Private Wealth and the Family Office: Different Structures for Different Families

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The impressive growth of private wealth on a global scale in recent decades has resulted in "The Forbes World’s Billionaires" list growing from some 140 billionaires when it was first launched 25 years ago to a record 1,226 in 2012. The emergence of new industries, particularly financial industries, is largely responsible for this unprecedented growth in "new wealth," and its magnitude has inevitably drawn attention to the individuals who have succeeded in amassing these fortunes. On the other side of the private wealth spectrum is "old wealth," i.e. wealth that was created by earlier generations, passed down to subsequent generations and either enhanced or impoverished along the way.

At IMD, for a quarter of a century, we have studied and educated families that have wealth and own businesses. Our focus has been global and it has concentrated on one key question: Why do some families succeed at sustainably building their wealth and businesses and passing them on to subsequent generations, while the vast majority of others destroy wealth over time? Is wealth destruction an inevitable by-product of human nature’s evolution? After all, almost every language has a translation or a similar version of the famous saying, "The first generation builds the business, the second generation develops it and the third generation destroys it."

Our research has brought a structured approach to understanding private wealth, including how it is created, managed and passed on to subsequent generations. We are convinced that wealth destruction over time is not inevitable. In fact, we believe quite the opposite because we have seen many families around the globe quietly, effectively and sustainably managing their wealth for their benefit and for the benefit of future generations.

Of particular interest is the extent to which relationship dynamics among family members influence the creation, distribution, management and performance of private wealth. Families, as wealth creators, owners and subsequently investors, often tend to take an entrepreneurial stance in running their companies and their other financial assets. However, given the rising complexity of the financial markets, non-family managers are increasingly playing an important role in their businesses and financial interests.

Introducing the family office

In this article, we present a model for the stages of private wealth development of family owned businesses. We also show how the development of the business leads to the establishment of an entity to manage the family’s financial interests – the family office. We present highlights from an in-depth study of 12 of Europe’s largest family offices, illustrating aspects of these institutions that are of great relevance to managers who are working directly and indirectly with and for family owners.

Origin: Entrepreneurial dream

It all begins with an entrepreneur ...

The entrepreneur, the original founder and manager of what will become a family business, controls all the power levers of the newly created business entity vis-à-vis ownership, management and family standing. He or she provides the founding narrative for the family that captures the core family values and a vision that can be shared across generations. The family business will play a significant role in the dynamics of the family for generations to come. The business is in fact an integral part of the family’s daily life and is a platform for their interactions within the family and with outsiders.
Then other family members become manager–owners ...

Moving to the next generation, as both the family and business grow, we see an increased demand for other family members to participate in the firm. They are perceived as a ready source of trustworthy talent that understands the business. As they join the business, a degree of management control is passed on to the younger generation of the family. Later, as the founder retires from direct involvement in the family business, siblings find it necessary to share power and control of the business with each other. While there is a growing need to formalize some aspects of the family business governance, this is often done in a limited way because the relationships between family members remain close.

Eventually, it turns into a family in business ...

Over time and generations, the businesses tend to be the “glue” holding together the family branches that appear after the founding generation. When the original business declines in importance over other business and financial interests, it becomes necessary to find a “glue” other than the family business to keep the family together. The business is part of the family’s history and tradition and it is difficult to see it simply as an investment that forms part of the family’s overall wealth.

While the business is a family enterprise, once we get past the founder, not everyone in the family is or wants to be involved directly in the business as a manager. In such situations, there is a clear need to think strategically about the family’s financial position and design a new structure and a plan of action – it has now become a family in business.

Destination: Maintaining and Growing Private Wealth

A family in business needs a platform to capture its wealth – business and financial – and to address the broader needs of current and future generations.
But what is a family office?
A family office is an entity that takes care of the day-to-day management and administration of the collective assets and business affairs of one or more families. Its long-term goal is to preserve and grow the wealth for current and future generations. For the family in business a family office takes on the rallying role previously served by the family itself.

Why are family offices established?
One of the key motivations for creating a family office is to centralize the management of a substantial family fortune and more effectively transfer the established wealth across generations. It allows a family in business to create a trusted environment with a maximum level of control and the possibility to reflect the personal risk attitude as well as the long-term view of the family. It also enables families to include alternative investments (i.e. art collections) or dedicate some of their wealth to private equity and/or venture capital activities. The ultimate decision-making stays with the owner community and potential conflicts of interests with financial services companies such as banks can be avoided.

- To transfer assets across generations
Family offices have served as vehicles for intra-family and intergenerational transfer of assets. The most common example for the establishment of an office is the retirement of the original founder(s). Family offices can be established on behalf of heirs, so as to have the structures necessary to cost-effectively manage inherited assets in common, rather than liquidating the assets and dividing the proceeds.

- To improve family governance
A family office could be a strategic decision by family members to create a formal distinction of the family wealth from the assets of the family business. Financial risk diversification is a primary motivation. Also, separation can be done in the spirit of improving transparency and corporate governance of the family business.

- To manage cash inflow from liquidation of family business
The third source of funds is the sale of at least a portion of the family business, leading to a sudden increase in overall liquidity. To illustrate the importance of trade sales as a liquidity source for family offices, the aggregate reported assets of the family offices we interviewed were €30 billion. Out of this total, 71% results from the complete or partial sale of the family business. In comparison, only 14% of assets come from historical family wealth. The remaining 15% is liquid wealth from other investments.
What determines the structure of a family office?

Our research identified four key factors shaping the structure and operations, as well as the governance and investment allocation of the family office.

- **Type of clientele**
  The primary determinant of the family office structure and operation, as well as eventual investment decisions, is the type of clientele it serves. Two factors characterize the clientele: the number of family members and their “generational spread” – the distance between the latest generation of family members served by the office and the founder’s generation.

- **Who is involved in the family office?**
  Family member involvement in itself can be a goal embedded in the establishment of the family office. Generally, more entrepreneurial individuals prefer to be more involved either in running the office or in the investments undertaken. In several of our cases, the family office had become a new “family business” for family members to run.

- **Connection to family business**
  The fresher the experience or involvement of family members in the business the more they are involved in the family office. For example, they are more involved when they are still holding significant portions of the business, participating in its corporate governance, and/or part of the day-to-day management team. However, in situations where the business is a distant memory, there tends to be less interest from family members in being involved in the family office and more demand for lifestyle management. However, many families want to retain an entrepreneurial spirit within the family and encourage individual family members to run their own businesses. Some families, as a group, invest in or acquire businesses often related to their origin. We have also encountered families that have come to regret the sale of the family business as they find little excitement in managing the financial assets. The key issue here is to distinguish between the “dream” of a senior generation that has fond memories of the family business in the past, and the aspirations of the next generation who may have very different preferences and objectives.

- **Family background and circumstances**
  The establishment of a family office is often the result of a transitory phase in the history of the family and the family business. While reassessing their current circumstances, families may discover that they are very
different from those before them who put the current governance arrangements in place. Thus they find it necessary to reconfigure their link to the family business and with each other. One of the family offices interviewed sold off a minority portion of their family business specifically because they felt that running the family business was becoming “burdensome and did not give us the managerial autonomy we cherished.” Thus, they undertake investments as a family for “fun” in order to realize their “entrepreneurial will as a family.”

**What types of family offices exist?**

Up to now, the main classification of family offices has been according to the number of families they serve and the amount of assets under their belt – i.e. single vs. multiple family offices whether they serve one family only or whether they serve more than one family – thus single vs. multiple family offices. Our research changes the categories based on two of our key findings – the full financial extent of the original founder’s family office and the distance of the latest generation served by the family office from the original founder. Both are extremely indicative of investment appetite, risk tolerance and interest in financial matters. Based on this new criteria view, we outline five categories of family offices.

**1) Single-member family office – Founder/Controlling Owner Stage**

The first type of family office is the single-member family office, and generally includes the original entrepreneur and owner/manager of the family business, or the controlling owners in subsequent generations. This type of office thus corresponds to the mindset of a manager-owner in a family business. Here the principal is greatly involved in the decisions of the family office – the family office in fact tends to become the new family business.

**2) Limited-membership single family office – Sibling Stage**

The second type serves a limited number of family members, generally the first heirs of the founder or controlling owners of the family business. In these offices, greater attention is paid to issues related to governance and the use of formal channels for review and communication. However, because there is still little generational distance between the current members of the family office and the original principal [the source of the wealth], the family members remain quite entrepreneurial and business savvy and therefore tend to be more involved in the family office than would family members in later generations.

**3) Multi-generation family office – Cousin Stage**

The third model of family office is the multi-generation family office, which in the words of one of the interviewees was characterized as “a single family private bank.” The distinguishing feature from the previous two categories is that there is increasing distance between the founding principal and the office’s clientele. Further, members served by an office of this type tend to be much less familiar with the family business.
the relatively larger number of clients there tends to be even more attention paid to formalizing decision-making and governance. The increase in clientele also means that there is a large discrepancy in terms of the members’ stage in life, and in turn, of their investment needs and horizons. Therefore, capital allocation has to be rearranged so that it will provide current income for older generations and plan long-term for younger ones.

4) Multi-family offices and 5) Family Office Services

Our research revealed two other models to complete the taxonomy presented here – multi-family offices and family office services. A multiple family office manages the pooled wealth of members of different families, allocating funds into investments either in aggregate or per family. The last model is composed of the family office services offered by banks for ultra-high net worth individuals that mirror those provided by a multi-family office.

What does it all mean?

Private wealth is difficult to create and to manage sustainably over generations. The easiest part is losing it! Today we have a better understanding of how families can effectively manage and pass on businesses and private wealth to current and future generations. This involves a clear understanding of the role of the family as a whole and as individuals, as well as the appropriate application of strategies and governance structures over two or three generations. The family office can be the right supporting structure or that helps families remain focused and manage their wealth to meet the varied needs of different generations.

Leading a family office goes beyond the pure management of a financial organization; it is about a comprehensive, responsible and inclusive way of steering the family wealth with a sustainable, trans-generational and long-term vision. It involves building a family vision and governance structures that address the diverse needs of founders/controlling owners, siblings and cousin generations. Its key objective goes beyond pure financial profit maximization and management to serving what a family in business wants and needs both now and in the long-term future.
References:


Related Program:

Leading the Family Office is a program that helps families of wealth determine the best and most appropriate structure and governance model to set up and sustainably maintain their own Single Family Office. During the program, you and your family will:

- Create a sustainable platform with the capacity to preserve and pass along your family business wealth, values, philosophy and history to future generations.

- Gain insights on how to make informed and educated choices regarding the structure and objective of your Single-Family Office.

- Develop competencies and expertise to manage your wealth in a sustainable and preserving manner.

- Build family unity through a shared vision and jointly develop long-term objectives for the family, the wealth and the business assets.

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