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The resilience of family-controlled business groups: Survival of the unfit?

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The Covid-19 pandemic has been a black swan event. It has resulted in an existential challenge for many firms. Even in the countries where governments are most supportive, businesses are struggling to stay afloat and avoid bankruptcy. What will differentiate the resilient from non-resilient firms?

The intuitive answer is that well-run firms will weather the storm better. True, but we also believe that companies displaying some attributes of "inefficiency" are also more likely to survive this crisis. By highlighting this, we hope to provoke some questioning about how we evaluate corporate success.

Led by the rise of shareholder activism and private equity in recent decades, firms in the developed world have become lean and focussed in their pursuit of maximising shareholder value. With the exception of a handful of bellwether tech companies which seem to get a free pass, companies have loaded up on debt as well as returned cash to shareholders through share buybacks or dividends. For example, substantial cash on the corporate balance sheet elicits the sneer that "you are not a bank". Furthermore, conglomerates trade at a discount under the belief that they do many things, but none of them really well, without an ability to extract synergies from unrelated businesses. Activist shareholders have led this charge to break up the diversified company and sell unrelated parts as standalone firms.

The Covid-19 pandemic makes us reflect on what does an organisation that is resilient to such unexpected large-scale disruptions look like. The answer that research on organisations provides is that organisational survival is more likely in the presence of slack and loose coupling; two features in normal times viewed as signalling management incompetence.

First, slack or excess resources, such as cash, beyond those that are currently necessary matters. When it is business as usual, slack may look like a sign of inefficiency and administrative fat; but that is how bears beat harsh winters. To be clear, not all inefficiency implies the existence of slack; but all slack is liable to look like inefficiency in a world where unexpected disruptions that need these excess resources are truly unanticipated.

Second, weak coupling of the components of a system allows shocks to be localised, without jeopardising the survival of the entire organisation. Half a century ago, the Nobel laureate Herbert Simon offered a classic illustration of this principle. He expressed the insight through a parable of two watchmakers, Tempus and Hora.

While Tempus built his watches all in a single assembly process, Hora built them from smaller sub-assemblies. When unexpected interruptions caused them to lose the work they had done on a watch so far, Hora fared better as at most he lost a sub-assembly. Tempus, on the other hand, lost the entire watch.

The lesson is that systems composed of weakly coupled parts can take unexpected hits to some parts without the whole system crashing. However, in "normal times", such loose couplings will appear as missed opportunities for optimisation and efficiency through enhanced coordination.

Interestingly, the above two attributes are frequently observed together in traditional family controlled businesses, especially Asian business groups. These are typically a set of diverse businesses, each held in different subsidiary companies under an umbrella holding company. Usually, the holding company is unlisted, while the more mature larger subsidiary firms are listed individually on the stock exchange with the holding company as the promoter. The smaller and less mature companies in the group comprise fully owned unlisted subsidiaries, waiting their turn to be on the stock market. This loosely coupled structure tends to go hand in hand with a highly diversified portfolio of businesses, with little or no operational synergies or shared infrastructure.

Furthermore, family control often brings a multi-generational long-term perspective, where continued survival often trumps maximising returns to shareholders in the short run. This preference may result in cash reserves at the holding company level that exceed what more professionally run firms possess. These two properties of loose coupling and slack are precisely what may allow such organisational forms to tide over major disruptions that may wipe out the more “lean and mean” optimised organisations.

To be sure, we do not mean to offer a blanket licence to be incompetent and sub-optimised, and we acknowledge that the survival of firms may not always be the right objective. Rather, we are merely stating a well-known property of complex adaptive systems: what looks like efficiency today may well be the hallmark of fragility in a dramatically different world, and vice versa. If one is convinced that this is not the last major economic shock that we will observe in our lifetime and organisational resilience matters, then there may be some lessons to learn from the disdained inefficient practices of traditional family-controlled business groups.

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