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by Dominic Houlder and Nandu Nandkishore

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The public corporation is typically bedeviled by the gap between managers' and shareholders' interests. Over the years, governance has attempted to close that gap by aligning incentives with measures of performance. These attempts have often failed. But where they have succeeded, they

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have left public corporations increasingly swayed by short-term results (which are easy to measure) at the expense of future success.

Over the last 30 years, the private equity model has risen to the fore as a solution to the governance problem. In private equity, managers and shareholders are closely connected. Typically, there is a very clear medium-term investment thesis that downplays short-term pressures, with a view to an exit within three to five years. The great strength of the classic private equity model is the clear-sighted medium-term focus on strategy. The weakness is the generation gap, losing continuity of purpose as ownership passes through successive private equity houses and new cadres of top management.

Is there a sweet spot that uses the strengths and addresses the weaknesses of the private equity model? We believe so — it is a form of governance that is much older than the public and private equity models, one developed in sophisticated Western capital markets. And it starts with family businesses.

The Family Firm

The family firm is arguably the oldest form of governance. The age-old advantage of family ownership is having a view across the generations, combined with a concentration of ownership that can ensure management alignment. We are struck by the extraordinary success of family firms that both find talent in the broader families of their owners and attract and retain phenomenal external talent. Family-owned business sectors have become engines of growth, particularly across the U.S., and economic powerhouses, most notably in the German, Austrian, and Swiss Mittelstand.

Some family firms have become global champions, including Mars. One major decision at the company — to restrict calorie counts to 250 calories per serving of chocolate — may have looked questionable from a short-term perspective, but it has not stood in the way of Mars becoming the unrivaled global leader in chocolate.

Mars invested in China not only with a long-term purpose and commitment, but also with a clear medium-term strategy that was not swayed by short-term setbacks. It takes time and courage to establish a chocolate habit in a completely new market, without compromising the original brand name, quality, or taste standards. Today, Dove ("Do-vu", in Chinese), a Mars brand, is the undisputed chocolate leader in China.

Now in the fourth generation of the owning family, Mars offers the most sought-after career paths to professionals in the FMCG sector. But family firms often face scale disadvantages, due to lack of capital or the family's reluctance to dilute equity by going public. An even greater disadvantage is the paucity of family talent, particularly beyond the third generation, and limited opportunities for talented outsiders. Addressing these challenges requires a governance model that combines the best of family firms and private equity.

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The Hybrid Model

The hybrid model melds the disciplines of the PE house with the continuity of purpose of the family firm, at the same time unleashing potential through full access to capital and talent markets.

Many successful examples can be found outside the Western world. Samsung is a global leader renowned for innovation talent, yet with strong family control. Cathay Pacific, based in Hong Kong, is frequently rated as the best global airline, and its managers are keenly headhunted by its peers; few know that it is controlled by the Swire family, which has sustained a commitment to Hong Kong and China for over 150 years. SABIC, partly owned by the Saudi Royal family and partly public, has emerged from a third-tier regional position in petrochemicals to become a global leader. Indian business groups, such as Tata and Birla, are magnets for the best talent within India and, increasingly, outside it. The families that control these groups remain the custodians of purpose, providing assurance to those they recruit as well as other key stakeholders — governments, partner organizations, and communities.

These examples are hybrids not just of family ownership and professional management, but also of private and public ownership. Typically, the families exert control of publicly listed affiliates through their private holding companies. Private control allows the owning family to act as the custodian of purpose and protect management from short-termist distraction. Public listing of businesses in which the family holding company has a controlling stake then provides access to capital and an important external reality check.

From a competitive standpoint, hybrids can overcome scale disadvantages through engagement with capital and talent markets, and maintain a steady course through the storms while rivals fixated on the short term flail and falter.

Mutants

In addition to the hybrid alternative, Western governance models are being challenged by a mutation of the classic private equity–leveraged buy-out model.

The weakness of the classic private equity model is the inherent challenge of the exit: It is hard to look strategically beyond the typical three-year exit plan and likely departure of the top management team. Our London Business School Sloan Fellows recently researched 3G, the Brazilian private equity house. They saw how 3G went far beyond its roots in Brazil by creating global giants in brewing (AB Inbev), groceries (Kraft Heinz), and fast food (Burger King–Tim Hortons). At the same time, 3G departed fundamentally from the classic private equity model. Although it intervenes to improve cashflow and margins and makes full use of debt capacity, 3G commits to long-term profitable growth rather than a medium-term exit. From its earliest days, 3G set out to ensure that its businesses became magnets for top talent, emphasizing culture change and best practices in recruitment, training, and retention as much as financial transformation. The “3G way” has been injected into all the businesses 3G has acquired across the world.

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Where does success, and its underlying competitive advantage, come from? The fundamental source is governance: the processes, relationships, and measures through which corporations are governed. The classic Western governance models — for both public and private equity — are becoming dinosaurs. Those who would be winners need to look beyond those models to the emerging hybrid and mutant forms of governance that will be the sweet spots for the future.

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