

Managing Risk in the Family Enterprise: It's More than Financial

By: Michael L. Fassler and Wendy Sage-Hayward
The Family Business Consulting Group

All businesses face risk — family businesses are no exception. Generally thought to adopt a more conservative approach toward managing their business operations, family businesses are often considered more risk averse than their nonfamily counterparts. According to the *Harvard Business Review's* article “What You Can Learn from Family Business” they “forgo the excess returns available during good times in order to increase their odds of survival during bad times.”

When it comes to managing risk, it is important to ask: How does your family dimension impact your appetite for risk? How do you manage risk tolerance differences among family members? What process do you have in place to communicate decisions that may involve greater risk in order to build alignment and understanding within key stakeholders?

To help answer these questions, we will define the types of risk family enterprises face and explore how they can take an intentional approach to identify and manage risks to their businesses. We will then examine how to measure and monitor risks as they arise. Lastly, we will share how to strengthen the communication of this process within the family enterprise so that decisions around risk are better understood and rationalized or explained.

Types of Risk in Family Enterprise

Too often, the word “risk” evokes the feeling of danger, uncertainty and the probability of loss without recognizing the potential upside that is inherently present with good business decisions. For our discussions, we will adopt the Chinese symbol for risk that combines two components: danger and opportunity. This definition perfectly captures both the essence of risk and the problems with focusing purely on the reduction of risk.



There are many domains in which a loss or gain (opportunity) can arise within a family business context:

- Financial risk: The potential for gain or loss on a financial level measured in terms of revenue, return on investment, return on equity, shareholder value, profitability, debt level, capital expenditures and free cash flow. Financial risk is the most commonly understood meaning of the

term within a business context.

- Performance risk: The potential for increased or decreased performance of the business. Decisions include operations, production, materials and human resources. An example of performance risk is purchasing a new machine to potentially reduce production time.
- Reputational risk: The potential for gain or loss to the standing or status of the family and business including its name, brand and products or services. Decisions include ethics, safety, security, quality, innovation and sustainability.
- Relationship risk:

Nonfamily: The potential for solidifying or weakening the rapport and trust with customers, employees, suppliers and other stakeholders. Decisions include contractual, financial, procedural, communication and safety. Reputational and relationship risk are closely associated with one another. There is greater relationship risk for family businesses, for example, when making decisions about layoffs due to the loyalty and closely held relationships many family businesses establish with their nonfamily employees.

Family: The potential for strengthening or abating trust and cohesion within the family. Family relationship risk is similar to relationship risk except it focuses on family relationships and the family legacy. These decisions are not merely financially oriented because they can affect the livelihoods and quality of life for parents, uncles, siblings, cousins and other family members.

- Safety risk: The potential for creating harm or increasing the protection of people as well as material goods or properties. Decisions include compliance, regulatory, training, operational and procedural.

Family Enterprise Decisions and Risk Appetite

A framework for having dialogue about risk is foundational to aligning stakeholders on risk and incorporating risk management into your family enterprise decisions. The framework starts with uncovering and articulating your family business's "risk appetite." Most likely, the risk appetite has evolved over the life of your family enterprise and always been a part

of making decisions. Identifying your family enterprise's risk appetite helps formally align stakeholders around risk and more deeply imbeds risk management in the company's decision-making process. The risk appetite can be defined as the amount and type of family risk and business risk the family enterprise is willing to assume in order to achieve its strategic financial and nonfinancial objectives. What makes risk appetite statements unique for family enterprises is the influence of the family's values and vision on how risk is viewed and managed. After considering family input, the management team and board can develop a risk appetite statement that outlines the boundaries.

As an example, one of our client families values close geographic proximity of family members and views growth outside of their geographic core as a risk to family cohesion. They also value individual freedom of choice and support individual growth. In their risk management framework, they established that business growth beyond their core geography is an option for consideration if a family member chooses to live in the more distant geographic area. In order to mitigate the risk to family cohesion, the business provides an annual travel budget for that family branch's trips back home.

Measuring Risk with Quantitative and Qualitative Criteria

To make the risk appetite statement come alive and robustly incorporate it into strategic decision-making, quantitative and qualitative criteria are needed to measure risk. This information guides the board and management on resource allocation decisions on where to deploy talent and capital. It also enables both teams to make speedier decisions and to focus on managing risk within the established boundaries.

Quantitative criteria are measurements represented by numerical indicators that are objective and verifiable such as financial ratios or a customer satisfaction survey scores. As you think about developing quantitative criteria, consider using a threshold-target approach to their measurement. This provides a range for the criteria, with the target or better being the preferred achievement and the threshold being the minimum achievement. Once the threshold and target relationships are set, the strategic decision can be modeled.

Examples of quantitative criteria include:

- Percentage of total equity or dollar amount of equity capital committed to the decision
- Liquidity to maintain in the business
- Reinvestment rate into the business
- Reserve capital and talent remaining for other opportunities in the next three years? In the next five years?
- Solvency ratio
- Impact to earnings volatility
- Impact to credit rating

In contrast, qualitative criteria are subjective and difficult to verify. But what they lack in terms of certainty, they make up for in terms of context for the stakeholders' perceptions of risk. They play a significant role in identifying constraints as to the viability of a particular strategic decision that may not be readily apparent from only quantitative measures. Examples of qualitative criteria include:

- How does engaging in this activity support achievement of our family vision?
- What will be the impact to the family's reputation?
- What will be the impact to the company's brand?
- How does it leverage our core competencies?
- Do we have leadership and management capacity available?

In order to manage risk, it has to be measured. This is where both qualitative and quantitative criteria come into play. The risk appetite statement sets the boundary and when combined with qualitative and quantitative criteria, the board and management team have the guidance to make decisions which align with the family enterprise's risk preferences.

Risk Management and Ongoing Communication within the Broader Family

Managing risks in the family enterprise can be a tricky affair given the different personalities and many other nuances that may exist within this unique environment. Ongoing communication with all of the key stakeholders is critical to the success of the management's ability to effectively manage risks. Some important tips for

fostering alignment amongst family members around risk include:

- Develop a common base level of knowledge in all key stakeholders. Invest in training and development of family, owners and management. A strong foundational knowledge about the business and its industry will provide an educated basis for decision making.
- Ensure good data and information is available to all key stakeholders. Be transparent and open about information relating to the decision and its potential risks and opportunities. Provide timely management information to help all involved paint a clearer picture of the potential upside and downside of the decision.
- Establish useful decision-making criteria. Understand the most important criteria upon which the decision will be based. In addition, perform an assessment using each of the types of risks defined in this article, as well as others you may face. This process will help highlight what is important to those who will be affected by the decision.
- Identify exceptions to nonalignment. Often there is consensus on many aspects of a decision or event and only a few areas of misalignment. Therefore, it is helpful to identify those areas where alignment exists and focus attention on those areas where greater agreement is required.
- Reframe nonalignment. Sometimes misalignment can become a source of tension and conflict from the feeling of "you don't agree with me." Name calling and other negative behavior can arise at these times. Instead, try to frame the misalignment as an opportunity to better understand priorities and interests, as well as to build cohesion between those involved.
- Help the family pull back to macro-level thinking. Sometimes risk-related decisions and conversations can take families, management and owners into the weeds where they lose sight of their vision, goals and the bigger picture. Refocus the discussion by reviewing the higher level strategic direction and priorities.
- Fostering alignment around risk starts with

having an agreed upon process for making decisions on strategic matters in advance of a decision at hand. It continues with a good set of discussion questions and dialogue related to the family enterprise's future in order to develop consensus on how to integrate decisions related to what the business needs, the overall family objectives, individual family branch needs and wants, and individual needs and wants. Some of these questions include:

- At what rate does the business need to reinvest profits to remain competitive in our markets?
- What is the risk to our family enterprise and our family if we don't reinvest adequately?
- What is the risk to family cohesion if we don't grow the business further to create additional leadership and employment opportunities for family members?
- What constraints do we have that impact our commitment of capital to the family enterprise?
- To what extent do we want our investment in our family enterprise to generate personal liquidity as compared to reinvesting in the business?
- Do we prefer one focused business or more of a diversified business?
- To what extent do individual family members identify themselves with the business?

When Sufficient Alignment Cannot Be Achieved

Sometimes a family cannot achieve sufficient alignment on strategic choices and their accompanying risk. In these cases you might:

- Reduce your family enterprise's share of the risk by aligning with another group through a joint venture.

- Bring another family enterprise or other equity partner into the mix on the opportunity.
- Segment the opportunity and fund it with capital from those family members that do want to participate.
- Establish a class of capital with a more predictable and less risky return for those owners whose personal risk appetite has deviated from the group.
- At the extreme, consolidate the ownership group.

Insufficient alignment on strategic matters and related risk to capital can be managed structurally. Family relationships can be protected in the face of insufficient alignment by having structural choices which enables the business to execute its strategy. It is having choices itself which often causes family members to be more patient with their capital.

Where to Begin?

Starting the discussion in the board room or at an owners' meeting helps ground the family and board in the business' realities and garners the family's input and commitment. Involving your management team in these discussions at the appropriate time is critical to effective decision-making execution within your risk management framework. The guidance provided will deepen their engagement and be appreciated.

These initial discussions will likely feel very intangible so it will be important to develop a level of comfort with the ambiguity. The family will need to push through this phase and work towards creating version 1.0 of its risk management framework and plan. They can then apply version 1.0 of its plan when making strategic decisions as they move forward-updating and evolving the framework to match upcoming and new realities as a key part of stewarding the family enterprise.



Risk Management Conversation Starter

This tool is a guide to start the risk management conversations with your family ownership group and executive team. In either a group planning session or through a survey, gather responses to these questions. Analyze the answers looking for the areas of alignment on responses and the areas where there are divergent viewpoints. Use the results to prompt further discussion to move toward a consensus

viewpoint on your family enterprise risk appetite and to begin the development of your risk management framework.

Not all questions will be relevant to your family enterprise. You may also need to develop additional questions for the risk management circumstances unique to your family and business.

Risk Domain	Questions
Financial	<ul style="list-style-type: none"> • What is the maximum amount of leverage we will employ as a family enterprise? • What percentage of our total equity are we willing to commit to any one investment or enterprise? • What is happening in our marketplace which will impact our reinvestment rate in order to remain competitive? • How does a continued investment in our legacy business represent our best investment alternative? • Under what scenarios would our dividend rate need to be reduced?
Performance	<ul style="list-style-type: none"> • What type of leadership and management capability do we need to manage the risk associated with our planned growth? What is our current capacity in this regard? • To what extent is our next generation leadership development program producing leaders that will assure our continuity as a family enterprise? • Are we willing to commit the capital and talent to manage the risk associated with this new investment? • If we accept this risk, what opportunities are we foregoing in the next 3 years? 5 years? • What checkpoints do we need to ensure we have sufficient family commitment in the long term, and to manage through a significant economic downturn? • What external market factors may impact our ability to generate return on equity consistent with the past? • How might our performance be affected if we make this strategic decision/investment?
Reputational	<ul style="list-style-type: none"> • Is this business venture consistent with our family enterprise values? • What stakeholders are we dependent on in this venture? How could they impact our reputation? • What cyber security risks do we face? What do we need to do to mitigate these risks? • Does our reputation exceed our capabilities to meet the expectations of the marketplace? • How are changes in cultural norms affecting our reputation in the marketplace? • Under what conditions would we exit from our legacy business? How would this impact our family's reputation?

<p style="text-align: center;">Relationship</p>	<p><u>Nonfamily</u></p> <ul style="list-style-type: none"> • To what extent is our business dependent on external stakeholder(s) in order to be able to create value and compete in the marketplace? • To what extent does our customer concentration expose our company to risk of a sudden downturn in revenue? • To what extent does our supplier concentration expose our company to risk of interruption of our ability to meet our commitments to customers? • Do we have sufficient outside influence within our governance system to ensure accountability for expected behaviors and results? <p><u>Family</u></p> <ul style="list-style-type: none"> • How are we building relationships and emotional ownership in our family to ensure continuity? • What family participation policies and protocols do we need to effectively manage the family's interaction with the business vice versa? • How are we investing in development of the next generation ownership group? • How do we strengthen our capacity as a family to effectively communicate, resolve conflicts and make decisions together?
<p style="text-align: center;">Safety</p>	<ul style="list-style-type: none"> • What safety risks do we have in our workplace? • How are we addressing these risks? • What safety training do we need in our workplace? • What resources do we require to monitor our safety program and improve it over time? • What recovery measures do we need to adequately handle a major disaster? (i.e., to sustain safe operations, meet customer commitments and recover operating costs)



Micheal Fassler is a Senior Consultant with The Family Business Consulting Group, Inc. He can be reached at fassler@thefbcg.com or 269.382.8144.



Wendy Sage-Hayward is a Consultant with The Family Business Consulting Group, Inc. She can be reached at sage-howard@thefbcg.com or 604.803.7420.

To learn more about The Family Business Consulting Group and how we serve families like yours, call us at (773) 604-5005 or email us at info@thefbcg.com. There is absolutely no obligation.

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