Why it pays to join the family firm

Studies show that family-run businesses do better than their peers over the long term. But how can ordinary investors get in on the act? Richard Beddard explains

As a model of a successful British family business, component maker **Dewhurst** (**LSE: DWHT**) takes some beating. Walking through its factory in Feltham in west London with its chairman, Richard Dewhurst, is like being shown around a home by the proud owner. Richard, a trained engineer, shows a familiarity with electronics, metal bashing, and the processes and people that bring them all together that only comes from decades of decisions shaping the factory, its products, and its relationships with staff, suppliers and customers. The factory is nearly brand new – Dewhurst came to Feltham four years ago, when it outgrew its ancestral home in Hounslow. But a few of the machines hark back to an earlier era. They moved with the company, as did the expertise built up since it was founded in 1919 by Richard's grandfather, Melbourne Dewhurst.

Melbourne, the son of a warp setter in a cotton mill, graduated from university and worked on electric motors and generators for Marconi and Crompton during World War I. The workshop produced countless switches, brakes, and motors for cranes, docks, and paper-rolling mills, as well as lifts. But in the 1960s and 1970s, Dewhurst struggled as hydraulic controls replaced electric ones and the UK economy declined. The development of a vandal-resistant lift push button in the 1970s sparked Dewhurst's renaissance. Its push buttons became commonplace on trains and on cash-machine keypads. Richard and his brother, David Dewhurst, the managing director, took over in the mid-1980s, and have globalised the business. In 1994 it made 28% of its £11m revenues overseas. By 2015, it made 72% of its £46m revenues from across Asia, Australia, the Americas and Europe.

"It's their adaptability and long-sightedness that makes family businesses attractive to long-term investors"

This is what appeals to investors about family-run firms. They're established companies with long track records, run with an eye on the profit potential for this and the next generation, not just the next half-year. Sure, like any business, Dewhurst faces new challenges. Destination dispatch systems, often used in hotel lobbies, use one control panel to manage many lifts, so lift designers are using touchscreens instead of push buttons in control panels. Dewhurst buys in the touchscreens rather than making its own, which means they're less profitable. But Dewhurst is adapting by extending its product range to hall lanterns, for example, and making fully assembled panels as well as components. It's this adaptability and long-sightedness that makes family businesses attractive. Today, investors worry about Brexit and "banksterism" – but family firms have survived through two world wars and the social upheaval of the three-day week. In many ways, they are natural bedfellows for long-term investors. So how can you invest, and which are the best bets?

Rare gems

Listed family firms are quite rare, and the family often exerts more control than the numbers on the shareholder register might lead you to believe. A 75% shareholding gives a family near-total control. Special resolutions at a general meeting – those that fundamentally change a firm's status, such as a decision to return to private ownership – require 75% of the vote. Ordinary resolutions to pass routine matters – such as approving the dividend – need a 50% vote. But in practice, families can still wield influence with smaller shareholdings – their experience may justify a seat on the board, for example, and their voting power enables them to team up with other shareholders on key votes.

Of course, this ongoing involvement is what enables such firms to take a long-term view – and various studies suggest it pays off. One study from IE Business School in Spain compared the performance of 832 firms from across Europe, 255 of them family businesses, between 2001 and 2010. Family firms (those where the family had at least a 20% shareholding, and one or more family members on the board) were more profitable, fewer went bankrupt, and their share prices were less volatile than those of their peers. Returns were better too – family firms earned investors a compound annual return of 12% compared with 9% for their peers. In the UK, the average return on assets for family firms was 16%, compared with 12% for non-family ones. Compound annual stockmarket returns were 16% versus 10%. The report's authors describe this added return as a "family premium". However, there is an optimal level of family control – the study reckons around 40% (the Dewhurst family controls more than 50% of the voting shares). The type of business matters too: it seems manufacturers benefit most from family ownership. An investment in a large piece of kit may only pay off over many years, so shareholders need to take a long-term view if the firm is to invest to its full potential.

Goodwin (**LSE: GDWN**) is another solid family-run manufacturer. Its shares have returned more than 14,000% (including dividends) over the last 20 years, by taking long-term decisions that "did not necessarily produce what a short-term trader would have wanted in terms of annual profit and dividend", says

14,000%

What Goodwin's shares have returned over the last 20 years

Most family firms are run better than this

John Goodwin, the company chairman. "Over the many industrial cycles the company has seen, we've come through by investing for the future." John and his brother Richard have been directors since 1980, and are the fifth generation to run the firm. The sixth is represented on the board by their four sons. Goodwin was founded by John and Richard's great-great-grandfather Ralph in 1883. He rented old colliery buildings in Hanley in Stoke-on-Trent and converted them into an iron foundry and machine shop by installing a cupola furnace and steam driven lathe. In its time, the firm has supplied castings, machined components and machinery to industries that catalogue Britain's industrial past.

While the sector has endured many ups and downs, Goodwin prospered, only suffering its first loss in 1987. Back then – as now – oil prices collapsed. The decline of the UK coal and steel industries had left Goodwin reliant on manufacturing valves for oil pipelines. In response to the oil-sector downturn, it cut production sharply and diversified by buying Easat Antennas, a manufacturer of radar systems. Today, the diversified firm is faring better, despite the current oil-price slump. Profitability has halved, but the company is comfortably in the black, and is seeking more customers in construction and defence. Easat's order book is at a record high. Hoben International (bought by Goodwin in 1965), is one of a group of ten businesses owned by the company that supplies minerals and machinery used to cast jewellery, tyre moulds and other specialised products. This division earned about a third of the revenue of the larger mechanical engineering unit in the year to April 2016, but after recent investment its immediate prospects are better. Goodwin's businesses face distant challenges. Alternative energy sources could hit long-term demand for oil, and additive manufacturing (3D printing) could spell the end of casting as a means of making certain items, such as high-value, low-volume jewellery. For now, though, the process remains slow and expensive, and in the meantime Goodwin is taking steps to diversify its minerals business.

The downsides

However, Goodwin's determination to preserve the company for the next generation also demonstrates the risks of investing in family-controlled businesses. At its AGM next month, the company plans to vote on a new incentive scheme. This will award each of eight directors – six of them family members – with options on 1% of the company's share capital if it should rise substantially by April 2019. The scheme could boost the family's control significantly for the first time since it listed in 1958 and shift more shares into the hands of the next generation, while diluting the interest of existing shareholders by 8%.

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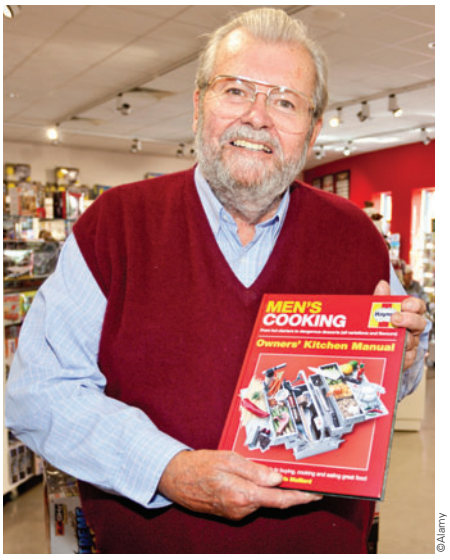
Resistance is likely to be futile, because the family has all the votes it needs to pass the motion. The stewardship of the Goodwins is one reason why the company has prospered, and the incentive plan is probably a price worth paying. But the vote shows how control can be used to favour the majority shareholders.

"So despite the family premium, the same rules apply to investing in family firms as any other – fundamentals matter, and diversification protects portfolios when things don't go to plan"

What might mitigate these risks? A long history as a listed company helps. And a premium listing, such as Goodwin's, also offers minority shareholders more protection than the rules that govern other firms. Companies with independent non-executive directors and formal remuneration and nominations committees may also be more accountable. Goodwin has the former, but not the latter. However, equipment-hire company **Andrews Sykes (LSE: ASY)** and fire safety-equipment manufacturer **London Security (LSE: LSC)** – owned by the Murray family – probably win the prize for the ultimate in family control, while still being listed. A full 99% of London Security's shares, and 86% of those in Andrews Sykes, are owned by trusts set up by Jacques Gaston Murray, who is also chairman of both companies. His two sons are non-executive directors. Yet despite this near-total control – the Murrays could take either company private without the backing of other shareholders, for example – minority investors have lived with the risk and profited from their shares for decades.

This sort of concentrated ownership can mean that shares are harder to get hold of, resulting in a wider spread. The spread is the gap between the price you pay to buy the shares and the price you get if you sell. If you buy shares in Andrews Sykes, for example, they might immediately be worth 8% less if sold. For long-term investors, this immediate "loss" should be near-irrelevant. And for more liquid businesses, such as Goodwin, with less concentrated family shareholdings, the spread is typically only about 1%. Nevertheless it is a cost to set against the family premium.



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John Haynes: manuals for the new man

No guarantee of success

In all, the evidence from academics and individual family firms suggests that investing in them is a sound strategy.

That said, family ownership is no guarantee of success. For example, investors in **Haynes Publishing (LSE: HYNS)** must be wondering whether J Haynes, son of founder John Haynes, can turn the company around. Haynes is famous for its motor manuals. But modern cars are so complex and reliable that few of us maintain or repair them any more. Those who do can often find instructions freely online. In response, Haynes has started producing quirky manuals for all manner of pastimes, and it has bought and grown a business that supplies the motor trade with digital schematics. However, profitability and cash flow have been under pressure for over a decade, and the dividend has been cut twice. It's too early to write the company off, but an investor who had invested everything alongside the Haynes family ten years ago probably feels pretty queasy today.

So despite the family premium, the same rules apply to investing in family firms as any other – fundamentals matter, and diversification protects portfolios when things don't go to plan. Below I've listed five family firms worth considering for your portfolio today.

Five family firms to buy now

The most suitable businesses for long-term investing are those that need only adapt slowly to stay relevant. That's why Haynes, which must reinvent itself, is not included here. More narrowly, I've also left out Goodwin due to the challenges it faces, although industry is still likely to require complex castings in future.

Company	What it does	Market capitalisation*	Debt adjusted p/e*
Colefax (LSE: CFX)	Designs and distributes high-end wallpaper and fabric.	£46m	10
Dewhurst (LSE: DWHT)	Manufactures components for lifts, keypads and railway rolling-stock.	£42m	9
FW Thorpe (LSE: TFW)	Manufactures lighting systems for commercial and public buildings.	£272m	23
PZ Cussons (LSE: PZC)	Supplies consumer goods, including personal hygiene, beauty, home and nutrition products.	£1,465m	20
Solid State (LSE: SOLI)	Manufactures and distributes specialist electronic components and computer systems.	£34m	7

*Source: SharePad, 9 Sept 2016

Of my five tips, Colefax, Dewhurst, and Solid State are all on attractive valuations, considering the underlying stability of the firms. PZ Cussons, the consumer brands giant, and FW Thorpe are pricier, but I'm comfortable with that – good businesses can compound returns by re-investing profits every year (in manufacturing capacity or marketing, say), which will earn even more profit in the future, justifying a higher valuation.

FW Thorpe's most famous brand, Thorlux, is making a successful transition as LED systems are chosen over incandescent lighting in commercial and public buildings. Profitability remains high, justifying Thorpe's high valuation. PZ Cussons has raised its dividend for 43 years in a row, which the firm ascribes in part to the influence of the founding Zochonis family.