The Wendel International Centre for Family Enterprise

The Global Private Equity Initiative

THE INSTITUTIONALIZATION OF FAMILY FIRMS

Latin America

FEBRUARY 2019

This report would have not been possible without the engagement of the 131 families who participated in our survey and the many more that we interviewed. Equally valuable was the expertise of all the private equity professionals who shared their experiences of investing in Latin America and helped frame our research questions.

We would like to thank Clayton, Dubilier & Rice (CD&R) - our long-term partner in this global research series. In particular, we are grateful to Tom Franco, Partner at CD&R, for his guidance. We also thank Russell Reynolds Associates for their generous contribution.

The team at INSEAD's Wendel International Centre for Family Enterprise (WICFE) provided invaluable access to their network and shared their expertise for this report. A special thanks to Lise Møller, Strategic Advisor of WICFE, and Morten Bennedsen, the André and Rosalie Hoffmann Chaired Professor of Family Enterprise and Academic Director of WICFE. The WICFE team wants to extend a special thank you to Gert Wunderlich, INSEAD MBA92, for his support.

Finally, a thank you to Indira Pant for editing the final document.

This report was produced by the team at INSEAD's Global Private Equity Initiative (GPEI), which included Alexandra Albers-Schoenberg, Associate Director, and Claudia Zeisberger, Senior Affiliate Professor of Entrepreneurship and Family Enterprise and the Academic Director of GPEI.

Contents

131 **Family Firms**

7 **Leading PE Firms**

This report brought a representative sample of families from Latin America together and started to address questions that will be critical for their sustainable growth in the coming decades. More work is needed for a complete picture, but without doubt, family businesses hold up a significant part of the macro-economic sky and connecting them in a global network remains the target of INSEAD and its centers.

Claudia Zeisberger
Senior Affiliate Professor of Entrepreneurship & Family Enterprise
Academic Director, Global Private Equity Initiative

Long Term Planning and professionalization related to the transition of family firms across generations is without doubt the biggest challenge of most family businesses worldwide. Our report gives local examples and global perspectives on how to avoid looming disruption and conflict in family firms. Our hope is that the report will also inspire Latin American family firms to become long lasting and sustainable family businesses.

Morten Bennedsen
The André and Rosalie Hoffmann Chaired Professor of Family Enterprise
Professor of Economics and Political Science
Academic Director, Wendel International Centre for Family Enterprise

Partnerships between private equity investors and family enterprises will continue to grow across the globe because of the favorable outcomes they have often achieved. INSEAD has established itself as an academic leader in understanding the dynamics of these rewarding partnerships by examining the broader challenges and opportunities facing family-owned businesses globally and, in this report, in Latin America. Importantly, INSEAD's valuable perspective provides a foundation for a much deeper dialogue about how families can create sustainable long-term value for their multiple constituencies.

Thomas C. Franco
Partner
Clayton, Dubilier & Rice

Overview: *How Can Family Firms Ensure Long-Term Value Creation?*

Family owned and controlled firms form the backbone of Latin American economies, accounting for 75% of all $1 billion-plus businesses in the region[1] and 60 percent of its aggregate GNP[2]. It follows that family businesses must create value and thrive for the economic well-being of their home countries. So how can family firms ensure long-term value creation?

As family businesses mature it is critical that they embark on a process of institutionalization whereby they introduce and embed formal policies and procedures that strengthen commitment to their mission and values, preserve their competitive advantage and facilitate long-term growth. In 2017, INSEAD explored this process among 123 family firms in Asia-Pacific and the Middle East. The Institutionalization of Family Firms – From Asia-Pacific to the Middle East examined the opportunities and challenges these firms faced across key attributes of institutionalization: family ownership and succession, intangible family assets, corporate governance and leadership, growth capabilities, organizational design, and access to capital. We complemented these findings with insights from a group of leading private equity (PE) firms who, as regular investors in family-owned firms in the region, had their own perspective on the development paths of these businesses.

In Phase 2 of the research series the geographical focus shifts to Latin America. INSEAD surveyed 131 family firms and interviewed select PE experts to understand the dynamics of the region. This report examines how institutionalization can help a family business secure its long-term survival and unlock growth. It includes an analysis of the survey results and individual case studies that can help family firms understand their own strengths and weaknesses and learn from their peers. It also explores partnership opportunities between family firms and PE investors and uncovers areas of best practice that support sustainable value creation.

Institutionalization is Crucial for Family Businesses to Thrive

Family firms – defined as companies where a family has significant ownership and decision-making roles – are an important driver of growth and employment, particularly in emerging markets. They benefit from concentrated, yet flexible family ownership and, in many cases, a recognizable brand. They typically draw on the family's name and heritage, their political and business connections, and the values of the founder – none of which are easily transferrable to an external owner[3]. Perhaps their greatest strength is a sharp focus on building a business that can be handed over to the next generation. As a result, family owners strive to retain control of their businesses and take a long-term view of their reputation, their relationships with key stakeholders and value creation[4].

Unfortunately, few family firms are able to capitalize on these strengths. Almost two-thirds either wind-up or are sold by the founder, and less than 15% see a third-generation family member lead the business[2]. The principle causes for this lack of continuity are:

Succession planning difficulties: Despite being the most common reason why family firms fail, succession planning is rarely addressed directly and openly by family business leadership. On the contrary, it is a topic that is often deferred or avoided altogether[5]. Differences between the priorities, values and vision of the current leadership and potential successors compound succession planning difficulties[6]. Since successors are mostly selected from a small pool of family members, there is a significant risk that the new leader lacks the necessary expertise. Unsurprisingly, firm performance almost always declines after the succession process, particularly when a firm passes from the founder to the second-generation leadership[7,8].

Talent management challenges: Family businesses frequently struggle to attract high quality talent as career growth opportunities for non-family members are perceived to be limited. In addition, compensation in family firms frequently lags market rates with the largest pay deficits occurring in first-generation businesses[9]. Where firms are able to attract high-quality talent, they lack the resources to nurture and transform it to tackle the challenges and opportunities of an ever-changing environment.

Leadership and governance deficiencies: Nowhere is the talent deficit more visible than in the leadership of family firms. A survey of 1,000 corporate directors found that non-family businesses outperformed family businesses on every measure of board effectiveness – with the largest skill deficit in the areas of talent management and technology[10]. Frequently, first-generation family firms have no boards at all; others have notional boards that "rubber stamp" the family leaders' decisions. Subsequent generations "often see their board positions as a birthright that allows them to protect their interests in the company, rather than as a responsibility—based on one's qualifications—to guide the firm and protect all shareholders" [11]. This has a profound impact on corporate governance standards in family firms, leading to suboptimal control and decision-making.

Decision-making weakness: Decision-making in first-generation businesses is often inefficient as the founder's approval is required at every stage. As subsequent generations enter the business, decision-making slows down further and becomes more contentious. Even when there are external minority shareholders, the family often retains voting - and therefore decision-making - control[12]. This can lead to decisions that are aligned with the family's interests, priorities and risk appetites but result in the inefficient allocation of resources and suboptimal firm performance[13].

Family firms can overcome these deficiencies through institutionalization. This report assesses institutionalization in family firms across both family attributes and business attributes. Family attributes measure the sophistication of engagement between the family and the business, and the family's unique strengths. Business attributes measure the strength of a family firm's operating model and its ability to sustain a competitive advantage (Exhibit 1: Research Framework: Attributes of Institutionalization).

While family firms are an enduring and valuable pillar of corporate economic activity all over the world, their continuity is often at risk. Institutionalizing their operations will enable them to leverage their strong brands, values and long-term focus to survive and thrive over generations.

The Survey

To assess the degree of institutionalization in family firms in Latin America, we asked 131 family firms to participate in a survey that investigated six key attributes of institutionalization.

The dataset reveals two distinct groups: 'Ascendants' (1st, 2nd or 3rd generation family firms) and 'Champions' (firms in the 4th generation or older). We identify specific areas where Ascendants can institutionalize their operations more effectively thereby unlocking growth.

We would like to thank members of the following organizations for their engagement:

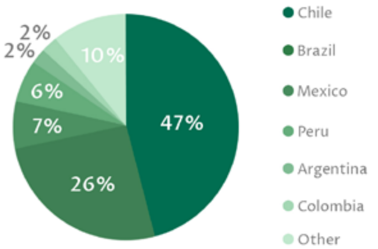
ESE Business School Chile • INSPER Sao Paolo • YPO Global Family Business Network

66%
OF ASCENDANTS HAVE A PROFESSIONAL BOARD

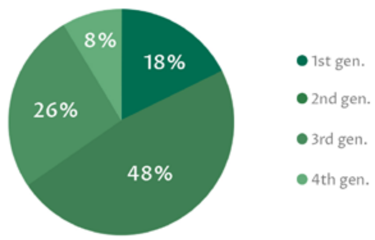
100%
OF CHAMPIONS HAVE A PROFESSIONAL BOARD

131 Family Participants

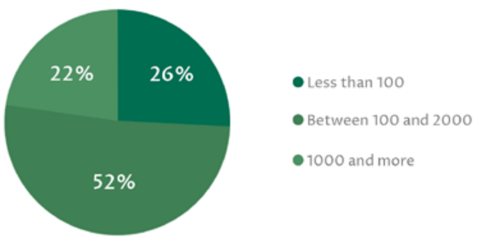
Region



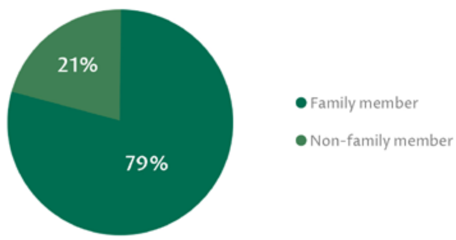
Generation



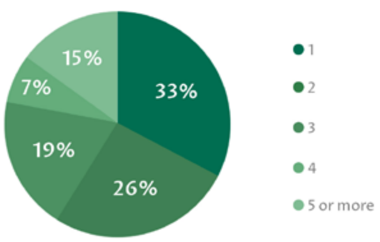
Number Of Employees



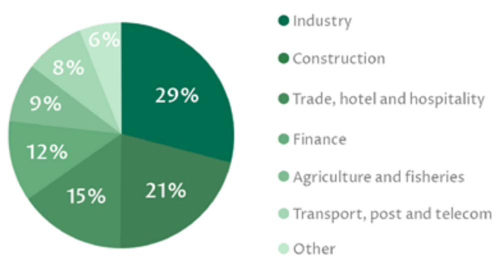
Company CEO



Number Of Industries



Industry/Sector

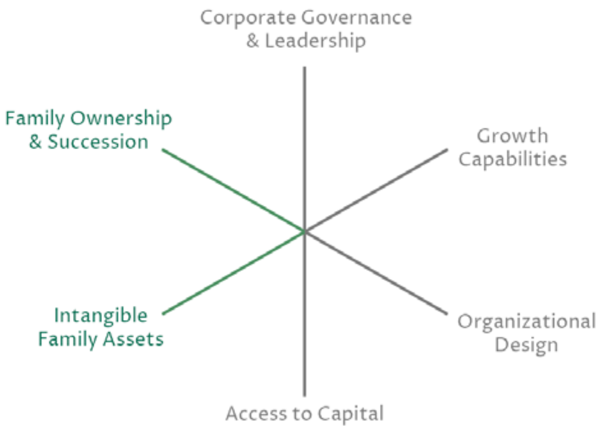


15 Countries • 1st to 7th Generation • 1 to 100,000 Employees

Survey Framework

The survey evaluates the degree of institutionalization in family firms across six attributes shown in Exhibit 1. These attributes include four standard measures of institutionalization (Business Attributes) as well as two characteristics unique to a family firm (Family Attributes). The output for each family firm participant across these six attributes, when combined and normalized, provides a total institutionalization score for that firm. This firm-level data allows us to make overarching observations for the whole dataset as well as compare and contrast individual participants with their peers.[i]

Exhibit 1: *Research Framework: The Attributes of Institutionalization*



Family Attributes ***– Measure the sophistication of engagement between the family and the business, and the family's unique strengths.***

Business Attributes ***– Measure the strength of a family firm's operating model and its ability to sustain its competitive advantage.***

1. Family Ownership & Succession: Assesses how the family engages with the firm as owners and leaders, and whether the family is aligned regarding the future of the firm.

2. Intangible Family Assets: Assesses the importance and strength of family values, connections and heritage in the day-to-day operations of the family firm.

3. Corporate Governance & Leadership: Assesses the composition and capabilities of the bodies and individuals that drive decision-making at the family firm.

4. Growth Capabilities: Assesses the family firm's ability to identify and execute organic and inorganic growth strategies in the firm's specific geopolitical context.

5. Organizational Design: Assesses the existence and effectiveness of the systems and formal policies used to govern the day-to-day operating activity of the business.

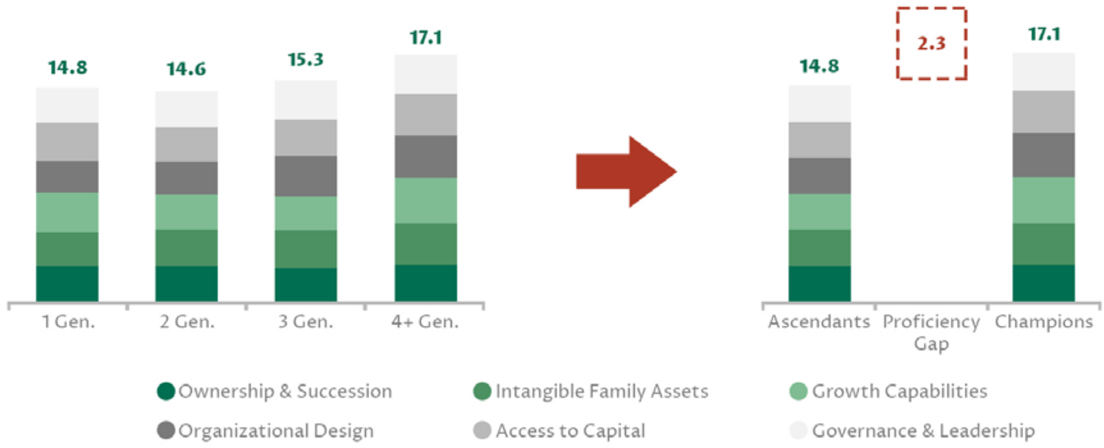
6. Access To Capital: Assesses the family firm's ability to raise debt and equity capital to fund current and future business operations.

[i] The scores for each attribute were calculated as follows: We assigned points (from 0 to 5) to every question relevant to the attribute, added the points together, standardized the total points (z-scale), and added 2.5 in order to make the standardized numbers positive. The higher the score, the higher the level of institutionalization.

Survey Findings: Bridging the Gap

Exhibit 2 presents the average institutionalization score of our Latin American survey participants by generation. The different color segments represent the contribution of each of the six attributes measured in our survey to the total institutionalization score.

Exhibit 2: *Level of Institutionalization by Generation*



Clearly visible in the graph is the significant increase in the institutionalization score for family firms in their 4th generation and beyond. Interestingly, we observed a similar jump in institutionalization scores in our first report of this research series: *The Institutionalization of Family firms – from Asia-Pacific to the Middle East*. To enable comparison between the two studies, we categorized the firms in the same way distinguishing between "Ascendants" (1st, 2nd or 3rd generation family firms) and "Champions" (4th generation or older family firms). We define the gap between the institutionalization scores of these two groups as the "proficiency gap".

Research suggests that less than 15% of family businesses survive long enough to be led by the 3rd generation[2]. Since inadequate institutionalization is a key factor contributing to the demise of a family business, it comes as no surprise that, on average, Champions achieved higher institutionalization scores than Ascendants. Our survey data also suggests that Champions not only outperformed the Ascendants in aggregate, but also on each of the six attributes that we measured.

The following section analyzes how each of our six attributes and their input factors contribute to the proficiency gap based on the share of their contribution – from highest to lowest.

Growth Capabilities

The average "Growth Capabilities" score of Ascendants deviated the most from that of Champions, accounting for 28% of the total proficiency gap (0.65/2.28).

This was primarily because Champions were less affected by the external environment, including changes in macroeconomic policies, governmental regulation and corruption in government circles.

They were also able to exploit growth opportunities more effectively because of stronger in-house business development resources as well as the presence of specialized M&A teams.

Not surprisingly therefore, they registered higher inorganic growth - 55% of Champions had executed M&A transactions, while the comparable figure for Ascendants was only 25%.

Champions also had slightly more robust organic growth activity, primarily because they had higher levels of innovation at the business unit level and more scalable business models.

Organizational Design

At 24% (0.54/2.28) of the total score differential, the deviation in "Organizational Design" scores formed the second largest component of the proficiency gap.

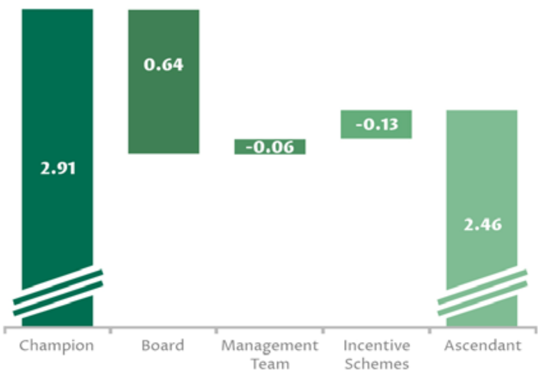
This was because Champions had more developed HR policies related to hiring, incentivizing, training, evaluating and terminating employees.

Spending policies contributed almost as much as HR policies to the proficiency gap. With pre-approved spending authority that was better dispersed, Champions were more efficient and effective in decision-making than Ascendants.

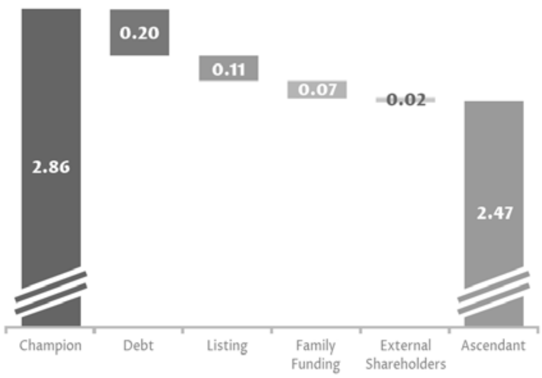
Champions also followed more formal resource allocation and reporting processes than Ascendants. In particular, more Champions had a formal budgeting and reporting process, responsibility and accountability charts, as well as balanced scorecards.

Information systems were generally more robust in Champions than Ascendants. Fewer Ascendants had a supply chain and vendor management system or a human resource management system. Also, virtually every Champion but only 66% of Ascendants had a financial resource management system.

Corporate Governance & Leadership



Access To Capital



Differences in the "Corporate Governance & Leadership" scores accounted for 20% of the proficiency gap (0.45/2.28). In this category, however, Ascendants outperformed Champions in two out of three sub-categories.

The main reason for the overall score differential was that every Champion we surveyed had a board compared to only 66% of the Ascendants. Among firms that had a board, both groups had comparable scores for the proportion of independent directors on the board and the existence of appropriate sub-committees.

Even though, fewer Champions were led by a CEO who was a family member, Ascendants had higher diversity scores for their management teams.

Ascendants also scored higher in terms of their incentive schemes. More Ascendants (36%) had an employee stock ownership plan (ESOP) for non-family managers than Champions (27%).

The Champions' ability to access capital accounted for the fourth largest gap in the level of institutionalization: 17% of the proficiency gap (0.40/2.28).

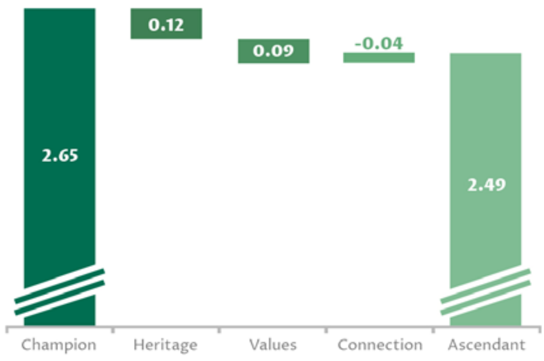
This differential was largely because Champions had larger debt capacity than Ascendants. They had greater access to debt-financing instruments, such as unsecured bank loans, mezzanine loans or corporate bonds. Despite this, Champions had lower levels of debt on their balance sheets in percentage terms than Ascendants.

The number of Champions with public market listings slightly exceeded that of Ascendants.

Champions also benefited from marginally superior access to additional funding from the family.

However, Champions and Ascendants were almost equally as likely to have raised equity capital from external investors, including private equity funds, strategic investors and high net worth individuals.

Intangible Family Assets



Family Ownership & Succession

The Champions' outperformance in the intangible family assets category accounted for 7% of the total institutionalization score differential (0.16/2.28).

Champions had greater "Heritage" - a special skill, recipe or business strategy that had been kept within the family and sustained the business. Champions were also more active in leveraging the family name and brand in their products and services. Being firms that were 4th generation and older, Champions had a richer history than most Ascendants, which was as a crucial element of their business strategy.

Surprisingly, there was only a marginal difference between Champions and Ascendants on the degree of shared mutual core "Values" and family values shared with the current CEO.

Champions also scored slightly lower on the "Connection" sub-factor - their scores did not exceed that of Ascendants with regards to relationships with central and local government officials, as well as with other business families. However, Champions had stronger relationships with their customers and suppliers.

The attribute "Family Ownership & Succession" accounted for the remaining 4% of the proficiency gap (0.08/2.28).

Given that Champions had weathered at least 3 generational transitions, it was surprising that they did not have significantly higher succession planning scores. According to the survey, Champions had slightly fewer disagreements regarding succession planning and were only marginally more likely to have started discussing a succession plan.

Another small differentiating factor was the utilization of an indirect shareholding model; for example, ownership via a trust, foundation or family holding company – 64% of Champions employed these vs. 48% of Ascendants.

Both Champions and Ascendants were almost equally as likely to have formal conflict-resolution mechanisms. They were also just as successful in dealing with operational issues such as employing family members or tackling disagreements relating to business strategy, day-to-day operations, organizational structure or task division between family and non-family members.

Our analysis of the proficiency gap between Champions and Ascendants in Latin America indicates that Champions outperformed Ascendants in terms of all business attributes, particularly those relating to inorganic growth capabilities, formal systems and processes, corporate governance and access to capital. However, Champions fared only marginally better than Ascendants with respect to the family attributes of "Intangible Family Assets" and "Family Ownership & Succession".

70%

OF ASCENDANTS HAVE A FORMAL BUDGETING PROCESS

82%

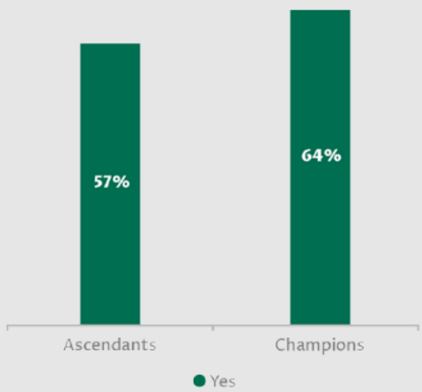
OF CHAMPIONS HAVE A FORMAL BUDGETING PROCESS

Box: Importance of ESG factors for Champions vs. Ascendants

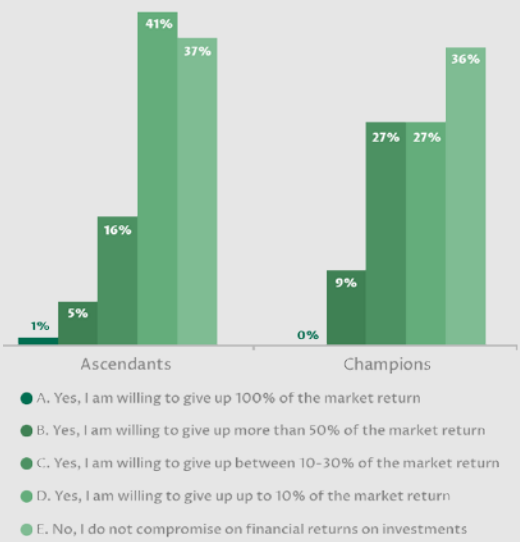
In recent years, Environmental, Social and Governance (ESG) factors have begun to play an increasingly important role in evaluating the long-term success of a company. Hence, we included three questions to assess the significance of these factors to the family firms we surveyed.

Overall, awareness of ESG factors was greater among Champions than Ascendants. Champions were more likely to take into account non-financial factors when making operational and investment decisions (64% for Champions vs. 57% for Ascendants). They were also more willing to give up higher market rates of return for investments that created deep impact – 9% of Champions vs. 5% of Ascendants were willing to cede more than 50% of market return; 27% of Champions vs. 16% of Ascendants were willing to cede between 10-30% of market return. Finally, only 16% of Ascendants vs. 40% of Champions reported significant increases in their activities as ESG investors over the previous three years. In fact, almost half the Ascendants vs. 20% of Champions reported no increase in ESG investments at all over the same three-year period.

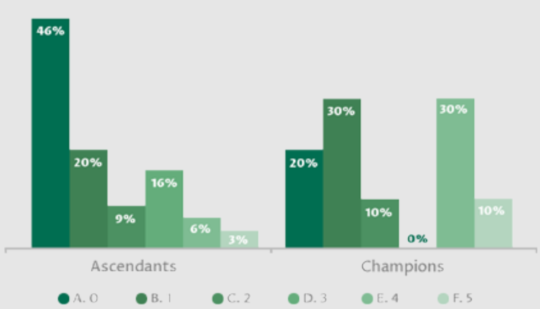
Do non-financial factors such as Environmental, Social and Governance (ESG) criteria play a role in your operational or investment decisions?



Are you/ would you be willing to trade market rates of return for investments that can create deep impact either socially or environmentally?



Has your activity as an ESG investor increased over the last three years? (0 = not at all; 5 = very much)



Comparing Latin America with Asia-Pacific & the Middle East

In November 2017 we published the first study in this research series that focused on family firms in Asia-Pacific and the Middle East[14]. In this section we compare the output of that study with our dataset from Latin America. It is important to note that the comparison is constrained because of the limited number of data points from companies in the 4th + generations (11 in Latin America and 11 in Asia-Pacific & the Middle East).

To get a snapshot of the data from the two studies, Exhibit 3 shows the output of all the survey participants in Latin America and Exhibit 4 covers participants in Asia-Pacific and the Middle East.

Exhibit 3: *Level of Institutionalization by Generation – Latin America*

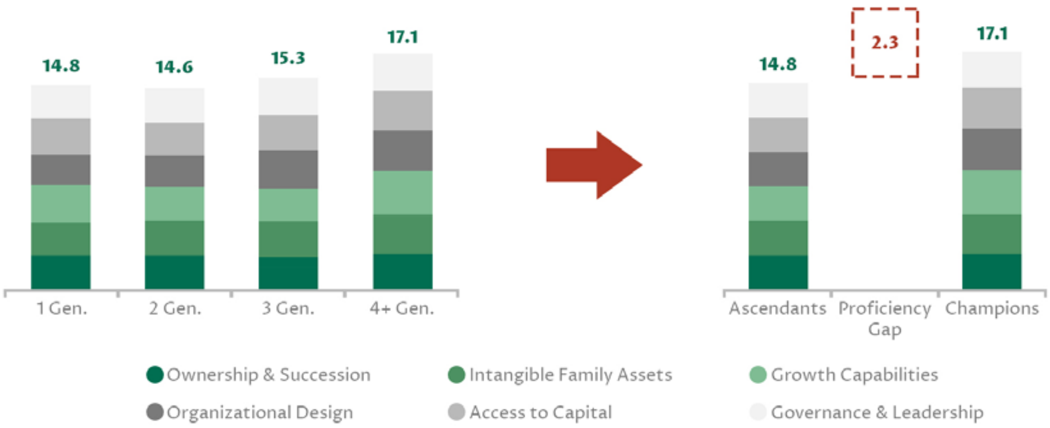
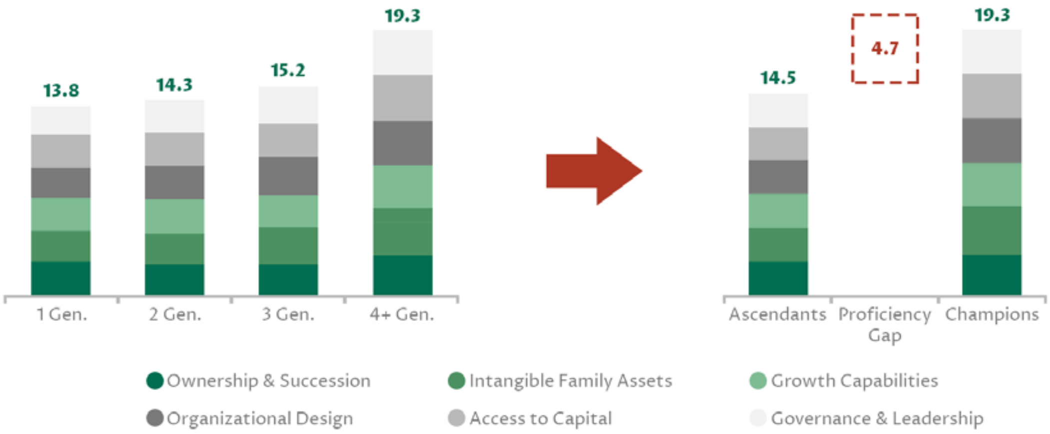


Exhibit 4: *Level of Institutionalization by Generation – Asia-Pacific & the Middle East*

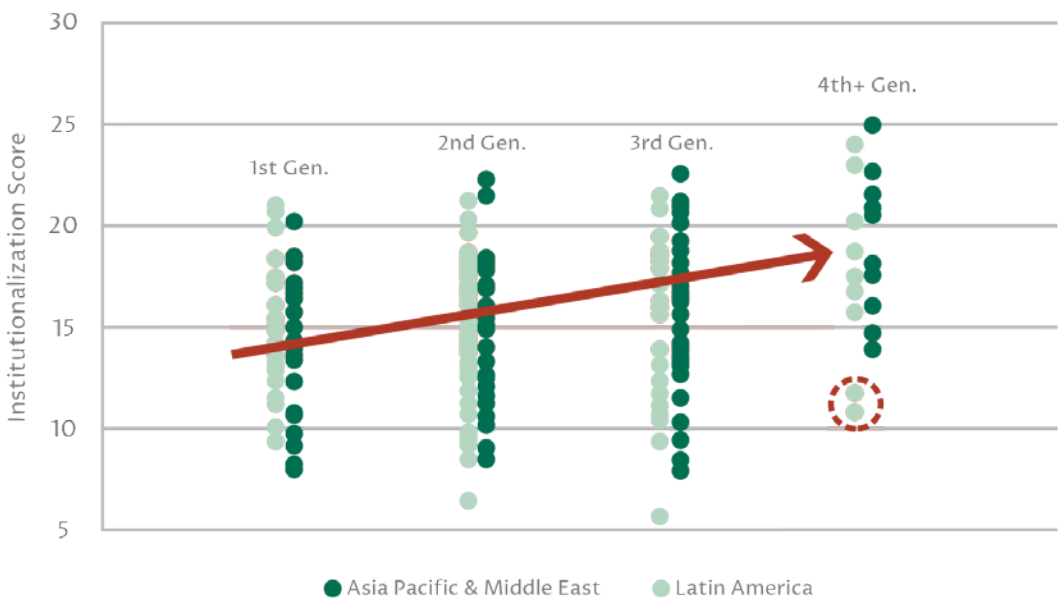


Comparing Latin America with Asia-Pacific & the Middle East

At first glance, it seems that Ascendants have slightly better scores in Latin America than in Asia-Pacific & the Middle East, while Latin American Champions have significantly lower scores than their Asia-Pacific & Middle East counterparts. Consequently, the proficiency gap between Ascendants and Champions is lower in Latin America than in Asia-Pacific & the Middle East. However, a deeper analysis of the data reveals additional insights.

Exhibit 5 shows the institutionalization scores for every respondent in each of the four generational groups for both datasets. As our analysis suggests, we see a clear upward trend of scores by generation in both regions. Also, the highest score in Latin America as well as the highest score in Asia-Pacific & the Middle East come from companies in the 4th + generations (Champions). The granular data also shows that the average score of Champions in Latin America is pulled down by a few outliers with significantly lower scores. Excluding them from the analysis brings the proficiency gap in Latin America closer to that of Asia-Pacific & the Middle East.

Exhibit 5: *Level of Institutionalization by Generation – Asia-Pacific & the Middle East*



The Latin American dataset showed the same distinction that we found in Asia-Pacific and Middle East between family firms that are "Champions" and those that are "Ascendants". While there are differences in the actual numbers, the data from both studies tell the same story: There is a clear institutionalization gap between Champions and Ascendants as seen by the marked difference in their overall institutionalization scores.

While Ascendants can proactively pursue institutionalization, they often need help. The next section in this report explores how private equity investors can help bridge the proficiency gap by providing capital and expertise.

The PE Perspective

To complement our findings with an expert practitioners view on the level of institutionalization of family firms in Latin America, we asked 7 private equity firms – all experienced investors in family businesses in the region – to share their experience.

After a brief overview of the benefits and drawbacks of partnering with a PE firm, we examine how these firms invest in a family business and how they unlock value.

We wish to thank partners from the following firms for their input:

Actis • Advent International • Capital Global • HIG Capital • Patria Investimentos
Performa Investimentos • Warburg Pincus

Can The Partnership Work?

There is a fundamental difference in the way family firms and PE investors operate. Family businesses strive to create long-term value over generations. In contrast, PE firms, whose funds have a finite life, seek to transform investee companies over a relatively short period of time in order to produce competitive returns for their investors (Appendix: Private Equity Investment Model). Nonetheless, their interests occasionally converge, particularly when family firms are in the process of institutionalization. A clear understanding of the dynamics of the family business-PE firm partnership can help manage the expectations of both parties.

Benefits

PE firms can provide tailored solutions to meet the specific needs of family businesses; their approach differs depending on whether they acquire a majority or minority stake in the family firm.

Managing succession is the most common reason cited in academic literature for a majority purchase.[15, 16]. Selling a majority stake to a PE firm allows a family to realize value, while remaining active within the business post-buyout. It also preserves, to some extent, the firm's identity and culture. A trade sale to a strategic investor, on the other hand, typically ends the family's involvement[17].

The literature also identifies the most common reasons for selling a minority stake as raising capital for growth or financing an acquisition[18, 19]. Other motivations include assisting in succession planning and providing an exit to one or more family shareholders.

Academic studies indicate that bringing in a PE shareholder, whether as a majority or minority investor, transforms family businesses. This transformation is usually achieved by improving corporate governance, professionalizing management teams, formalizing internal control systems and establishing incentive schemes for non-family managers[20,21,22.]

Drawbacks

Despite the significant benefits of a PE partnership, family firms must be aware of the downside of raising capital from PE firms. Drawbacks most commonly cited in academic literature include the loss of managerial freedom, pressure to meet performance targets set by a third party, and dilution or loss of equity control[18, 19]. Additionally, PE investors conduct in-depth due diligence when assessing a target, which entails disclosing sensitive information often available only to family members[16]. Most family firms lack centralized data systems, which places additional pressure on the due diligence process making it even more disruptive.

Once a PE investment has been made, family firm owners ought to anticipate tension resulting from the relatively short investment horizon of their PE partner. PE firms have a contractual duty to return capital to their investors within a pre-specified time period, while most families have time-horizons that stretch over generations. In addition, bringing in a PE investor can disrupt the firm's culture and replace informal networks and operating practices with stricter reporting structures and performance-oriented goals[20].

25%

OF ASCENDANTS HAVE EXECUTED M&A TRANSACTIONS

55%

OF CHAMPIONS HAVE EXECUTED M&A TRANSACTIONS

Buyout Deals

Private Equity-Backed Buyout Deals in Latin America

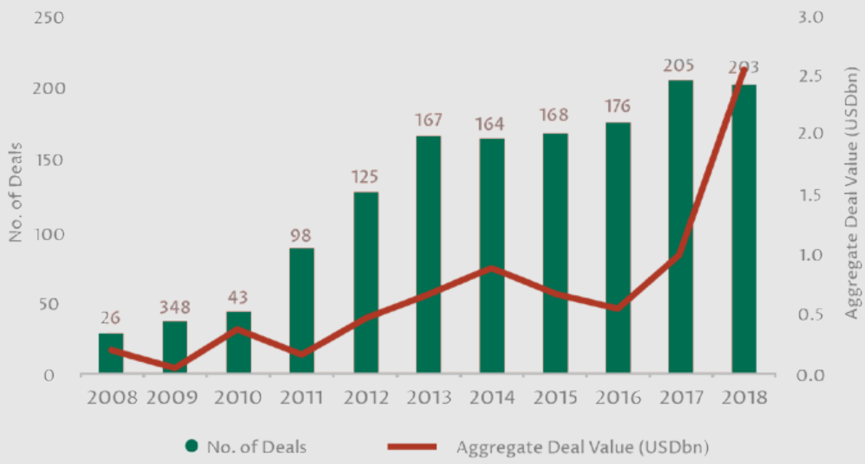
Largest deals - last 5 years

Firm	Investment Type	Deal Date	Deal Size (USD mn)	Investors	Location	Primary Industry
Saavi Energia	Buyout	12/22/17	1256	Actis	Mexico	Power
BRK Ambiental Participações S.A.	Buyout	08/18/16	908	Brookfield Asset Management	Brazil	Utilities
Notre Dame Intermédica Saúde S.A.	Buyout	03/22/14	850.88	Bain Capital	Brazil	Insurance
Fermaca	Buyout	02/20/14	750	Partners Group	Mexico	Oil & Gas
St. George's University	Growth Capital	08/08/14	750	Altas Partners, Baring Private Equity Asia	Grenada	Education / Training

Source: Preqin

Venture Capital Deals*

Venture Capital Deals* in Latin America



Largest deals - last 5 years

Portfolio Company Name	Deal Date	DealSize (USD mn)	Investors	Location	Primary Industry
iFood.com Agência de Restaurantes Online S.A.	11/13/18	400	Innova Capital, Naspers Ventures	Brazil	Internet
99Taxis	1/3/18	300	Didi Chuxing	Brazil	Telecoms
HydroChile Pty Limited	2/5/10	200	Eton Park Capital Management	Chile	Power
Rappi SAS	9/1/18	200	Andreessen Horowitz, DST Global, Sequoia Capital	Colombia	Internet
Netshoes (Cayman) Ltd.	5/6/14	170	GIC, Iconiq Capital, Kaszek Ventures, Temasek Holdings, Tiger Global Management	Brazil	Internet
Nu Pagamentos S.A.	3/1/18	150	Dragoneer Investment Group, DST Global, Founders Fund, QED Investors, Redpoint Ventures, Ribbit Capital, Thrive Capital Partners	Brazil	Internet

*Figures exclude add-ons, grants, mergers, secondary stock purchase and venture debt.

Source: Preqin

Insights of PE Professionals into Investing in Family Firms

Economic and political factors, which are particularly varied across Latin America, significantly influence the PE investment process. In order to understand this complex landscape, we spoke to leading PE professionals experienced at investing in Latin American family firms. The following section describes the challenges they face and the means by which they unlock value at all three stages of the investment process: 1. Pre-investment, 2. Post-investment and 3. Exit.

Pre-investment

The pre-investment stage can be protracted and complex – effective negotiation, alignment and mutual trust is critical for a successful partnership between a family business and a PE firm. The following factors influence the nature and outcomes of this first stage in the investment process:

Reasons for family firms to partner with a PE firm: According to one of our interviewees, over half of all PE investments in Latin America are in family businesses. The reasons for family firms to pursue a transaction with a PE partner vary according to the situation. Some of the most common reasons identified by our interviewees are:

- **Tackling succession problems:** In many instances, family business owners have no heir or have potential heirs who lack the interest or ability to lead the business. In such situations, PE firms can either assist or completely manage the generational transition.

- **Controlling shareholder base:** Over time, the shareholder base of a family business can grow unmanageably large. PE firms can provide liquidity to buy out one or more of the shareholders.

- **Unlocking growth:** Family firms that lack the financial resources or expertise to expand their business frequently pursue growth equity transactions with PE firms. A PE partner can provide capital, technical expertise and management skills that enable the family business to exploit opportunities for hyper growth.

- **Providing financing:** Another reason for PE involvement is the difficulty in accessing capital markets or other sources of financing in many Latin American countries. Family businesses find it hard to obtain debt capital at reasonable rates. For example, one interviewee told us that in Brazil, mid-market firms can be charged an interest rate of ca. 15% p.a. in a good year, with the long-term average rate closer to 25% p.a. The financing challenge is compounded by banks often asking for excessive collateral.

- **Other reasons:** Better governance, talent acquisition, M&A experience and initial public offering (IPO) preparation.

Deal sourcing: According to several interviewees, family businesses instinctively adopt a long-term perspective and therefore present good investment opportunities. PE firms typically seek companies that have a strong founder, promising business models, innovative products or services and a good reputation or brand, but lack efficient processes, a highly skilled team or a clear business strategy.

Deals sourcing is either passive - PE firms are approached by M&A boutique firms or investment banks with a mandate to sell a company; or active (proprietary) - PE firms identify target companies directly.

A strong reputation is valuable asset for a PE firm, particularly when trying to win deals with family businesses. Interviewees mentioned being approached by family firms that had heard that they were good partners from other family businesses. Preserving a good reputation is so crucial for PE firms, it incentivizes them against aggressive short-term practices.

Active deal sourcing can be a slow and painstaking process. One interviewee described how they spent 10-years getting to know a family prior to the deal. While this was an extreme case, he believed that the best deals require PE firms to spend a minimum of 7 months in this preliminary stage of the investment process. During this phase, PE firms frequently have to educate the family business about the role and value of private equity, which requires both skill and patience. Most families do not have an advisor and, as is the culture in Latin America, prefer to deal directly with the PE firm via face-to-face meetings.

It is extremely difficult to gather reliable and comprehensive financial data on private firms which poses a huge challenge for deal sourcing. PE firms struggle to assess the true value of SMEs, significantly slowing down the due diligence process.

Alignment and mutual trust: Several interviewees underlined the importance of building trust with their family firm partner. In fact, PE deals almost always failed due to misaligned partners and not because of a flawed investment thesis. This is because in Latin America, there is a culture of doing business with people who share your beliefs and values. As one interviewee said: "I do business with people I invite to my house to have dinner with my wife…It is very important that they feel that you are family. We must have empathy."

PE firms typically have defined investment goals that they hope to achieve in a limited timeframe. For a partnership to succeed, the family firm has to endorse its PE partner's goals. For example, if the family wishes to maximize dividends whereas the PE firm prefers to reinvest surpluses in the business, the partnership will be fraught with conflict and likely fail.

Another challenge, unique to family businesses, is the absence of a clear boundary between family affairs and company affairs. These occasionally conflicting interests make it difficult for PE firms to implement certain decisions such as replacing a family member post-investment. These decisions become even more challenging when multiple family members own stock or are involved in running the business.

Every interviewee emphasized how critical it is for PE firms to negotiate these potentially sensitive decisions and achieve overall alignment at the pre-investment stage itself. A vital first step is understanding the family's history, internal relationships between key family members and, most importantly, any prior or festering conflicts. This requires a measure of openness and trust which is not always present. In fact, it is not unusual for PE firms to face skepticism and resistance in the early days. To convince family firms of their value, PE firms frequently connect the family with other firms they have successfully partnered with in the past.

While a strong, trust-based relationship is important, PE firms have to guard against drawing too close to the family. Maintaining a close but professional relationship with the family is critical, especially when difficult decisions have to be made. PE firms that successfully negotiated this delicate balancing act enjoyed fruitful and enduring partnerships. One interviewee took pride in his relationships with family firm partners, some of whom helped source deals and even invested in his firm's fund after their partnership ended. In growth equity situations where there is a strong relationship between partners, the family firm founder or manager often stays on with the company in a management or board function for a period of time and becomes a de facto partner of the PE firm.

Identified risks: While PE activity in Latin America carries the promise of rich rewards, there are attendant risks. According to the firms we spoke to, PE funds are typically denominated in US dollars making currency risk their prime concern. Over the decade, political and economic instability has severely eroded the currencies of several Latin American countries. The long horizon of PE deals makes it prohibitively expensive to hedge this currency risk. One interviewee said that "the best hedge is high growth". Other firms invest in businesses which generate revenue that is either US-dollar denominated or can be "dollarized". They also diversify their deal portfolio to avoid being over-exposed to any one currency.

Reputation risks are also significant when doing deals in the region. Several interviewees emphasized that they are careful to avoid regions or sectors where corruption is rampant. As one interviewee mentioned: "It takes 20 years to build your reputation and one day to destroy it."

Post-investment

The volatile economic environment in Latin America makes leverage expensive and risky. Therefore, most PE firms avoid leveraged buyouts that are popular in developed economies. Instead they focus on extracting value from the family firm's operations by taking a few important steps:

Following a structured post-investment process: The post-investment process followed by PE firms is well-defined with dedicated teams of specialists at every stage. One PE firm described a complex 10-stage process that they followed, starting from the investment thesis in Stage 1 to the exit in Stage 10. Following the takeover phase in stage 7 when the family firm is "bought", the PE firm spends the next 100-180 days laying the groundwork for the growth push to follow. This includes implementing a new governance structure, organizational redesign, developing new processes, setting KPIs and taking control of the finance function. The planned restructuring is executed over the following 3 to 4 years and involves building a new team, hiring C-level management to complement the capabilities of the company, overhauling critical processes and launching growth projects. Thereafter, capital is injected for one last growth surge after which the company is prepared for sale.

All PE firms have a range of value creation mechanisms that they can draw upon at the post-investment stage. Depending on the investment situation they select a few that they believe will have the greatest impact and implement them over a 4 to 7-year holding period. While there are differences in the tools used and the processes adopted, all the PE firms we interviewed pay special attention to the finance function. Their priorities include maintaining proper accounting records, professionalizing reporting and making sure there is a strong CFO at the helm.

Replacing gut-feeling with data-driven decision making: A PE firm instills discipline in the family businesses they invest in – arguably one of the greatest benefits arising out of the partnership. They design and implement systems and processes that require portfolio companies to follow an organized, data-driven approach. An interviewee described how one family business pursued growth by opening new stores based almost exclusively on its leader's gut-feeling. Following the PE investment, however, the company undertook a rigorous assessment of potential new stores that included 5-year IRR estimates and a projected payback schedule.

Appointing an effective board of directors: According to the PE firms interviewed, most family businesses in Latin America do not have a board of directors. Boards that exist are largely dysfunctional or comprise of friends of the main shareholder and are not always capable of providing effective corporate governance. Boards with qualified directors have to be hands-on and meet regularly in order to obtain information to fulfil their governance role. Installing an effective board is often one of the first steps taken by a PE firm, even in deals where they have a minority investment. Many of the PE firms we spoke to appoint a board on the first day post-investment and set up governance standards on par with those of publicly listed companies.

The composition of the board varies depending on the PE partner; some PE firms appoint independent board members, usually individuals with relevant industry experience, at the beginning of the organization's restructuring process. Others appoint independent board members in the final stages or not at all. To further improve governance, PE firms often create board sub-committees, particularly in areas such as risk management, expansion, finance, HR, audit or IT.

Building a skilled management team: While establishing an effective board is a priority for all the PE firms we spoke to, perhaps the most critical component of the post-investment process is strengthening the company's leadership team. Most PE firms we interviewed focus on the top two tiers of the organization, identifying personnel changes, defining roles and even interviewing candidates.

One of the most challenging steps of this senior management team building process relates to retaining or replacing family members. Decisions on this highly charged issue are influenced by several factors including the type of investment (buyout or growth equity), the goals of the PE firm, likely expectations of future buyers and the family members themselves – their personalities, skills, motivation levels and aspirations. However, all interviewees agreed that the deciding factor was business performance. If the company is doing well, PE firms rarely replace family members. In such transactions, the family remains at the helm and the PE firm focuses on more specialized tasks such as M&A or developing internal systems and processes. If, however, the company is performing poorly, there is pressure to professionalize the business quickly. This usually means replacing family members – a delicate task requiring sensitivity and tact.

When family members remain involved with the company, their role often evolves over time. Frequently the founder transitions from the CEO role to become the Executive Chairman or a board member. PE firms clearly delineate the twin roles played by family members – as a shareholder and as an executive. They have to be sensitive, yet transparent when emphasizing that family members in an executive role will be treated and evaluated as any other professional. As a result, family members that remain with the firm are subject to close scrutiny to ensure they play their roles competently. This is necessary to dispel any perception that they have been retained merely because of their family connection.

In growth equity situations, PE firms induct new talent to plug gaps in the skillset of the family business. Some firms retain the business's founder or manager but let go of other family members. Our interviewees explained that having a motivated and capable family member lead the firm is a real advantage, as talent is scarce in emerging markets. Family firms struggle to attract and retain qualified professionals who are reluctant to join because career growth options are seen as limited. While partnering with a PE firm makes family firms more attractive to such professionals, retaining them is an expensive proposition for small-to-medium sized firms. Less committed to the company than family members, these professionals are often lured away by the prospect of a higher salary within a year of joining the firm.

In buyout situations, the management is invariably fully professionalized. While some family members voluntarily exit the firm post-buyout, others are either replaced or stay for a short transition period. In some circumstances, family members who are considered key to the business are asked to remain longer.

Exit

While PE firms invest resources to transform their family businesses partners, their goal is to have a successful exit within 5 to 7 years. It is therefore imperative for PE firms to ensure that the family business partner understands that an exit is inevitable and is committed to it. In fact, the exit route is often determined before entering into the deal. In a buyout situation, the exit decision is taken by the PE firm and endorsed by the founder who is consulted about the timing of the exit. Apart from timing, the principle exit-related decisions that have to be made relate to the following:

Exit routes: The two main exit routes are either selling the company to a strategic investor or an IPO. When an IPO is the preferred choice, families partner with a PE firm to prepare their company for the public market. Occasionally a PE firms sells its stake in an IPO, while the family retains theirs. The IPO route is risky in Latin America because most public markets in the region are highly volatile, illiquid and, most importantly, not always open – between 2014 and 2016 there was just one IPO a year in Sao Paolo, each raising on average only about $200m[23]. Consequently, PE firms prefer selling the whole company to a strategic investor or a multinational seeking access to the region. Such exits also frequently command higher valuations.

Drag-along and tag-along rights: PE investment deals in Latin America invariably carry tag-along rights for the founder or family. Most deals also include drag-along rights for the PE firm. In fact, interviewees mentioned that they would not enter into a deal without them. In some instances, there is a minimum price that has to be met for the PE firm to be able to "drag-along" the family. Such a "floor" is often extremely difficult to negotiate with the family.

Even though drag-along rights are legally enforceable, in practice it is very difficult to sell a company when the family is not on board. Also, enforcing the drag-along right could take between 1 and 1.5 years in courts or arbitration, making it impractical. Occasionally the family demands a high floor which can make the drag ineffective. While these rights are challenging to enforce, negotiating them serves the purpose of driving key decisions and managing the family's expectations.

Institutionalization is core to the private equity investment model. By understanding the benefits and drawbacks of partnering with a PE investor and learning about the investment process, family businesses can make the partnership both smooth and successful.

[ii] If a majority shareholder sells its stake, a tag-along right gives the minority shareholder the right to join the transaction and sell its stake too.

[iii] A drag-along right enables a majority shareholder to force a minority shareholder to join in the sale of a company. The majority owner doing the dragging must give the minority shareholder the same price and terms and conditions as any other seller.

19%

OF ASCENDANTS HAVE
A NON FAMILY CEO

27%

OF CHAMPIONS HAVE
A NON FAMILY CEO

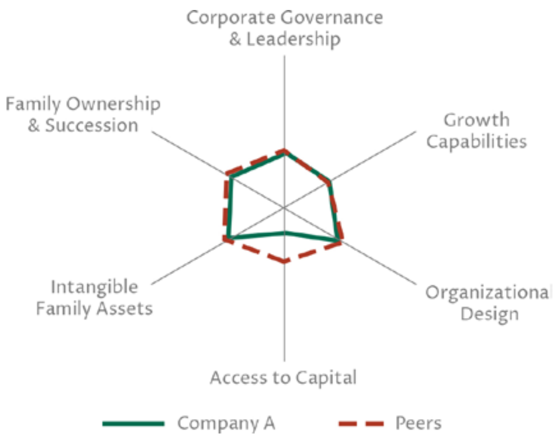
Case Studies

We gave our participating family businesses an opportunity to share their stories and comment on the institutionalization process within their firms. Featuring 2nd, 3rd and 5th generation firms, these case studies share lessons learned from a diverse set of families.

Each case study links back to our survey by comparing the family firm's score to its peer group; two describe partnerships between a family firm and private equity investors.

Ensuring Continuity Over the Generations

This case shares the perspective of a fifth-generation family member who holds a management position in his family firm. Effective corporate governance, professionalized organizational design and strong intangible family assets have helped ensure the continuity of the business over a several decades.



Employing about 100 people, our family firm, which is based in Brazil, is active in the real estate and forestry industries. My grandfather, who currently runs the business, started to work for the company at an early age but took a break to complete his studies. Upon graduation, he branched out and successfully started his own business. Meanwhile, partnership issues emerged in the original family business which belonged to his father and three uncles. My grandfather, an only child, managed to buy out his uncles and merge his newly established business with the original family business. He steered the firm through several political and economic challenges transforming it into the company it is.

Corporate Governance & Leadership

A few years ago, my grandfather appointed my uncle as CEO to assume leadership of the business. Sadly, my uncle passed away a few years later. This tragic and unexpected event changed the family dynamic, compelling my grandfather to lead the business once again. It was at this point that he brought me in to work for the company. Currently four members of the family are active in the business - two belong to the fourth generation and I am one of two from the fifth generation. Our family business has successfully survived several generations primarily because of the exceptional leadership provided by my grandfather and my uncle. Consequently, our employees and all the other stakeholders have become accustomed to working with one strong leader. However, there are currently four family members who are company directors. We have therefore hired coaches to advise us on family and business matters as well as to implement a new leadership model. Additionally, our board, which has six directors (four family members and 2 other shareholders), meets every month to provide an update and present our results.

Organizational Design

About 10-15 years ago, we were fortunate when a friend of the family with rich experience in running companies joined us as an independent board member. With his expertise and support in organizational design matters we were able to set up formal systems and processes in critical areas including budgeting, review and human resources.

Intangible Family Assets

Our family firm has a very strong culture and shared values, supported by our religious beliefs. The business has a social component, which is very important to us. Our deep commitment to this social purpose acts as a unifying factor – it is one of the main drivers of continuity for the family business.

Benefiting from a Strong Reputation

This case shares the perspective of a third-generation family member who has recently become CEO of his family firm. Effective corporate governance, funding from a PE partner and a strong reputation in the market have helped the company prosper over its 60-year history.

We are a third-generation family business based in Brazil, operating in the construction industry since the 1960s. About 10 years after my grandfather founded the firm, his eldest son - my father - joined the firm. He worked alongside my grandfather and took over the reins in the late 1980s. I joined the company in my final year at engineering school and, barring a short break to do an MBA, have worked there ever since. I recently succeeded my father as CEO of the company, and he became our Chairman. By diversifying our business and acquiring a range of assets, we are now a full-service civil construction and infrastructure company. Currently, a PE investor holds a minority stake in our business.

Corporate Governance & Leadership

Studying overseas gave me and other family members an appreciation of global corporate governance standards. As a result, over 10 years ago we took the first important steps to improve our firm's governance - adding SAP software and appointing one of the big four as our auditors. Our governance practices strengthened further when we undertook to meet the exacting standards of our new PE investor. We currently have an effective board that includes two members from the PE firm. Succeeding my father as CEO together with a well-defined organizational chart has provided clarity about the firm's leadership. A proposed stock option plan will further strengthen our firm's corporate governance and leadership - a vital advantage in the construction sector and the current challenging market environment.

Access to Capital

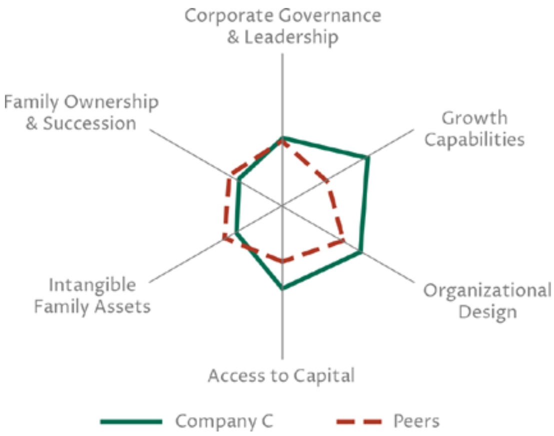
A few years ago, a PE investor acquired a minority stake in our business, injecting both capital and expertise. Other strategic investors were also interested but they wanted a majority stake, so we decided against inducting them. Prior to having an external investor, we reorganized our stockholding structure, creating a family holding and an operational holding, and formulated a shareholder agreement for family members. These initiatives not only created a more professionalized structure for family shareholders but also smoothed the way for a PE firm to invest in our business.

Intangible Family Assets

After 60 years our family business has developed a rich history and a strong culture. We have many loyal employees, some of whom have been with the company for over 25 years. Our firm enjoys an excellent reputation with its clients, suppliers and peers. We are also deeply committed to anti-corruption - we have an ethics code with a strict compliance program. In our industry, companies that successfully complete projects receive certification which becomes a key component of the company's "curriculum vitae" when applying for new projects. The many certifications we have collected are among our most valuable assets.

Achieving a 100-fold Sales Increase

This case shares the perspective of a second-generation family member who is currently the CEO of the company. Effective sales channels, a professionalized organizational design as well as funding and expertise from a PE partner have enabled the company to achieve extraordinary growth.



We are a Brazilian second generation family firm engaged in the consumer electronics sector. My father founded the company around 40 years ago, providing maintenance services for home appliances. At a very early age my brother and I helped my father in the company. Thereafter, I left the company to study, then worked abroad for a few years before returning to the family business. After several years of significant growth, a PE investor recently bought a minority stake in our business. Today, my father is the Chairman of the company, my brother is a Director and I am the CEO.

Growth Capabilities

Our company has grown rapidly over the last 8 years - sales increased more than 100-fold and the number of employees surged from less than 40 to more than 300. This high-growth phase started in 2010 when, despite being a small firm, my father and I decided we would think like a big company. We introduced stronger corporate governance measures and incorporated new leadership development practices. We also made it a point to continually invest in optimizing our business and developing new technologies. One of our most successful initiatives, spearheaded by my father, was to sell online. In the very first year, turnover from our new e-commerce website exceeded that of every other sales channel. Today, we are one of the top 20 e-commerce sites in Brazil. Over the years, new distribution channels and collaborations with partners outside our ecosystem have enabled us to provide a broader range of products and associated services.

Access to Capital

Even though we were not seeking new partners, our firm's high growth attracted several overseas investors. As demand for our products and services soared, I decided to explore the possibility of bringing in an investor. We started an organized M&A process to identify a PE firm that fitted our needs - we were looking for a minority investor who had growth capabilities, access to capital and could help us strengthen our governance process. We received many PE proposals and finally chose a partner with whom we felt the strongest connection. Even though this PE firm did not have the best company valuation, we know we made the right decision because we enjoy an excellent relationship that is based on mutual respect.

Organizational Design

Throughout our growth journey we prioritized professionalizing our organizational design and it is one of our core strengths today. We monitor KPIs on a regular basis and have formalized most processes and procedures. We emphasize complete transparency, so every employee knows our sales and profit numbers. We also have stock options for some of the more senior employees. All our employees recognize that profit is important for every stakeholder of the business, even their own rewards depend on our results. This ensures that we all work towards the same goal – achieving profit.

Turning a Government-owned Business into a Family Firm

This case shares the perspective of a second-generation family member. Strong relationships with suppliers and customers, funding from a strategic investor and a professional CEO have helped the company successfully transition from a Government-owned to a family-owned business.

Our family firm is based in Mexico. In the 1990s my father, together with a few other investors, bought the business from the government as part of the country's privatization program. Today, my father is the Chairman of the company and we have a professional CEO in place. I am in charge of operations and a few family members hold other leadership positions in the firm. There are no direct reporting lines between family members. Over the years we have managed to diversify our business and are now active in multiple industries. We are currently listed on the stock exchange.

Access to Capital

Our family firm has had several different partners over the course of the years. We acquired the company in the 1990s, with an institutional investor and a group of "family and friends" investors. We have also raised public debt in local markets and private debt in international markets. Today, we focus more on local debt as the market has matured and there is more money available. A part of our business is also listed on the stock exchange. Despite having discussed it several times, we have never had a PE investor, due to concerns about losing control.

Corporate Governance & Leadership

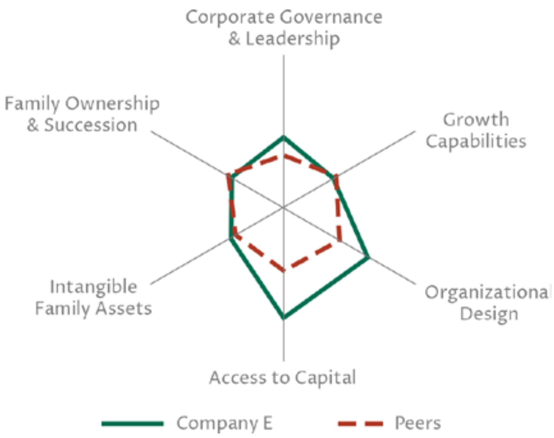
We have always believed in the importance of strong corporate governance. Our board includes several independent board members who are all well-respected in the business community. Apart from this principal board, we also have a second board that is comprised of only family members. We use this second board to formulate opinions and find a consensus among the family on a best-effort basis, so that we can present a unified front when making decisions on the main board. Lastly, we have professionalized the firm's management starting at the top with a professional CEO. This transformation has helped us institutionalize the company and align incentives.

Intangible Family Assets

We recognize the important role stakeholders play in our firm's success and so work proactively to build good relationships with them. A few key suppliers are particularly critical to our business, so we invest in keeping these relationships healthy, even traveling around the world to see them. We also meet our customers, with whom we have mostly local relationships, on a regular basis. We also enjoy a good relationship with the government, as we understand the need to build consensus with government officials in projects that generate value for our investors as well as society. Reflecting the values of our family, the management and our partners, our business cares about human resources as well as being environmentally and socially responsible.

Institutionalizing the Business by Setting up a Holding Company

This case shares the perspective of a third-generation family member who is the current CEO of his family firm. Structuring a holding company, bringing in external partners and professionalizing the management of every subsidiary have helped ensure sustainability.



Our company was started by my grandfather in the early 1930s. Over the years, the company added different business units and grew significantly. The number of family shareholders also grew over the generations, so it became necessary to restructure the company. We set up a holding company and bought out the shareholding of other branches of the family. At the same time, we brought in two new shareholders. Having a holding company significantly improved our "access to capital" and strengthened our "organizational design". Currently, my father is the Chairman of the Board and I am the CEO. We strongly believe that family matters are as important as business matters, but they must remain separate, else both suffer.

Access to Capital

A few years ago, we were looking for partners with expertise to help us in the next phase of our development. We found two individuals, both with exceptional experience, working in their own family businesses; one sold his family business to a strategic investor and the other took his family business to the market. These two partners joined us with share ownership at the holding company level. We also have partners at a few of our subsidiaries.

Organizational Design

During our search for new partners we learned that institutional and private investors require considerable transparency, particularly relating to the company's structure and operating numbers. To fulfil this requirement, we created a reporting deck for new partners who are not involved in day-to-day operations but need to understand what is happening at the business unit level. The holding company structure enabled us to integrate our investments in separate companies to create a single entity at the top with a consolidated balance sheet. This restructuring allowed us to be more transparent with investors, banks and other third-parties. After working for almost 2 years to establish the holding company, the subsidiaries and reporting lines, our investors came on board. We continue to work on strengthening the company's structure and have also hired a coach to help us.

Corporate Governance & Leadership

Our firm has multiple boards, one at the holding level and one for each subsidiary. The board of the holding company has two family members, the two partners and a person that they brought in. The boards of our subsidiaries typically consist of two family members, partners (if there are any), and several carefully selected independent members. Independent board members are especially beneficial to subsidiaries based outside our home country as they have valuable business contacts and also understand the local market. All our subsidiaries have professional managers, two of whom are my brothers-in-law. Since they began working at the company before they got married, they are viewed as part of the professional team and not as family members. We believe that professionalizing our management team has been crucial for the sustainability of our business.

Conclusion

Family firms are a key driver of economic growth and well-being in Latin America. As they develop, family businesses need to institutionalize their operations to ensure long-term value creation.

Our survey of 131 family firms identifies a proficiency gap between ‘Champions’ and ‘Ascendants’ and shares recommendations from the owners of mature family firms. In particular, Champions clearly outperformed the Ascendants in the four business attributes, underpinning the importance of formal policies and procedures.

Selectively drawing on expertise from external sources – such as private equity investors, independent directors or professional managers – can help a family business leapfrog the institutionalization curve.

Appendix

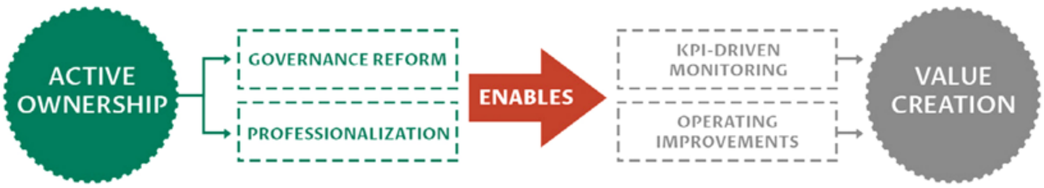
The Private Equity Investment Model[iv]

PE firms have traditionally financed their investment activity by raising closed-end funds with a 10-year term. The structure of a typical 10-year fund includes a 5-year investment period (i.e. from year 0 to year 5) during which the PE firm acquires equity stakes in private companies; the PE firm is required to sell all fund stakes and return capital plus a portion of any profits to investors by the end of the tenth year. Successful PE firms typically raise a fund every three to four year to provide a continuous supply of investment capital and finance their day-to-day operations.

As a result of this closed-end fund structure, PE firms hold stakes in their portfolio companies for a relatively short time (typically 4 to 7 years). To maximize an investment's value during this period, firms engage regularly and directly with companies' senior management teams, and often at a granular operating level, to shape strategy and management style, monitor performance, and drive change. As highlighted by Michael Jensen in "Eclipse of the Public Corporation" in the Harvard Business Review (1989), this "active ownership" model has been the bedrock of PE investing from the industry's inception.

Exhibit 5 provides an overview of two core elements of the PE investment model – Active Ownership and Value Creation.

Exhibit 5: *Value Creation in Private Equity*



Active Ownership

PE investors have a defined approach to influencing and monitoring their investments, placing emphasis on sound corporate governance and professionalizing its investee company's systems, processes and human resources. Implemented in a repeatable fashion, active ownership allows PE investors to align key stakeholders in a portfolio company and efficiently monitor performance.

Governance reform: PE firms employ specific corporate governance mechanisms to oversee and coordinate activity at their investments. The board of directors is the main channel through which PE investors execute their rights as owners and influence the performance of their investee companies; influence is ensured through a controlling equity interest in a majority investment and via a board seat, or – at a minimum – board observation rights, in a minority investment. PE investors also seek to align their economic interests with existing shareholders and

[iv]This section is based on the following book: Zeisberger, C., Prahl, M. & White, B. (2017). Mastering Private Equity: Transformation via Venture Capital, Minority Investments and Buyouts. New York: John Wiley & Sons.

management to driver performance, either through a significant, personal investment in company equity from senior management in a majority investment, or via shared equity ownership with existing owner-managers in the context of a minority investment.

Professionalization: PE investors engage from the beginning of their ownership period to professionalize their investee companies. This begins with ensuring that the right management team is in place. When a gap in the team is identified, new managers will be recruited to complement the existing team; in some instances, managers will be replaced. PE investors focus specifically on the finance team to ensure accountability and professional standards in financial reporting. PE firms also leverage talent both within their organizations – operating partners and operating teams – and from outside – executive mentors and consultants – to augment the professional resources available to an investee company. PE firms also typically implement comprehensive management information systems that provide accurate, on-demand metrics of business performance. Other initiatives may include IT system upgrades and the optimization of pensions, insurance and tax.

Value Creation

Value creation activity in a PE-backed company focuses on driving performance improvements in a company's existing operations to build a more efficient, better-run business. Leveraging the active ownership model, PE investors are able to identify and drive specific operating improvements backed by KPI-driven analysis.

Operating improvements: PE investors often engage beyond the board to drive targeted operating improvements during their period of ownership, often leveraging specific, in-house domain or functional expertise to drive change. An in-depth examination of the previous owner's operating model will not only aim to build on the company's established strengths but also look for new ways to release cash or increase profit margins. Driving revenue growth through increased sales volume is the preferred lever for value creation in PE, with overhead reduction and working capital optimization also commonly employed. PE firms typically focus on a small number of operating improvements at any one time to avoid over-burdening management, often beginning with priorities identified during due diligence.

KPI-driven decision-making: PE investors closely monitor financial and non-financial key performance indicators (KPIs) to drive fact-based decision-making. Leveraging data from management information systems, PE investors identify and track the evolution of a handful of KPIs that represent the performance of critical areas of a business model. KPIs also provide simple metrics through which to measure employee performance and to implement performance-based compensation schemes.

References

[1] Business in the blood, Nov 1, 2014, The Economist

[2] IFC (2018). Family Business Governance Handbook, 2018.

[3] Bennedsen, M. & Fan, J.P.H. (2014). The Family Business Map: Assets and Roadblocks in Long Term Planning. Basingstoke: Palgrave MacMillan.

[4] Miller, D. & Le Breton-Miller, I. (2005). Managing for the long run. Boston: Harvard Business School Press.

[5] Lansberg, I. (1988). The succession conspiracy. Family Business Review, 1(2), 119-143.

[6] Le Breton-Miller, I., Miller, D., & Steier, L. (2004). Toward an integrative model of effective FOB succession Entrepreneurship Theory and Practice, 28(4), 305-328.

[7] Bennedsen M., Nielsen K. M., Pérez-González F. & Wolfenzon D. (2007). Inside the family firm: The role of families in succession decisions and performance. Quarterly Journal of Economics, 122(2), 647-691. 8 Villalonga, B. & Amit, R.(2006). How do family ownership, control and management affect firm value? Journal of Financial Economics, 80(2), 385-417.

[9] Werner, S., Tosi, H. L. & Gomez-Mejia, L. R. (2005). Organizational governance and employee pay: how ownership structure affects the firm's compensation strategy. Strategic Management Journal, 26(4), 377-384.

[10] Groysberg, B. & Bell, D. (2014). Generation to Generation: How to Save the Family Business. Harvard Business Review. Available at: https://hbr.org/2014/04/generation-to-generation-how-to-save-the-family-business

[11] Davis, J.A. (2001). Organizing the Family-Run Business. Working Knowledge, Harvard Business School. Available at: http://hbswk.hbs.edu/item/organizing-the-family-run-business

[12] Villalonga, B., Amit, R., Trujillo, M. A., & Guzman, A. (2015). Governance of Family Firms. Annual Review of Financial Economics, 7, 635-654.

[13] Mahto, R. V., Davis, P. S., Pearce, J. A. & Robinson, R. B. (2010). Satisfaction with Firm Performance in Family Businesses. Entrepreneurship Theory and Practice, 34(5), 985-1001.

[14] The Institutionalization of Family Firms – From Asia-Pacific to the Middle East, November 2017, INSEAD Global Private Equity Initiative

[15] Howorth, C., Westhead, P., and Wright, M. (2004). Buyouts, information asymmetry and the family management dyad. Journal of Business Venturing, 19(4), 509-534.

[16] EVCA (2005). Private equity and Generational Change. The contribution of Private Equity to the Succession of Family Business in Europe. Brussels: European Private Equity and Venture Capital Association.

[17] Scholes, L., Westhead, P. & Burrows, A. (2008). Family firm succession: the management buyout and buy-in routes. Journal of Small Business and Enterprise Development, 15(1), 8-30.

[18] Achleitner, A., Schraml, S., and Tappeiner, F. (2008). Private Equity Minority Investments in Large Family Firms: What Influences the Attitude of Family Firm Owners? SSRN Electronic Journal.

[19] Poutziouris, P. (2001). The Views of Family Companies on Venture Capital: Empirical Evidence from the UK Small to Medium-Size enterprising economy, Family Business Review, 14(3), 277-291.

[20] Wright, M., L. Scholes, R. Ball, C. Howorth, O. Kloeckner, P. Westhead and A. Burrows (2008). Private Equity in Family Firms - A Report on Private Equity Investments in Family Firms across Europe. Nottingham, The Centre for Management Buy-out Research.

[21] Scholes, L, Wright, D.M, Westhead, P, Bruining, J, & Kloeckner, O. (2009). Family-firm buyouts, private equity, and strategic change. Journal of Private Equity, 12(2), 7–18.

[22] Wulf, T., Stubner, S., Gietl, R., and Landau, C. (2010). Private Equity and Family Business – Can Private Equity Investor Add to the Success of Formerly Owned Family Firms? HHL-Leipzig Graduate School of Management. HHL Working Paper, 87.

[23] *Azul float raises hope for Brazil's stalled IPO market*, Financial Times, 18 April 2017

About Us

The Wendel International Centre for Family Enterprise (WICFE). INSEAD's activities in family business started in 1997, when the Large Family Firm Chair was founded by Wendel with the purpose of studying the unique dynamics of family enterprises; in the same year, the first cohort of students attended the MBA Family Business Elective. Two decades later the Centre has grown into a leading international resource for family business learning and we are continuously generating and sharing knowledge that benefit family businesses. The Centre has also adopted a wider advocacy role by raising awareness and understanding of the importance of family enterprise as a business model.

The Global Private Equity Initiative (GPEI) drives teaching, research and events in the field of private equity and related alternative investments at INSEAD. It was launched in 2009 to combine the rigour and reach of the school's research capabilities with the talents of global professionals in the private equity industry. The GPEI aims to enhance the productivity of the capital deployed in this asset class and focuses attention on newer areas shaping the industry such as impact investing and operational value creation, and specific groups of LPs like family offices and sovereign wealth funds. Its core supporters are:

Project Supporters

Clayton, Dubilier & Rice (CD&R) is a private investment firm founded in 1978 with a strategy based on building great businesses by growing the top and bottom lines sustainably. Since inception, CD&R has managed the investment of more than $24 billion in 75 companies, representing a broad range of industries with an aggregate transaction value of more than $100 billion. The firm is recognized for driving operational and strategic initiatives through a combination of growth, talent, productivity, and capital efficiency improvements – approximately 78% of the firm's historical returns have been the result of EBITDA growth. The firm has offices in New York and London. For more information, visit www.cdr-inc.com.

Russell Reynolds Associates is a global search and leadership advisory firm. Their 425+ consultants in 46 offices work with public, private and nonprofit organizations across all industries and regions. They help their clients build teams of transformational leaders who can meet today's challenges and anticipate the digital, economic and political trends that are reshaping the global business environment. From helping boards with their structure, culture and effectiveness to identifying, assessing and defining the best leadership for organizations – their teams bring their decades of expertise to help clients solve their most complex leadership issues. For more information, visit www.russellreynolds.com.