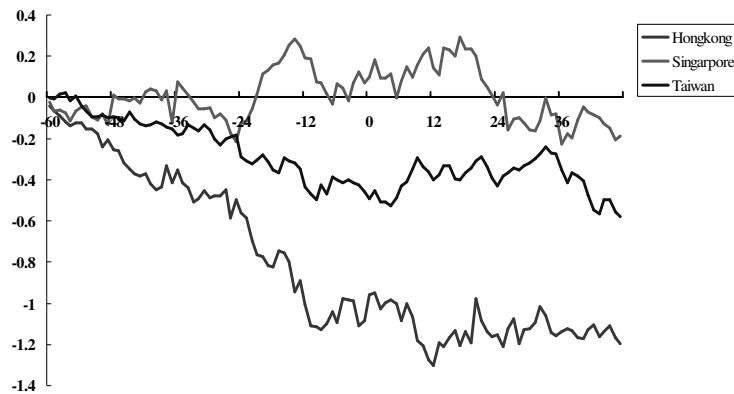
Year	Hong Kong	Singapore	Taiwan	Total
1987	0	0	2	2
1988	0	0	4	4
1989	0	0	6	6
1990	0	0	6	6
1991	0	0	5	5
1992	0	4	6	10
1993	0	5	4	9
1994	0	6	7	13
1995	0	4	6	10
1996	4	5	11	20
1997	7	2	6	15
1998	3	3	8	14
1999	9	4	12	25
2000	12	4	13	29
2001	9	1	12	22
2002	8	3	0	11
2003	6	4	0	10
2004	2	1	0	3
2005	2	1	0	3
Total	62	47	108	217

Severe Dissipation of Firm Value in Leadership Transition

Monthly cumulative abnormal stock return (CAR) around succession



Severe Dissipation of Firm Value in Leadership Transition (by Economy)

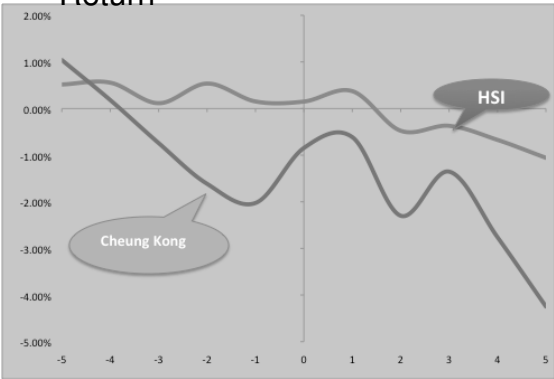


Why is succession challenging? Specialized assets are difficult to transfer

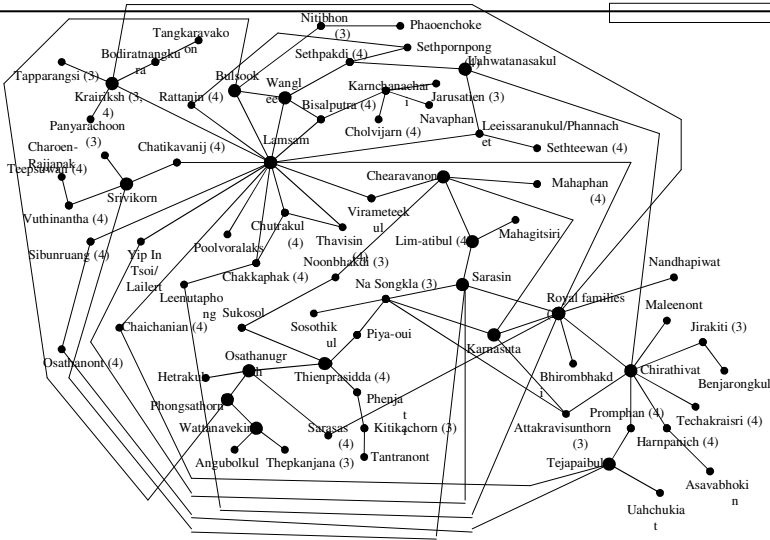
- There exist specialized assets, rules, procedures, concepts, and/or ideologies within every family business
 - Ideology (strong personal interest)
 - Implicit, specialized contracts
 - Reputation, political connection, social network, relationship, implicit rules and non-standardized procedures
 - Team work (family members, co-founders)

Li Ka-shing (77) was sent to hospital on Sep. 6th, 2005.

Cumulated Daily Stock Return



Example of specialized assets Relationship Network in Thailand



Marriage as a method of building relationship network (Bunkanwanicha, Fan, Wiwattanakantang, 2008)



Marriage Sample from Thailand

Year	Number	Percentage
1991	12	5.9%
1992	14	6.9%
1993	8	3.9%
1994	15	7.4%
1995	12	5.9%
1996	15	7.4%
1997	7	3.5%
1998	13	6.4%
1999	12	5.9%
2000	11	5.4%
2001	18	8.9%
2002	13	6.4%
2003	11	5.4%
2004	9	4.4%
2005	23	11.3%
2006	10	4.9%
Total	203	100.0%

Note: The sample includes 91 families (2 marriages/family on average)

Marriages & Networks

	Number	Percentage
A. Family background		
Top business (i)	42	20.7%
Business, Professional (ii)	52	25.6%
Royal, Noble (iii)	17	8.4%
Politician, Military, Civil servant (iv)	50	24.6%
Foreigner (v)	11	5.4%
Others (vi)	31	15.3%
B. By type of network		
Business network (i)+(ii)	94	46.3%
Political network (iii)+(iv)	67	33.0%
Others (v)+(vi)	42	20.7%
C. By type of marriage		
Business & Political networks	161	79.3%
Others	42	20.7%

Where are network marriage prevalent?

	Network marriage		Other marriage	
	No.	%	No.	%
A. Concession-based businesses				
Concession-based	14	93.3%	1	6.7%
Others	147	78.2%	41	21.8%
B. Real estate businesses				
Real estate	43	95.6%	2	4.4%
Others	118	74.7%	40	25.3%
C. Diversified businesses				
Diversified	48	84.2%	9	15.8%
Others	113	77.4%	33	22.6%

Stock Price Effects of Marriages

	Event: Announcement Date	
	CAR (-1,+1)	CAR (-2,+2)
A. Total sample (N=140)		
Mean (<i>clustering</i>)	0.85%***	1.22%***
Median (<i>sign-test</i>)	0.54%***	0.81%***
Positive CAR(%)	67%	69%
B. By type of marriage		
- Network marriage (N=110)		
Mean (<i>clustering</i>)	1.08%***	1.54%***
Median (<i>sign-test</i>)	0.71%***	0.91%***
Positive CAR(%)	72%	71%
- Other marriage (N=30)		
Mean (<i>clustering</i>)	-0.02%	0.03%
Median (<i>sign-test</i>)	0.00%	0.21%
Positive CAR(%)	50%	63%

Stock Price Effects of Marriages

	Event: Announcement Date	
	CAR (-1,+1)	CAR (-2,+2)
C. By type of network		
- Business network (N=66)		
Mean (<i>clustering</i>)	0.94%***	1.31%***
Median (<i>sign-test</i>)	0.65%***	0.85%***
Positive CAR(%)	74%	73%
- Political network (N=44)		
Mean (<i>clustering</i>)	1.29%***	1.88%***
Median (<i>sign-test</i>)	0.74%**	1.22%***
Positive CAR(%)	68%	68%

Marriages and Networks

- Marriages are not just about love, in particular to those couples in network based businesses
- Network marriages, though sometimes involve sacrifices, create value for businesses

Successful transition –

(1) Professionalize your company

- **Standardize and professionalize your company as much as possible, and as early as possible**
 - Don't wait until the last moment. The more special is your business, the earlier should you start the succession process
- **Exit is always an option.** Here, standardization is utmost important.
 - Few buyers are interested in something that they don't understand or appreciate

Standardization – making your business understandable

- Standardization facilitates the partition, valuation, and transfer of business rights, and hence is very important to a smooth transition and business success
- By standardization, we mean a scientific procedure to divide a task into sub-tasks and measure the value of input and output of each of the sub-tasks

A Potential Working List of Standardizing Your Business

- Family versus business assets/liabilities (should there be a firewall?)
- Share ownership and business lines (should there be a clear division of rights among co-founders or family members)
- Raw materials (should secret formula be decoded?)
- Products (moving from custom-made to general products?)
- Production process (can they be divided into refined steps?)
- Work procedure (Can a team based task be divided into individual tasks?)
- Management function (can it be divided between heir and professional managers?)

A Potential Working List of Standardizing Your Business

- Arm's length instead of relationship based business
- Product instead of family reputation
- Rule based instead of authority based management
- Clear work manual and job division
- Balance between professional and family management
- Management by number - accounting system and transparency
- Independent corporate governance (board of directors, external auditors) providing check and balance
- Public listing provides external pressure to professionalize

Case Study: Li & Fung (Hong Kong)

The First 100 Years



Professionalization Helps Continuity

– Li & Fung

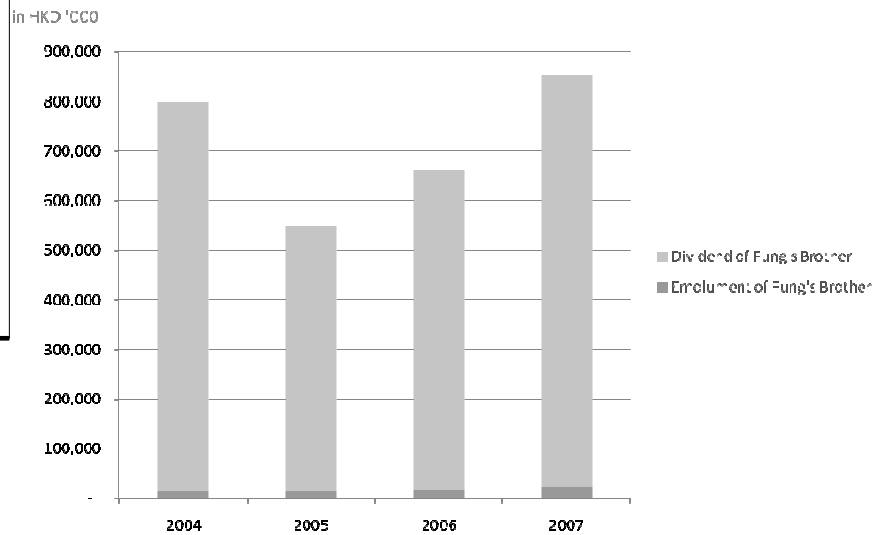
- The importance of standardization can be highlighted by Li & Fung, a Hong Kong based global consumer products trading company.
- After a series of difficult consolidation of ownership and control of the company in the 1980s, the third generation leaders have devoted to the professionalization and standardization of supply chain management and become a world class coordinator and distributor of high-volume time sensitive consumer goods.
- Li & Fung, based on this research's prediction, is likely to experience a much smoother transition to its next generation in the near future, compared with its past bumpy experience.

Cultivating a professional workforce

- Introducing, motivating, and rewarding non-family professionals
- Loyalty is not free
 - If you do not promote them as hard as your family members, you have to treat them well
- Blending professionals with family members

Remuneration of family managers (Li & Fung (HK))

How much are Fung's dividend income compare to their emolument?



Back Load Compensation of Family Members

Common in family run business, wealth sourced from:

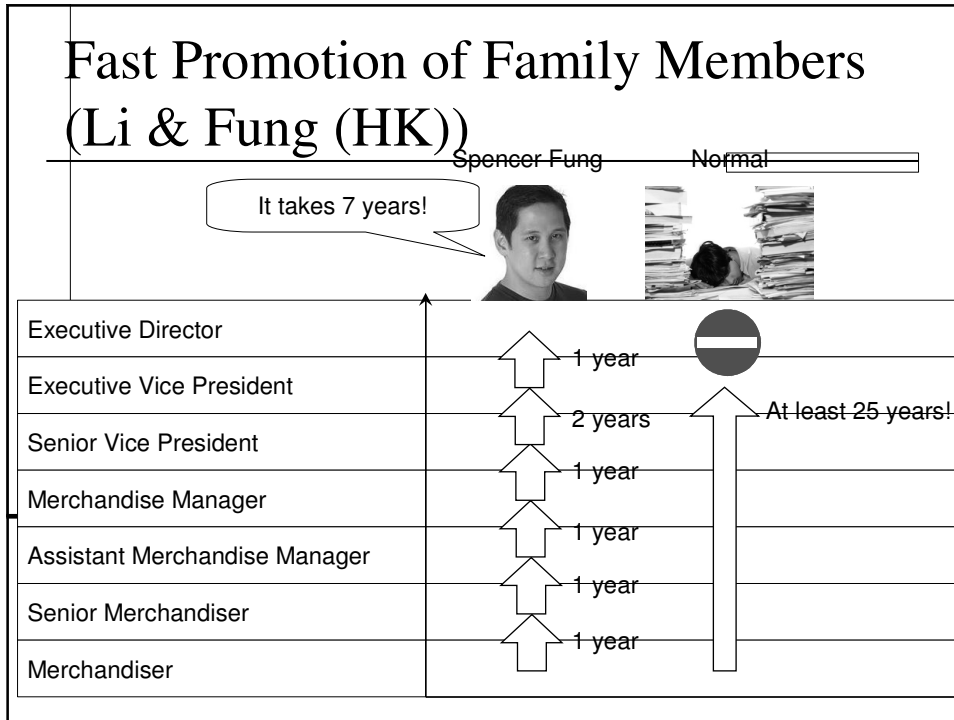
- Dividend Income
2004 to 2007 - Emolument of Fung's: HKD 65 Million
Dividend: HKD 2,790 Million
- Shares and investments appreciation

	Shares Appreciation	Dividend	Emolument
2004	(587)	784	12
2005	2,392	532	15
2006	10,902	644	17
2007	8,913	831	20

in HKD' Million

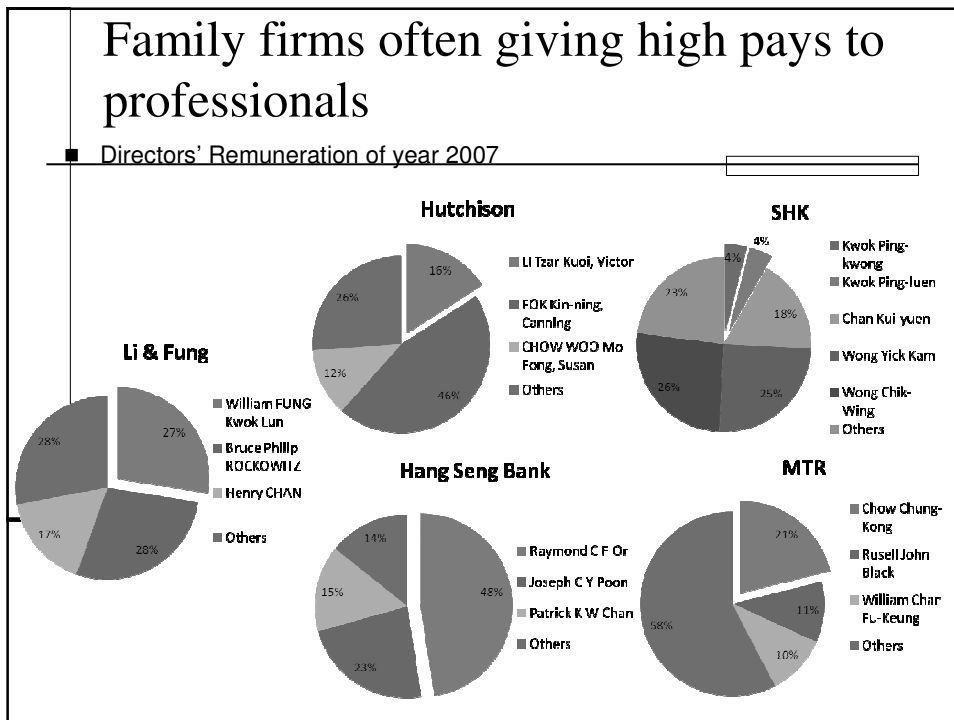
- Wealth success from the founder

Fast Promotion of Family Members (Li & Fung (HK))



Family firms often giving high pays to professionals

■ Directors' Remuneration of year 2007



Successful transition – (2) Preserving core value

- Identify the core value appreciated by your family and stakeholders
 - Core value: a belief that a set of practices or behaviors will lead to the highest reward (monetary and non-pecuniary)

Survivors: the world's oldest family companies (O'Hara, 2004)

- **1. Kongo Gumi**
Construction/Osaka, Japan
Founded: 578
40th generation
www.kongogumi.co.jp
Prince Shotoku brought Kongo family members to Japan from Korea more than 1,400 years ago to build the Buddhist Shitennoji Temple, which still stands. Over the centuries, Kongo Gumi has participated in the construction of many famous buildings, including the 16th-century Osaka castle. Today the family continues to build and repair religious temples and manage general contracting from its Osaka headquarters. Current president is Toshitaka Kongo; his 51-year-old son, Masakazu Kongo, is waiting in the wings.

株式会社 金剛組



Survivors: the world's oldest family companies (O'Hara, 2004)

■ 2. Hoshi Ryokan

Innkeeping/Komatsu, Japan

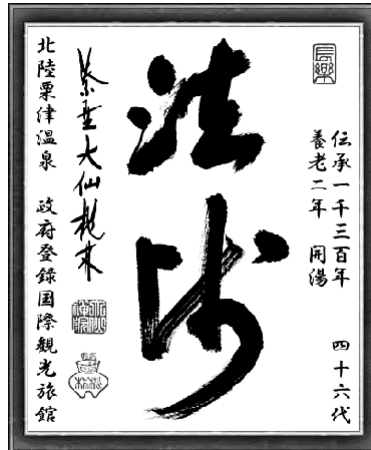
Founded: 718

46th generation

www.ho-shi.co.jp/jiten/Houshi_E/

According to legend, the god of Mount Hakusan visited a Buddhist priest, telling him to uncover an underground hot spring in a nearby village. The hot spring was found, and the priest requested that his disciple, a woodcutter's son named Garyo Saskiri, build and run a spa on the site. His family, known as Hoshi, have run a hotel in Komatsu ever since; the current structure houses 450 people in 100 rooms. Zengoro Hoshi is the current patriarch

Hoshi Ryokan



Survivors: the world's oldest family companies

(O'Hara, 2004)

■ 3. Château de Goulaine

Vineyard, museum, butterfly collection/Haute Goulaine, France

Founded: 1000

<http://chateau.goulaine.online.fr>

The castle, owned by the Goulaine family, houses a rare butterfly collection in addition to a museum. It hosts various functions, including weddings. Wine is available for sale at the castle's vineyards.

Château de Goulaine



What do we learn from these most enduring family businesses?

- They preserve specialized assets and value
 - Construction is not just construction, hotel is not just a hotel, vineyard is not just a vineyard
 - Each has a unique asset, the secrets of classic temple construction and wine brewing, and the hot spring came out of a myth
 - Each supplies basic human needs: religion and amenity
 - Does it worth a family's 1000 years of effort?
 - It has to be

Core Value of Amanco



- Business: plastic pipes
- Ownership: subsidiary of a Brazilian petrochemical SOE
- Market: Brazil
- CEO: Roberto Salas
- Mission: Deliver water to people who need it
 - Managers and employees have a strong sense of satisfaction in achieving the mission
- Challenge: corruption
 - The company (CEO) deals with it by communicating and organizing competitors to create a core value: **a non-corrupt industry norm**
- Issue: How can the core value be preserved and continued after succession?

Successful transition (3) Wise successor choice

	Hong Kong		Singapore		Taiwan		Total	
Family member	43	69%	17	36%	80	74%	140	65%
Heir	18	29%	4	9%	57	53%	79	36%
Relative	25	40%	13	28%	23	21%	61	28%
Outsiders	6	10%	17	36%	24	22%	47	22%
Sold-out	13	21%	8	17%	4	4%	25	12%
Unknown	0	0%	5	11%	0	0%	5	2%
Total	62	100%	47	100%	108	100%	217	100%

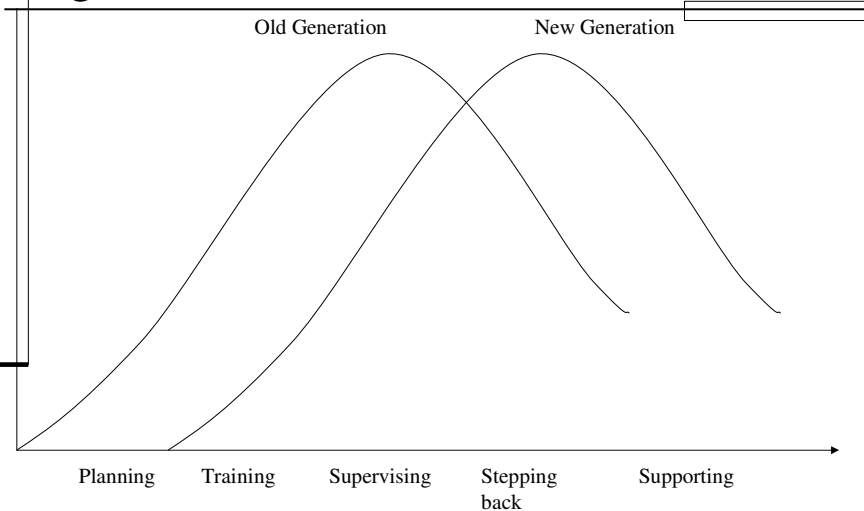
Experience of General Electric

- *“Heir succession is like choosing the son of the 2000 Olympic swimming champion to win the 2020 Olympic swimming contest”*

– Warren Buffett

- Research found that heir succession is associated with **worse** performance than outside succession
- If my son is such a bad choice, why insist?
- Would it be even worse if I don't?
- The key consideration, again, is whether and to what extent my business is special, hard for outsider to learn or for family to inherit, and it is best to keep it that way
- It is always useful to have a competitive process in choosing successor

It takes time to identify and train a good successor



Successful transition – (4) clear ownership and control within family

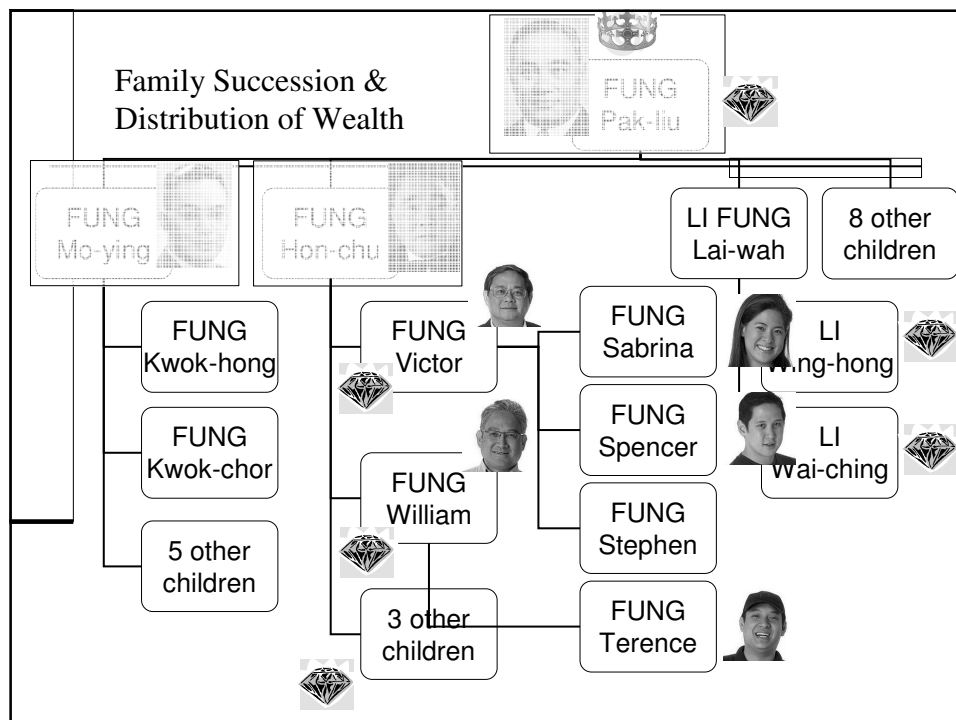
- Concentrating or dividing wealth?
- Trust or individual ownership?
 - Ensure ownership concentration, tax saving (if philanthropic)
 - Drawback: lack of divisibility and transferability; lack of exit mechanism if family members' interests diverge
 - Example: Sun Hong Kai Properties (Hong Kong); Formosa Plastic (Taiwan)

Clear Ownership and Control

- If your firm is managed by multi-family members, consider concentrate ownership on one or very few people, the rest members receive salaries
- Avoid distributing significant ownership to family members not involved in family business. Instead, distribute them cash or assets outside the business
- Example: Privatization and Re-IPO of Li & Fung (HK)

Going Private & Relisting of Li & Fung (HK)

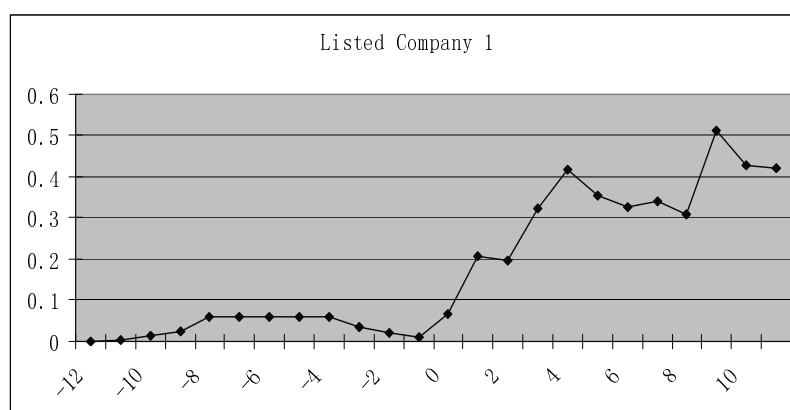
- IPO in 1973 (shares of 74.92% held by 9 main Fung's members, 25.08% held by minority shareholders)
- Fung's brothers (Victor and William) held around 35% shares of Li & Fung through privatization in 1989 and increased the shareholding to 42.4% in early 2000
- Concentrated ownership aimed to eliminate the negative influence of family members.
- Relisted in 1993



Successful transition – (5) Embrace changes

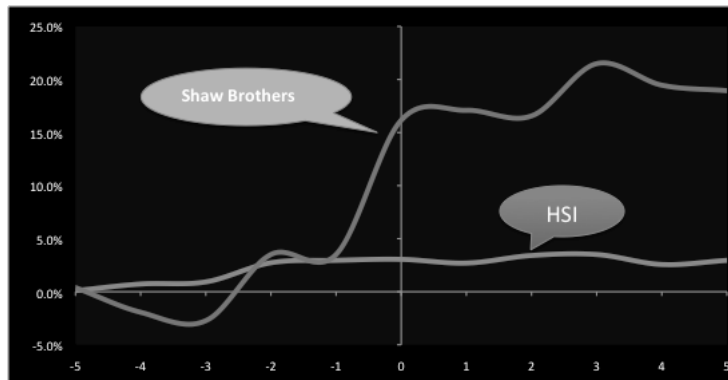
- It is sometimes difficult to persuade an owner-manager to make changes until very late.
- Firm value deteriorate until the entrenchment problem is corrected by succession

The death of entrepreneur is sometimes a good news to stock investors



Daily cumulative net of market stock return of a HK listed company around the news that its 98 year-old founder was sent to hospital

Cumulated Daily Stock Return



Department Retreat @ Shenzhen 2008

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Successful transition – (6) Improving corporate governance

- A governance structure that provides objective and professional **advices**, and provides **credibility** and protection to stakeholders is needed
- If successor cannot completely inherit his/her previous generation's credibility to stakeholders, he/she will likely subject to tighter governance constraints
 - More outside independent members on board
 - More professional management
 - Separating chairman and CEO positions
 - More concentrated ownership
 - More transparency in accounting and organization
 - Higher dividend payment

Board of Directors Across Generations (Li & Fung (HK))

	Founders (Fung Pak-Liu & Li To-ming since 1906) Traditional family business	2nd Generation (Fung Hon-Chu & Fung Mo-ying since 1946) After IPO in 1973	3rd Generation (Victor & William since 1981) After re-listed in 1992
Board size	Fung and Li's families	5-8	9-12 Exe 3-5 / Non-Exe 6-7*
Family members		3-5 (60%)	2-3 (20%)
Outsiders		2-3 (40%)	7-10 (80%)
Education		Secondary or above	Tertiary or above
Gender		1 female Fung's member	1 female non-Fung's member

*3rd generation: 3-4 Non-Executive directors are independent

Entrepreneur, do these before you get too old:

- Professionalize
- Preserve core value
- Enhance corporate governance
- Secure ownership and control
- Embrace changes, remove entrenchment
- Cultivate a competitive successor

Thank you



Joseph P.H. Fan

Passing on the Crown, *The Economist*, Nov. 4, 2004

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