How Did We Get Here?

When family firms get to the third generation, it's time for some serious analysis.

by Tom Davidow and Russ Robb

When Rod Laver, one of the world's greatest tennis players, reflected on his championship years of the 1950s and 1960s, he said, "You are most vulnerable when you are ahead."

The innuendo of Laver's statement is to be extremely careful when you are cruising along with the foreseeable position of easily winning, only to find that when the momentum shifts to the "other" player, the previous predictable victory becomes very much in doubt.

And so it is with many third generation family businesses, which by all logic and common reason should be almost assured of continued success once they reach the time earned success in reaching the third generation of continual operation. Yet just like the tennis analogy cited above, family businesses become highly vulnerable as only one out of 10 such businesses succeed in the third generation.

Let's take a look at one such business as it reached the third-generation tipping point. We'll call this company the Bridgewater Leather Bag Co. The company and its facts are real but the actual identity of the business and its principals have been disguised for confidentiality purposes.

Getting It Started

Founded in 1920 by Tony Manzella who immigrated to this country from Milan, Italy after World War I, the company withstood the test of time in the high end luxury women's leather bag business. Alessandro, Tony's son, became CEO in 1965, and his nephew, Louis, became CEO in 2000. Over the years, BLB always made money, but most of it was paid out to the family members by way of dividends to the shareholders and by way of salaries to the five family members working in the company.

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In 2004, BLB peaked at $140 million in annual revenue. Then in 2005, BLB's major African leather supplier delivered two months late, which was devastating for a highly seasonal business. In 2006, BLB's major customer, representing 30% of its entire annual sales, cancelled all of their orders when the leather bag shipment was halfway across the Atlantic Ocean. With $20 million of bank debt personally guaranteed and fully collateralized by the Manzella family stockholders, the 85 years of business momentum was severely jeopardized after two major upheavals in two consecutive years.

All of a sudden, after all those years of blissful progress, BLB was out of financial covenants and there was a call on the family members to provide the bank with more collateral and guarantees on the loans or liquidate the company. Historically, all members of the family had been living off the company's income with little of BLB's earnings reinvested in the business.

Family Self-Assessment

At the point of crisis, a family business consultant was retained to bring about a family consensus weighing both the family issues and the business issues. Some of the major considerations were as follows:

- The different levels of involvement by the fam-

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ily members, i.e., those who worked in the business and those who did not.

- The latter contingent are almost always less connected to the company emotionally and yet these non-management family shareholders caused nightmares for those managing family members.

- The company (in this case) is an asset which for several years has not yielded any income to the non-management stockholders, nor does the future appear to be any more positive.

What became clear is that the third generation had no exit strategy (85 percent of family businesses do not) and that most of BLB's shareholders' assets were tied up in this business (75 percent of family owners' net worth is in the company).

Since the family members were at odds with each other, there was a distinct possibility that BLB might fail and not survive the third generation. Louis, at age 60, and the current CEO, was the only family member currently employed by BLB who appeared capable of running the business.
The issues of whether to sell the company now, or wait to sell until the business improved or not to sell the business were all possibilities.

Dual Problems

Actually, the company is faced with two critical issues simultaneously. One is the deteriorating business issue caused by substantial losses for two years coupled with a bleak outlook, thus causing management to curtail all dividends to family members. The other major issue is a the aging family CEO without a succession plan in place nor the likelihood of finding family unanimity amongst the family members on this issue.

The business is facing this crisis due to their historical lack of communication about issues that are of vital interest to the family and its business. Families generally abhor addressing emotionally laden issues. The family had to face these questions: Can the business survive unless there is a sharp reduction of the working family members' compensation and indefinite curtailment of dividends to all family members including the non-working family members? And does the family have the strength to address the issue of whether the company should be sold now or whether to continue the business into another generation?

At this point in time, the company implemented three intermediate steps in order for BLB to rectify its family issues and survive beyond the third generation.

- Established buy/sell agreements which enable those family members who want to liquidate their investments to do so. These agreements have to be flexible ad creative with an understanding that minority investments in illiquid companies are valued at a discount.

- Conveyed to all family members that almost always there is an inherent problem of family members who have divergent interests, to therefore it becomes paramount that the family members come together as a community to communicate their common interests.

- Created a form of complete transparency with all family members on financials, strategic goals, capital expenditures, etc. through regular meetings which include all members.

The various issues of compensation, management benefits, strategic direction and executive succession were resolved over a year of continual and intense interaction with the counsel and guidance of an unbiased, third party family business consultant.

BLB defied the odds and survived the third generation, but without overcoming the ever dangerous tipping point. In this case study, the family addressed the immediate financial crunch by indefinitely running the company on a severity program eliminating all dividends, excessive salaries and "perks." Simultaneously, the family solved the succession issue and avoided the sale of the company by bringing in as well-qualified family member who currently was an executive for a Fortune 500 company as heir apparent CEO.

The tipping point was real, the solution was successful. ■