Juno Investment Partners sees significant differences between European listed family-owned businesses

“Governance can make or break a family-owned business”

Family-owned businesses are the backbone of the economy, are conservatively run and are attractive because of their focus on the long-term. Sometimes things go wrong, especially under the third generation, according to recent research by Erasmus University (Rotterdam, Netherlands). Juno Investment Partners delves deeper into the success factors and vulnerabilities. "One family-owned business is not the same as another. There are significant differences in terms of governance and financial ratios. "

Frans Jurgens, Lennart Smits and Rob Deneke have years of experience in investing in listed (family-owned) companies. Jurgens and Smits founded the Dutch asset manager in 2007, just before the financial crisis. For the selection of companies, they always start from the long-term development of a company, focusing mainly on earnings growth, cash flow, a healthy balance sheet and return on capital employed (ROCE). This is based on the belief that the stock market price in the long term is a reflection of the fundamental developments. “What struck us was that it were predominantly listed family-owned businesses that passed our scrutiny,” says Jurgens.

The two Juno funds mainly invest in European companies where the founder is at the helm or the founder's family is an important shareholder. At the beginning of last year, the Juno Continuation Fund was launched, which focuses on slightly larger companies. The new Juno fund is managed by Rob Deneke (who joined from Comgest in 2019) and Duncan Siewe.

Solid and reliable companies

It is not surprising that long-term investors end up selecting family-owned businesses. This usually concerns companies that have been around for a longer period of time, where the founder and his successors have a long-term vision to guide the company safely to the new generation. “It is obvious to customers that they are dealing with a solid party, one that will probably still be there in ten years' time. This also provides certainty and confidence to suppliers. For many, family-owned businesses are synonymous with good reputation,” says Jurgens.

A recent study by the Dutch Erasmus University into family-owned businesses ("The secret of eternal youth") distinguishes a relation between reputation and the company names of family-owned businesses: often the family name is on the facade. Jurgens: “However, that is by no means always the case. More importantly, stakeholders know that there is a family behind the company. Confidence is also high among the staff of family businesses. During our many company visits we notice how great their loyalty is. ”

Jurgens: “We do not only invest in family-owned businesses, but also in other companies where the focus is on the long term and where the company meets certain strict criteria. This is often the case, for example, if more than 10% of the shares are held by management and personnel. That leads to a significantly higher involvement in business success."

Good financial health and management

Another success factor for family-owned businesses is that they have a healthier balance sheet. First of all, this is a consequence of their long-term vision. Rather than paying dividends to shareholders, the earnings are reinvested in the company. Smits: “This long-term focus is logical: as CEO you want to leave the company to the next generation. When Freddy Heineken passed away, his daughter stated that she did not see the company as her inheritance but as a legacy. ”

Throughout their history, family-owned businesses have learned not to rely too much on banks. Long-term growth should mainly be financed from their own reserves. Smits: “The owners are reluctant about external financing. The experience is, that banks give you an umbrella when the sun shines, but leave you out in the rain when times are bad. When you consider that companies go bankrupt mainly because creditors demand their money back, this is a very important risk. Because family-owned businesses usually have little to no debt on their balance sheet, they are also better equipped to withstand economic headwinds."

Another important advantage of family-owned businesses is that the so-called agency costs are low. Whereas shareholders at other companies have to closely monitor management - because the interests of management and shareholders are not always aligned - in family-owned businesses, management and family are closely linked or the major shareholder is himself the CEO. This tends to align interests, which means that the "cost of control" is low. In addition, family-owned businesses are more interested in investments that only pay off in the longer term, whereas management at other companies often focuses more on the shorter term because their annual remuneration depends on it.

Risk averse

Family-owned businesses are generally careful with family capital. Earnings are invested in promising projects that should ensure future revenue and earnings growth. There is generally no cavorting in family-owned businesses, says Smits.

That risk-averse behavior can go too far. In combination with prudent financing, opportunities can be missed out on, and companies end up not getting the maximum turnover and earnings growth. But that is not what we want anyway, says Deneke.

Deneke: “You could say that family-owned businesses optimize and other businesses maximize. In the short term, say eighteen months, margins under a manager from outside the family could be greatly improved by, for example, cutting costs. However, family-owned businesses do not focus on eighteen months but rather on eighteen years. We are looking for marathon runners who achieve good results year after year. We do not want sprinters in the portfolio, you will ultimately not win the race with them. We are looking for quality and growth, that applies to the financial figures, but also to the managers of the companies we invest in. ”

These companies therefore offer relatively consistent returns for investors in the long term. That does not mean that they are companies with low margins, says Deneke. "We have portfolio companies with profit margins above 20%, with average annual earnings growth of between 10 and 20% and returns on capital well above 20%. But that is also why we select these companies: for their ROCE and high margins. We avoid the less solid family-owned businesses, with products or services that bring lower earnings predictability and greater sensitivity to economic cycles. "

When it goes wrong

The Erasmus University research concludes that the engine starts to sputter in family-owned businesses after the second generation takes the helm. The classic scenario is that the first generation builds up the business, the second grows it, and the third generation breaks it down.

According to Jurgens, this bump during the third generation is mainly a statistical fact. He says there are more important factors than whether the second or third generation is at the helm. "It is interesting to look at those underlying factors. There are major differences between family-owned businesses. It is important to always keep an eye on the ball and closely watch governance and financial ratios. "

First of all, there are differences in size. Large corporations, with the founder's name on their door, such as Heineken, Hershey and Hewlett Packard, are known worldwide, while most small to medium-sized companies are better known domestically. An example is the French BioMérieux, which, among other things, makes diagnostic tests.

It is more important to know in which growth phase a family-owned business is. With family-owned businesses that go public in England, it is important to be careful, says Jurgens. "Is it about raising capital to grow or because of inheritance planning, or does the family see that there are too few growth opportunities and are they trying to cash in? You see the latter relatively often in England." Jurgens makes no secret that the second group is not the best investment.

The manager's quality

A founder who made the company great has undeniable qualities. Things can go wrong after that, if the son or daughter takes over and turns out to be less suitable to run the place. "Especially if there is no strong internal supervision with independent and strong non-executive directors on the Supervisory Board, things can quickly go wrong. Therefore, such a generation transition is always a reason for us to be extra vigilant ", says Smits. "Certainly if, like us, you are an investor with a highly concentrated portfolio, you can afford few mistakes. In the past, we have therefore sometimes parted with companies at which such transfers were imminent."

Smits states that when assessing management, Juno mainly looks at the growth phase the company is in. "Then we see whether management fits in with that phase. Whether it is the founder's daughter or a grandchild is less relevant. You can also see that if the family takes a step back and hires an external manager but remains connected to the company, this often has a good effect. "An example of this is the German family-owned business Sartorius, manufacturer of lab products, where Joachim Kreuzburg took over in 2003 and managed to achieve very impressive sales and earnings growth.

Another negative development could be that although the family is more remotely involved, the external manager is overly guided by their interests, or experiences great pressure. This can easily lead to a too conservative policy, too little investment and too little risk taking, with all the consequences this entails for the long term. Smits: "Ultimately, this can reduce operating margins. We see that now at CEWE, the German producer of photo books. Instead of focusing on what they are good at and market leader in - photo finishing - they also keep a second activity going: online commercial printing (Saxoprint). However, this is a market with a lot of price pressure, because this service is in our view a commodity. Due a policy of risk spreading, which we suspect happens also because of the interests of the major shareholders, management still wants to remain active in this area. We don't understand that and believe it is a missed opportunity. "

Family influence can also be negative

The influence of a family can also go too far. The Juno partners see cases where a family is very committed to its own interests and forgets about other (minority) shareholders. Smits: "We really don't want a seat at the board for ourselves, but rather a good captain on the ship. If the ship is heading in the wrong direction, you want to be able to talk to him or her about it. Otherwise we will vote with our feet. As a shareholder, we don't have to be in the front of the line, as long as we are in the right line. "

It becomes difficult when the CEO is too headstrong. Smits refers to the Italian company Tod's, where the CEO and owner holds about 75% of the voting rights. "This man does not seem to care much for other shareholders. When he conducts three interviews in a day, he tells something different about his plans for the future strategy each time. Such a company is not for us because we cannot assess the intended course of "the captain" of such a ship. We prefer to avoid it."

What can also happen is that sometimes too much money is withdrawn from the company by the family. For example, because it has become so large that every niece and nephew is dependent on the dividend payouts it generates. This may be at the expense of significant investments, the ROCE and ultimately earnings growth.

This tension between family and other shareholders is particularly strong if the family owns the majority of the shares and the supervisory board does not or cannot offer sufficient resistance. Smits: "It is therefore important to take a good look at how that non-executive board is composed. Are there enough independent members who will speak out, or mainly friends and family members? "

Governance plays an increasingly important role

In addition to financial ratios, also taking into account their longer term development, governance is also important in the selection of family businesses. Governance concerns the internal rules of management, supervision and behavior that apply within a company. Good corporate governance plays an increasingly important role, not in the least as a safeguard against nepotism. "If the governance is not good, we sell the position, or rather, we don't take an interest at all," Deneke says firmly.

The shareholder structure can also cause problems. Smits paints a nightmare scenario in which 61 family members each own 0.6% of the equity. "Fashion company Hermès is such an example. You often see that such structures will be simplified over time. You then see agreements between family members that they act in concert and when selling, for example, first offer each other the shares to avoid share price pressure. In the companies we look at, usually one major shareholder holds the cards. "

At the aforementioned German family-owned business Sartorius, Horst Sartorius, the last directly involved descendant of the founder Florenz Sartorius, rigorously restricted the family in 1998, says Smits. "He determined in his will that family members are not allowed to sell their shares until 2028, so that for the time being a majority of 50% plus one share remains." As a result, management has been limited in recent years to finance the growth of the company through share issues. For this reason, a large number of (non-voting) preference shares are now outstanding.

Another pitfall of family-owned businesses in the field of corporate governance is that they do not like to allow third parties a peek behind the scenes. Smits: "In these times where ESG is very important, this is actually no longer acceptable. Certainly if you are listed on the stock exchange, shortcuts are not possible. The German financial services provider Grenke has recently experienced this. The share price went into free fall on the stock market following an aggressive short sellers report. The founder did not take the report seriously at first and then refused to disclose personal transactions he had made outside the company. "

Juno had Grenke in its portfolio for years, but the shares were sold in 2019 and early 2020. Jurgens: "Not because of this incident. We already had concerns about signals indicative of poor internal controls within the company. Added to this in 2020 was the negative impact of the pandemic on Grenke's key regions and customer groups. If you grow fast, the organization must also grow in order to keep an adequate overview of all activities." However, Jurgens does not believe that, according to critics, money has been embezzled at Grenke. "The company has clearly not responded adequately enough and investors are quick to think "where there is smoke, there must be fire." Inadequate or incomplete communication also occurs in family-owned businesses; usually as a result of their independence from outside parties. It proves once again that there are no short-cuts and as an investor you yourself have to do your homework and stay alert.

End

About Juno Investment Partners

Juno Investment Partners was established in 2007 as a fully independent fund manager and has an AIFM license (as referred to in Section 2:65 of the Wft), issued by the Dutch regulator AFM. Juno specializes in the selection of exceptional listed (family owned) companies in Europe. Companies that are able to achieve predictable and stable earnings growth year after year are considered for investment. The selection process focuses on the return on invested capital, a low debt ratio and free cash flows of a highly predictable nature. The analysts/portfolio managers compile a highly concentrated portfolio of approximately fifteen companies that they identify, analyze and visit regularly. Selected companies remain in the portfolio for a longer time period (usually more than five years). All analysts/portfolio managers have themselves invested in the Juno funds.

Juno offers three products: The Juno Selection Fund, which focuses on the selection of smaller and medium-sized listed companies, the Juno Continuation Fund for medium-sized companies and individual asset management using the same investment style, for larger clients through managed segregated accounts.

– The Juno Selection Fund was launched in 2008. This mutual fund invests in distinctive European small and medium-sized companies with an initial market capitalization of €250 million to €4 billion. In recent years, this investment style has resulted in above average investment returns for participants in the Juno Selection Fund. This fund has been hard closed for further (follow on) subscriptions since 2018.

– The same investment strategy is applied in the Juno Continuation Fund, which was launched on February 1, 2020. This fund focuses on unique, medium-sized European companies with a market value between €4 billion and €20 billion at the time of initial purchase. As is the case with the Selection Fund, the Continuation Fund also has a strong preference for investments in businesses that are family owned, or companies in which a family or management itself is also a shareholder.

www.juno-invest.com