Many family firms lack heirs. Unrelated help is at hand

economist.com/business/2024/01/29/many-family-firms-lack-heirs-unrelated-help-is-at-hand

Business | Pseudo-heir apparent

How to succeed when you have no successor

image: Paul Blow

Jan 29th 2024|Tokyo

Handing over a family business to the next generation can be a dramatic process. If the company is big and progeny bountiful, the intrigue is followed with zeal by both the financial press and the tabloids. When 29-year-old Frédéric Arnault, the second-youngest of five scions of the LVMH luxury empire, took over its watch unit at the start of the year, speculation swirled about the succession plan being put in place by his billionaire father, Bernard Arnault. Yet many more heads of family firms face the opposite predicament: they have no heir at all.

Legions of entrepreneurs born in rich countries during the two-decade baby boom starting in the 1940s are close to retirement age or past it. Some, like Giorgio Armani, the 89-year-old founder of the Italian fashion house, are childless. Others have offspring who want to chart their own career paths. Dalian Wanda, a sprawling Hong Kong conglomerate, faced a public headache when it turned out that the only child of the founder, Wang Jianlin, would not take over the company.

Most heirless firms are not quite so large or well-known. But they are numerous. Owners aged 65 or over run 23% of American firms with at least one employee, up from 20% in 2017. The share of German business-owners who are over 60 is 31%, three times the figure two decades ago. Only one in ten is younger than 40. By 2025 almost 2.5m small and medium-sized businesses in Japan will have owners in their 70s or older, reckons the country's economy ministry. Half of that group have made no plans for a handover.

No owner likes to see a life's work fall into desuetude. When otherwise successful companies fold without a new owner or are sold off piece by piece by inheritors, they also lose valuable know-how and intangible assets. Collectively, their disappearance into oblivion may be a drag on the broader economy's productive potential. Fortunately for owners and governments, help is at hand thanks to a fast-growing industry of pseudo-heirs.

The most established group of helpers, called search funds, is an offshoot of America's private-equity industry. The first such fund was created in 1984 by a professor at Stanford University's Graduate School of Business (GSB). Many are run by one or two MBAs in their early 30s—GSB graduates were historically particularly common. They raise capital from outside investors, identify one small or medium-sized company, typically worth less than $10m, buy it from its owners and take over as full-time chief executives.

Search funds are now popping up across the Atlantic, where Europe's ageing economies offer rich pickings. Arturo Alvarez, a Spanish search-fund founder, says he has looked at 3,000 companies in Spain and Portugal over the past two years or so, and has sat down for a conversation with about 400, of which he will pick just one. Jürgen Rilling, an investor in search funds from Munich, notes that many of the more than 500,000 small and medium-sized firms in Germany's formidable Mittelstand with annual sales of between €2m ($2.2m) and €50m are run by old-timers who might prefer to be soaking up the sun on Majorca.

The next target may be Japan. In the past some Japanese founders with no male heir relied on the practice of adult adoption—a son-in-law or loyal employee can become the legal descendant of a business owner, avoiding gift taxes. Nowadays adopted daughters are acceptable, too. But relentless demographic trends are making such adoption ever harder. Japanese 70-somethings, of whom there are 16.4m, outnumber 20-somethings by four to three.

Strangely, the world's most demographically challenged big economy has so far not attracted many search funds. Some enterprising types are, however, profiting from its demographic cliff in other ways. M&A Research Institute, created in 2018 and listed in Tokyo in June 2022, is a succession broker. It uses clever machine-learning algorithms to match buyers, mostly private-equity firms or larger Japanese companies, and sellers. Two-thirds of its target businesses are worth less than $3.5m. The firm's 32-year-old founder, Sagami Shunsaku, says that about four in five of the owners he encounters want to sell because they have no alternative plan for succession. Some are in their 90s.

The pseudo-heir industry is still tiny. Between 1986 and 2021 search funds made deals worth just $2.3bn in total. But they are rising in popularity: a third of that figure was invested in 2020 and 2021 alone, with a fair bit more almost certainly deployed since.

And they are doing a roaring trade. According to one GSB study, the typical search fund boasts an annual internal rate of return (IRR)—the private-equity industry's preferred performance measure, which calculates returns on deployed capital but ignores any uninvested money—of 35%. By comparison, conventional private-equity funds generated an IRR of around 15% over the past two decades. Jan Simon of IESE Business School in Spain (and an investor in search funds) says that the outsize returns are due to a combination of little competition from bigger private-equity firms, which prefer much larger deals, and plenty of involvement by the young managing partners.

The M&A Research Institute is similarly lucrative. Its operating profit more than doubled in the last financial year, to $32m. Its share price has risen by over 450% since its listing; last month Mr Sagami's stake made him Japan's youngest billionaire. He is already eyeing other rapidly greying places in Asia, such as Singapore. ■

Correction (January 20th 2024)*: This article was updated to correct Jürgen Rilling's name. Sorry.*

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This article appeared in the Business section of the print edition under the headline "How to succeed with no successor"