

FAMILY BUSINESS MATTERS

The Newsletter of the Family Business Center of Hawai'i

WINTER 2019

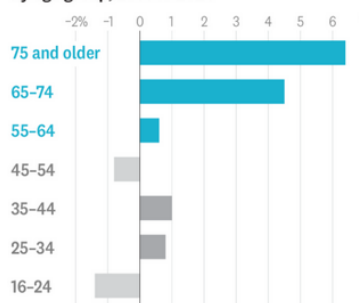
MESSAGE FROM THE FACULTY DIRECTOR

Today almost 27% of the people in Japan are over 65 years old. That percentage is expected to increase to 39% by 2050. The Japanese are not alone in the aging process, which is why a recent series in the *Harvard Business Review* (on-line), which was related to the aging workforce caught my eye (See <https://hbr.org/cover-story/2018/11/when-no-one-retires>). The U.S. population is also aging and this will have implications for all businesses and some special ones for family businesses, where the importance of attracting one's children to return to the family business may have added significance.

The data on the chart on the right shows two important trends. First, the rapid decline in young people indicates that staffing entry-level managerial positions will become increasingly difficult. The second trend is that the age group 45-54 is also declining and it is this age group that supplies many of the upper middle-level and top executives. The data suggests it will not only be harder to recruit in these two areas but it is also likely to be more expensive.

Succession is always an issue in a family firm but the demographic data suggests that other firms may be willing to pay a premium to keep your children employed at their firm. Research by our Associate Faculty Director, Prof. Marjan Houshmand indicates that some early involvement, such as working part-time, increases the probability that they will

Projected average annual growth rate
by age group, 2014 to 2024



Source: U.S. Bureau of Labor Statistics

want to join the family firm in the future.

Another critical issue to face is that firms have tended to not invest in training and development for older workers, usually

those over 50. However, the demographic data suggests all firms need to rethink this policy because more and more firms are likely to want their best employees to work to a much older age than in the past. For example, for years the government of the Netherlands encouraged people to retire early and provide employment opportunities for the young. Now, they have begun to encourage employees not to retire early because they are needed.

Best wishes for a happy and prosperous new year.



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UPCOMING EVENTS

Jan. 29 (Tues.) 11:30-1:00 Oahu Country Club. "Leading the family business when you're not part of the family," Norman Noguchi, President and Chief Operating Officer of Marcus & Associates, Inc.

Feb. 6 (Wed.) 11:30 to 1:00 Kalihi Golf Course, Maui, "Making Sense of Business Valuation for Family Business Succession Planning," Ethan Lee, CPA, ABV, CFF at Pacific Business Valuation

Feb. 20 (Wed.) 11:30 to 1:00 Imiloa Astronomy Center, Hilo "Market City-The Next Generation," Marvin Fong, Chairman and Treasurer; Sandra Au Fong, President and Secretary; and Timothy Fong, Vice President of Market City Limited.

BERNSTEIN'S TOM PAULOSKI DISCUSSES TAX SAVING STRATEGIES RESULTING FROM NEW FEDERAL LEGISLATION AT THE PRINCE WAKIKI HOTEL

The Oahu Chapter of the Family Business Center of Hawai'i met on election day (Nov. 6, 2018) to hear about possible tax saving strategies from Thomas Pauloski, National Managing Director of Wealth Strategies at Bernstein. In addition to an informative talk, entitled "Powers of Deduction: Tax-Saving Strategies Under the Legislation Formally Known as the Tax Cuts and Jobs Act", Bernstein helped by acting as a sponsor of the event. I've always thought that there are two sides to attending a presentation on potential tax cuts. One, you can enjoy them. Two, you can't and don't like the fact other people can enjoy them.

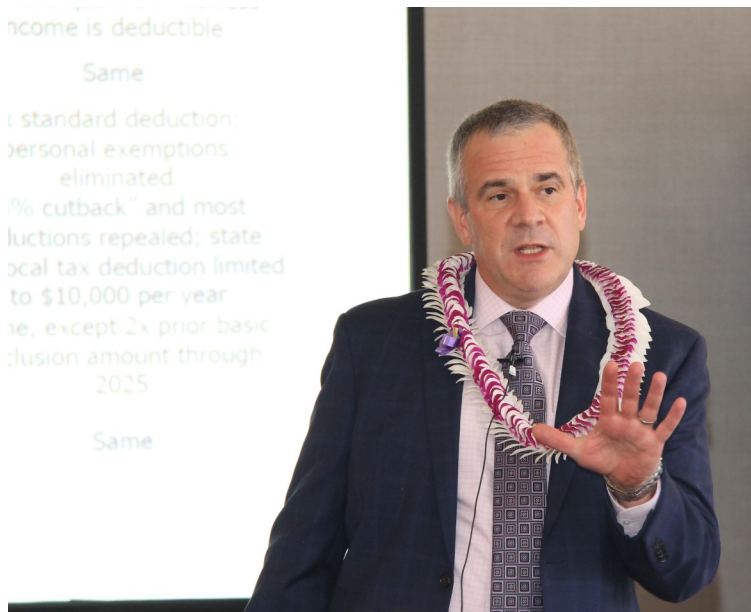
Can taxes be funny? Well, he related how legislation usually has a name attached to it, such as the Smoot-Hawley Tariff bill. However, in the case of the "Tax Cuts and Jobs Act," the Senate did not like the name and eliminated it and never came up with a replacement. Bernstein manages money, almost \$549 billion. Pauloski pointed out that it is always better to discuss tax strategies in advance and related how he was recently contacted by a client who just sold his business for \$100 million. He said he told the client that he wished he had been contacted in advance of the sale.

He also pointed out that while many people are concerned about inheritance tax only about 1 person in 1,500 pays any inheritance tax. Bernstein projects that the exclusion from one's estate tax will reach \$13.9 billion by 2028. Sounds good but Pauloski pointed out that the law expires in 2026 and that the exclusion will then fall back to \$6.6 million. Thus, depending on if you are an optimist or a pessimist there are some things you may want to consider concerning passing on assets to family members. One way to transfer wealth involves making a long-term loan to a trusted family member using the long-term federal interest rate (about 3.2%) for 10 years. The family member can then invest the money at the current diversified rate (about 6.2%) and then return the \$10 million to you at the end of ten years. The federal interest rates are going up, so this would have to be done promptly. You would also have to have confidence that the relative would invest the money diligently. Somebody once told me that it is best to consider a loan to a relative a gift but in this case, the relative would have to give you a promissory note. Yes, you have to charge interest or it would be considered a gift with a host of different tax implications.

Pauloski also said that the tax rates in individual states could also have a significant implication for giving. He has a son in Indiana where the income tax rate is 3.2% and a daughter in California where the rate is 13.3%. He said it might make more sense to transfer wealth immediately to a child in a low-income tax state and later to one in a high-income tax state. Hawai'i is not a low-income tax state but if you have a child living in Washington state the rate there is 0%.

Pauloski also talked about investing in Qualified Opportunity Funds. These funds were first set up in April of 2018 and involved investing in one of these funds (either a partnership or corporation) that invests in one of the designated areas. Bernstein is now trying to determine if these can be set up as diversi-

Income is deductible
Same
(standard deduction;
personal exemptions
eliminated
16% cutback and most
provisions repealed; state
local tax deduction limited
to \$10,000 per year
etc., except 2x prior basic
exclusion amount through
2025
Same



Thomas J. Pauloski, National Managing Director of Wealth Strategies at Bernstein speaking to the Oahu Chapter of the FBCH

fied investment vehicles. "First, investors can defer tax on any prior gains invested in a Qualified Opportunity Fund (QOF) until the earlier of the date on which the investment in a QOF is sold or exchanged, or December 31, 2026. If the QOF investment is held for longer than 5 years, there is a 10% exclusion of the deferred gain. If held for more than 7 years, the 10% becomes 15%. Second, if the investor holds the investment in the Opportunity Fund for at least ten years, the investor is eligible for an increase in basis of the QOF investment equal to its fair market value on the date that the QOF investment is sold or exchanged" (from the IRS home page). They appear to be an excellent way to shield capital gains in some cases. We'll invite Bernstein back next year for an update.



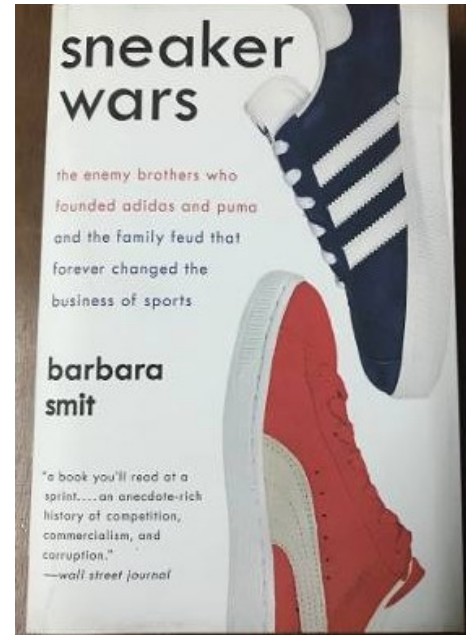
A FAMILY CONFLICT THAT GOES ON RIGHT TO THE GRAVE

In the town of Herzogenaurach, Germany the first things people looked at for years when meeting somebody was their shoes. Depending on if you were wearing Pumas or Adidas it signaled where you worked and if you were on the Adi or Rudolf Dassler brother's side of the family fight. The fight started early in life when they both worked for their father's shoe company (Gebrüder Dassler). Adi was more the technician, always trying to identify ways of making better shoes. Rudolf, on the other hand, was more focused on marketing and had the outgoing personality needed for the job. The firm's big break came at the 1936 Olympics, which were designed to highlight the Nazi regime when Adi persuaded Jesse Owens, an Afro-American sprinter and long jumper to wear their shoes. Owens went on to win four gold medals and the reputation of Gebrüder Dassler instantly became the favorite of Olympic athletes. Unfortunately, World War II begins and the production of athletic shoes switched to military boots.

The fight between the brothers reaches full boil during the War with a fight in a bomb shelter and Adi turning in his brother to the authorities for desertion near the end of the war. Both brothers were party members, had Russian prisoners of war working in their factory, and were under investigation by the Allies. This also made them so bitter that they decided to go their separate way. Adi named his factory after himself (Adidas) and Rudolph built his Puma factory on the other side of the river. The technical experts tended to go with Adidas while the marketing team went to Puma, which meant they both had a daunting task to make their firms profitable.

The brothers stopped speaking to each other but over the next few decades, they both became reasonably successful. They both were involved in the initial practice of paying soccer stars to endorse their shoes as well as active "under the table" paying of amateur Olympic athletes to wear their shoes. As the two brothers continued their fight another small competitor, NIKE began their operations in Oregon. Neither brother took much note of NIKE but they were aware of competitors such as Reebok. Rudolph dies first and of course, Adi does not attend the funeral. Each ends up buried in the same cemetery, one at one corner and the other another corner as far physically apart as you could be yet in the same cemetery.

You would think death would bring an end to the family feud but in this case, the oldest sons picked up the banner. Armand at Puma and Horst at Adidas picked up where their fathers left off. In their case, the feud became a little more childish using such tactics as cancelling others rental car or hotel reservations, especially when they were going to a big conference where they knew getting another room would be almost impossible. While the cousins are fighting, NIKE is turning athletic footwear into something that people



Sneakers Wars by Barbara Smit (2008), NY: Harpers Collins

wear every day, not just for sporting activities. The target market is no longer just world-class athletes but everyone. Nike and Puma were late to the show and PUMA made a mistake by letting discount retailers carry their brand. Adidas also had cash flow problems and eventually followed Nike's lead by moving their manufacturing facilities from Germany and France to Southeast Asia. However, rather than subcontracting they operated the plants themselves. In the end, both firms were sold to outsiders and most family members got nothing. However, recently a grandson of Rudolph joined Adidas so it looks like the feud is finally over and the family members can at least talk to each other even if they don't own the firm.

This book is an interesting read. I recommend it.



SANDY AND MARVIN FONG SHARE THEIR FAMILY'S STORY "MARKET CITY—THE NEXT GENERATION" WITH THE MAUI CHAPTER

Sandra and Marvin Fong have been loyal members of the Family Business Center of Hawai'i and both served multiple terms on our Board of Advisors. On Thursday, November 8, 2018, they journeyed over to Maui to speak to the FBCH Maui Chapter. Their family firm, Market City Shopping Center, opened in 1948 so this is its Happy Seventieth Birthday. When their son Tim joined the firm eight years ago, he became the third generation of Fongs to be associated with the management of the shopping center.

Marvin's father, the late US Senator Hiram Fong and two partners purchased the land in 1946 for \$100,000, which is about \$1.3 million today if you adjust for general price inflation. At the time, \$100,000 was considered a great deal of money. Average annual income was \$2,600 and average monthly rent was \$35 that year. When we look at Market City today we see a completed center and one that is fully occupied. However, as Marvin pointed out it was a vegetable patch when it was purchased and that his father and Mr. Sullivan closed the deal to open the first Foodland store on a handshake.

Marvin said he was glad to manage the center when his father asked him because although he had a law degree, he did not want to spend his work life as an attorney. He then persuaded Sandy to leave her successful career in commercial real estate to help manage the center. One of the interesting things about their talk is that they provided the details involved in managing a shopping center, which is much more complicated than most of us would think. Keeping the spaces full is essential but success also requires tenants that do not duplicate each other but yet form a mix that attracts customers to visit the center. I can't help but point out that Sandy's graduate degree in business from the Shidler College of Business provides that little extra edge.

One of the things that prompted Sandy and Marvin to talk to our members is because they want them to avoid some of the unpleasant things they had to endure along the road to success. There is, of course, no way to completely prevent family problems but any efforts to prevent them are clearly warranted. They pointed out that these issues can be very expensive if they reach the stage where lawyers get involved. Many people forget that most of the expense precede any trial and that hours of depositions can add up to hundreds of thousands or even millions of dollars.

Tim was supposed to come to Maui and give his perspective on being the third generation of Fongs to join the business. However, somebody had to stay and supervise a construction pro-



Market City Shopping Center as it looked in 1946 when it served as a vegetable garden but by 1948 the first store opened.

ject at the shopping center. Fortunately, he sent along his thoughts. The most important thing is that he wanted to join the family business and that his parents exerted no pressure to do so. He had spent several years working for other firms fully exploiting his finance degree earned at the University of Southern California. Sandy pointed out that he has brought Market City up to date with respect to computer technology. No more slips of white paper on spinal to track revenue and expenses. The Fongs have agreed to also make a presentation to our Hilo Chapter on Feb. 20, 2019.



Three Generations Of Fongs. From left to right, Sandy, Hiram, Marvin, Ellyn and Tim.

FAMILY BUSINESS CENTER OF HAWAII PHOTO GALLERY



FAMILY CONSTITUTIONS AND WHAT LITTLE WE KNOW

Family constitutions have become a popular tool for managing both family and family business issues since they were first publicized in the early 1990s although the earliest record one was the Mitsui merchant family in Japan that created theirs in 1722. Most family business that complete a family constitution do so with external assistance and there are some excellent guides available to those interested in the subjects covered. TaylorWessing, a large international law firm provides a superb brochure entitled *An Introductory Guide to Family Constitutions: Their Scope, Impact and Uses*, which is available online. I have found very few negative comments about the process of developing a family constitution other than some complaints about the time and cost involved.

Most constitutions include a section on the company's history, some norms or rules for family members involvement or employment in the business, succession planning, and shareholder agreements. Other areas may be added depending on the complexity of the family business and the size of the family.

However, what has been left uncovered is what are the benefits of a family constitution. According to a PwC study, the range of family firms with family constitutions varies significantly by country with Finland leading with 63% and Japan at the low end with 4%. The US percentage is 18%, which is similar to Germany at 19% and the UK at 14%. While these percentages may seem small, there are an estimated 5.5 million family firms in the United States, so almost 1 million of them have a family constitution.

The two major issues that should be of interest is if they have a positive impact on the family and do they have a positive effect on the financial performance of the firm. The first question is hard to answer because the tools for assessing family harmony are somewhat limited. However, we do know that family communication is a decisive factor for family harmony and you have to communicate to develop a family constitution. Most experts agree that if all members don't sign off on the completed constitution the process has not been successful. One thing consultants agree on is that the process of developing a family constitution should be done when things are good, not during a period of family discord.

Recently, the Spanish government decided to provide about half of the consulting costs so that firms could develop a family constitution. The consultants involved stated that avoiding conflict and maintaining control of the firm was the primary motivation for firms to participate in the program. While they did not collect data related to family harmony they did collect financial data. Two professors from the University of Oviedo in Spain published a paper in the *Family Business Review* entitled "Family Constitution and Business Performance: Moderating Factors". They were able to collect financial information for the period before and after the firms developed their

family constitution. They were also able to compare the performance of 265 family firms with constitutions to firms of the same size in their area and industry that did not have a family constitution.

The results, yes the firms that had completed a family constitution had financial performance that was higher than the other firms and the difference was statistically significant. The story does not end there because family firms all have many complicating factors such as the degree to which ownership is diffused, the current generation operating the firm and if the CEO is a non-family member. Each of these factors makes the family-firm relationship more complicated so the researchers wanted to see if they had any impact on the degree to which the presence of a family constitution had a positive effect. Each of the factors increased the positive impact of a family constitution on financial performance. Their conclusion was that as the business becomes more complex the need for a constitution increases but so do the benefits. It helps to makes those working for the firm as well as those with an interest in the firm to be "on the same page" when it comes to the governance of the firm.

The FBCH is planning several session on family constitutions this year, which will give members a chance to explore issues related to them and help them decide if they need one, want one or want to revise the one they have.



Burmar Family Holdings (an investment arm for Dabur India, Ltd.) spent 19 months, had two off sights in Nepal and was assisted by the consulting firm McKinsey & Company before completing their family constitution.

Equipping, educating and celebrating families in business.

(Mission of the Family Business Center of Hawai'i)

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FAMILY BUSINESS QUOTATION OF THE SEASON

"Tradition is like a bow. The more we stretch the bowstring, the farther we can throw the arrows of modernity and innovation."

Giovanni Ferrero, third-generation CEO of Italian chocolate maker Ferrero International SA (*Wall Street Journal*, Aug. 9, 2016)..

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