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Private

Unlocking Family Wealth

Family Office as a Building Block of Intergenerational Succession

MAKING AN IMPACT THAT MATTERS since 1845

Contents

1. Rapid Growth of Chinese Wealth

Since the opening of the country 40 years ago, China has undergone rapid economic and social development in becoming the second largest economy in the world. Its remarkable economic growth and monetization of assets has prompted a swift expansion in the number of ultra-high-net-worth individuals in China. According to UBS, as of late July 2020, Asia-Pacific counts 831 billionaires (of over US$1 billion in net worth), more than any other region in the world, half of whom are from China. By country, China has the second largest group of billionaires in the world. China also possesses stable economic fundamentals and has taken the global lead in recovering from the COVID-19 pandemic, with the IMF predicting it to be the only major global economy to have posted positive growth in 2020. Meanwhile, the internationalization of the RMB and the opening up of capital markets is attracting more overseas investors into China.

The COVID pandemic, combined with a slowing economy, brought numerous challenges to wealthy Chinese families. Decline in value of their global investments has caused their wealth to shrink, prevented their businesses from expanding overseas and hindered their day-to-day operations. The importance of non-financial matters such as the next generation's education and health management comes to the forefront, albeit subject to multiple restrictions. As the pandemic becomes the new normal, it continues to pose huge uncertainties, triggering problems within and beyond the family structure. Adapting, establishing certainties amid uncertainty, and making succession plans in advance are now perhaps key issues for wealthy Chinese families.

On the post-pandemic changes in the wealth management market, William Chou, managing partner of Deloitte Private, indicates that the pandemic outbreak is teaching family business many lessons, including crisis prevention, agility and adaptability. It also underscores the importance of self-assessment - examination on which measures are working and are not, as well as what's missing in the discussions. That's what effective governance is all about – building resilience. Effective governance is the key to family business' contribution to society in the long run, as well as the key to being prepared for challenging situations as seen in the present.

2. Major Challenges in Family Wealth Succession

As the Chinese proverb goes, "rags to riches and back again in three generations". According to the statistics of Toshio Goto, a professor at Nihon University of Economics and Economics, Japan has 25,321 family businesses with a history of more than 100 years, ranking no.1 in the world. China only has 204, less than 1% of its neighbor. According to our observations of Chinese family businesses, potential reasons for failure in family wealth succession include lack of guidance and training for the next generation successors, lack of governance framework for wealthy family and family businesses, and the failure to customize management models for families and family businesses in accordance to external environment.

William Chou, Leader of Deloitte Global Family Enterprise

China's one-child policy was in place for 35 years until 2016, rendering many family businesses now in face of a succession crisis. According to the Tanoto Center for Asian Family Business and Entrepreneurship Studies at The Hong Kong University of Science and Technology, about 36% of the younger generation in Asia will inherit the family businesses, and 34% hope to establish their own enterprises while leading or working for the family businesses.[1]

The first wave of reform in China led to the creation of an industry-based economy. But in the last twenty years, with the accelerated growth of internet and digital services, disruptive technology is compelling the traditional economic model to transform. The success factors of the past do not apply to our contemporary era and traditional industries are reckoning with challenges to evolve as new industries are in bloom.

On one hand, the first group of private entrepreneurs who benefited from reform and the opening up of the Chinese economy are entering their twilight years. Their successors will be taking the stage during a period of economic transformation. To them, entrepreneurship and innovation are more important than preserving their parents' heritage. For many, their forebears' past glories are a burden, making change difficult. In such families, the successors need to consider how they can avoid inertial thinking and adapt their family businesses to the new economic reality without coming into conflict with family traditions.

On the other hand, new industries are developing rapidly in China, hastening the arrival of a new generation of billionaires. Most of them come from emerging fields such as the internet, biotechnology, artificial intelligence and new energy. Their average age range lies between 40 and 50, and their children are either in their formative years or have just entered adulthood. For this new generation of wealthy families, the primary task is to begin cultivating successors as soon as possible, while recognizing how the next generation's attitude towards wealth differs from that of their predecessors.

With the end of the one-child policy, China's wealthy families are likely to rear more children, therefore bringing about family structures that are more complex and diverse. As the old Chinese adage goes, wealth does not survive three generations. While this can often seem like a curse that is cast upon families, China's new rich expect their children to acquire better educations, maintain family harmony and solidarity, manage the family wealth well, continue family prosperity, and avoid family divisions due to disputes around wealth.

1. Research by Tanoto Center for Asian Family Business and Entrepreneurship Studies at The Hong Kong University of Science and Technology

> Most private enterprises, including listed companies, are still led by first-generation entrepreneurs or founding teams. Though some have planned or are planning succession for the second generation, governance of both families and family enterprises remains inadequate. But the encouraging news is that two-tier governance models are taking shape in some leading families and family enterprises. We expect that wealthy families and private enterprises in China will likely to enter into a historically critical period of succession and inheritance in the next few years.
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> William Chou, Leader of Deloitte Global Family Enterprise

Against the backdrop of ever changing economic patterns and development models, as well as the takeaways from cases we have dealt with, we hereby outline three major challenges in family wealth succession that need to be addressed: first, ensuring a multi-year outlook for the future; second, the generation gap; and third, the competence of decision-makers or successors.

2.1 Dynamic Change in Family Relations—Future Plans Need a Multi-year Outlook

Recently, UBS helped a Chinese billionaire establish a single family office. In his early 50s, the self-made entrepreneur created substantial wealth and hence his main desire was to systematically and professionally manage his wealth and pass it down to the next generation. He was also clear that he needed external professional help to systematize his management framework.

Though the entrepreneur's family structure was simple (comprising the husband, wife and two young children), he needed a detailed plan which covers the family office's establishment, and implementation to meet their future needs. After working with his advisors, the entrepreneur was clear about the need for long-term planning to create a long-lasting legacy, and to include arrangements for the second and even third generation of the family, which required a well-designed family governance framework.

The needs and situation of each family are unique. Roles of family members shift along with the passage of time and also evolve—from the birth of their children, to their schooling years, their initiation into adulthood, when they would form their own families and pursue their own passions and careers. Just as well, as senior family members become older, their roles in the family also change. This is a continuous, dynamic process. As the number of family members increases over time, family dynamics become more complex. The entrepreneur understood that he needed professional help to establish harmonious family relationships and a well-structured family governance framework to ensure the family's sustained, long-term development.

2.2 When the Parents' Success Becomes a Burden—The Generation Gap

With the fast paced development of the Chinese economy, the ideas of people born in different generations became widely divergent, often creating a gap between parents and children in terms of culture and values. This can profoundly influence the transfer of family wealth. First generation entrepreneurs are often dissatisfied with their successors, believing them to be immature and always taking everything for granted, while successors view their elders as old-fashioned. The older generation hopes the next generation will take over the family business at the proper time and help it grow stronger. However, some members of the next generation would prefer to start businesses of their own in emerging investment areas, culture, art, the internet and other new industries. Hence conflicts arise.

Deloitte's Australian team helped a successful founder set up their family office. The founder, who started out in business in Shenzhen, is a well-known entrepreneur in the infrastructure sector. After decades of development, the company he founded became an industry leader. Older members of the family had numerous contacts in government and business partners at home and abroad. These connections and technology were capital which allowed the family to thrive.

The family heir was different. He was sent to study in Australia at the age of 15 and entered a phase of teenage rebellion while his father was striving to establish his business at home in China. In the son's eyes, his father was a prominent, successful man but in his father's eyes, the son was immature and failed to live up to expectations.

The father hoped his son would learn from him about how to behave in society and carry forward the business, leading it to new heights. But the son had his own ambitions, and did not want to live in the shadow of his famous father. Furthermore, due to having socialized mainly among the Western business community since childhood, the son was unfamiliar with China's social and economic environment. He hoped to start a business himself without relying on his father, to achieve his own career goals and to realize his ambitions in life. Both men were family-oriented, but due to a lack of communication, it was hard for either to abandon their positions. These issues, compounded by a lack of systematic arrangements for family succession, ended up fracturing family relations.[2]

In another case, the head of a family who served on the board of his company as chairman was considering his succession. The son, who was assistant to his chairman father, dealt with the operation and management of the family business. The father felt anxious about whether his son was willing and able to take over management of the family business. The son also had his own dilemmas. He was willing to take over the company, but his father had not yet discussed the topic with him. As an assistant to the board chairman, the son handled company affairs according to his father's instructions and had doubts about his own ability to perform and maintain same business presence as his father. He also felt that his father did not fully trust in his abilities.

Parental success can become a burden for the next generation. When the successor generation reaches maturity, the founder generation is often still healthy and strong, and often reluctant to fully hand over responsibility and decision-making power to the next generation. When it comes to inheriting a family business, it is hard to reconcile the different ideas of two generations and the issue is often too sensitive to be broached head-on.

The above cases illustrate the problem of the gap between generations. Without open dialogue and communication, it is impossible to build sufficient trust and rapport within a family, let alone successful transition between generations.

In addition, different generations often do not have the same concepts of business management and investment, and can differ greatly in their values. The *2020 UBS Global Family Office Report* shows that younger generations value social impact investment, as reflected in their portfolio allocations, extending their reach to areas such as climate change, green technology, and other issues.

2.3 The Temptation of Wealth—Competence of Decision-Makers & Successors

With the advancement in medical treatment and social development, humans have achieved a much longer life expectancy. Decision-makers in family businesses can live for many years, but still face chronic disease, incapacitation, disabilities and other health risks that affect their decision-making capacities. Their advisers must have the courage to raise questions about various issues, particularly when it comes to future plans.

The first is wealth distribution and business succession within a complex family dynamic. Currently, the patriarchs or matriarchs of many Chinese family businesses are first generation entrepreneurs. They typically have a simple family structure that includes a spouse and a single child. Their descendants will form larger families, including multiple marriages or even unacknowledged non-marital relations or children. News of family disputes over property have frequently caused a sensation among domestic and overseas Chinese communities, becoming "watercooler" topics, inflicting damage upon the reputation of the family.

The second issue is the potential for generations who grew up in luxury to squander their wealth. Wealth created by the first generation is often "hard-earned money" that has been accumulated over time. The first generation are now in their 60s and have substantial wealth, but maintain a frugal lifestyle. The nouveaux riches, however, are often criticized for spending money too quickly. Great wealth can make a man and also daze a man. The greatest dangers are trusting the wrong people after inheriting family wealth, a lack of belief in or absence of future goals, dissipating wealth through indulgence and thus compromising the mind, body or the family, or becoming a stereotypical "wealthy second generation degenerate".

The second generation of Chinese family enterprise owners (usually the sons or daughters of the founders), particularly those born from 1985 onwards, have grown up in the era of the 'new economy'. If they receive no professional or formal business training, it is very difficult for them to adapt to rapidly changing and often treacherous situations and quickly learn how to hold their own in business circles.

2. Melbourne Business Circle Magazine, Australia

3. The Role of Family Offices in Helping Intergenerational Succession

3.1 Blueprints and Family Harmony

With the growing demand arising from second generation of ultra-high net worth families studying abroad and family business expanding abroad, family enterprises have become more active globally, which requires family offices to have the capacity to allocate resources globally. The family founder has to think about the top designs of his or her family, the optimization and dynamic management within this design, in order to realize internationalization of the family enterprise and to prosper in the changing global environment. Our team works with the whole family to understand each family member's needs, aspirations and concerns. This helps us to create a solid foundation for governance, and deliver practical and sustainable solutions that enable families to achieve both their entrepreneurial and personal ambitions for the current and future generations."

Cynthia Chen, Director of Deloitte Asia Pacific Family Enterprise Consulting / Family Office

Establishing a family office is a long-term project. It requires commitment, time, energy and deliberation, a preliminary evaluation, prudent planning, and support from reliable professionals. In many cases, families cogitate for one, two or even several years before actually implementing their family office strategy. For them, finding external professionals who really understand their needs whom they are able to build trust with and grow together alongside the family is key.

Where there are needs of advice in philanthropy, art, wine, watches, jewelry or other kinds of passions, family offices can access resources through a wide range of platforms and help customize related frameworks and recruit professionals. Community platforms of various kinds can connect entrepreneurs who share the same interests or relevant industries and fields, allowing them to share knowledge and resources, interact and connect. These include communities on investment and emerging technologies such as blockchain and AI.

3.2 Building a bridge: Communication between the Generations

Chinese family businesses have been in development for only a few decades since the reform. Their successors are generally second, or at most, third generation. When the older generation was busy with the family businesses, they often neglected communication and exchange with the next generation. Family offices can reestablish connections between the generations.

However, nothing can be accomplished unless norms are established, usually facilitated by trusted advisors. Thus, a family first seeks to understand family members' individual aspirations, establish common values and goals, and set out a shared vision for the future for the family and the business. They will discuss what rules are needed to ensure smooth management and succession of financial, social and human capital. This communication and negotiation will gradually shape the family constitution, stipulations of which all members of the family agree to abide. A family office can support this process and oversee the creation of governance mechanisms. The family constitution will carry forward the values of the family into the future.

A family office also holds regular family meetings to provide a platform for communication between generations. All generations of the family share their vision for the future and personal ambitions. The founding generation have a strong sense of attachment to the business they established, and complex emotions about succession. Through family meetings, they can pass on their experience to the next generation and communicate the family spirit they wish their children to inherit. Through discussion, the successor generations can also acquire unique knowledge and seek help from the family on education, entrepreneurship and other matters.

With the phasing out of the one child policy, thereby allowing for two or even three children per family, the next generation will definitely have families of more diverse structures. Relationships among family members will become more complex. In this context, a family office is akin to a warden protecting connections between family members. It assists in coordinating family matters, promoting family interaction, strengthening cohesion, and enabling property and values to be passed down through the generations.

3.3 Taking Precautions and Ensuring Strong Risk Management

To address potential risks, family offices need to take precautions, plan in advance and establish risk prevention measures—rendering financial matters fair and transparent to minimize the risk of disputes arising that could damage family cohesion. A family office can help plan for family investment, enterprise development, cultivation of the next generation and even marriage, and establish guiding rules and conditions.

To distribute their wealth, families generally establish trusts and divide assets according to specific conditions. The methods of distribution are affected by the ideas and values of each family. Family members by marriage are usually not entitled to the same distribution of assets that blood relatives receive, and in some cases even blood relations are not entitled to family trust income, especially if such funds are designated for philanthropy by the family. Through a family constitution and governance framework established by a family office, family members can understand concepts around property distribution. In addition to or in place of the distribution of trust assets, support can be given to family members' livelihoods, welfare, personal investments, venture capital, or induction of non-blood relations into the family business.

To support the employment and entrepreneurship of the next generation, a family office can also determine appropriate sectors or functions, and provide professional consulting on educational and occupational choices. It can also assess projects family members wish to pursue, and grant assets or resources to those family members as donations or loans, deterring the abuse of family resources.

4. Conclusion

Countries across the world faced numerous challenges in 2020. We expect the wide-scale rollout of a vaccine in the first half of 2021 to enable global output to return to pre-pandemic levels at the end of the this year. With support from monetary and fiscal stimulus, we anticipate significant corporate earnings growth as the global economy moves above trend, and so expect equity markets to chart new highs. In China, the 14th Five-Year Plan has been officially launched, and the handover to the next generation has begun amongst Chinese entrepreneurs. This will be the key to the continued success of enterprises and vital to the steady development of China's economy.

Harmony and values are crucial to the smooth succession of family wealth. The next generation of young Chinese entrepreneurs are already inheriting family businesses and developing investment or philanthropic undertakings. Through governance frameworks developed by family offices, they can inherit and carry forward their families' principles and ideas many years into the future.
The family office concept began with investment, but has since expanded to the provision of comprehensive professional services. For wealthy families, it is vital to work with reliable external professionals who truly understand their needs.

In terms of its role in mediating an intergenerational succession, a family office can customize solutions, foster family communication, and help pass on family connections, values and assets. It can also manage potential risks, and through trust structuring and employment and entrepreneurship consulting prevent the abuse of connections, values and assets. With their knowledge of modern business approaches, a family office can bring in suitable talent and resources to a family enterprise, and effectively allocate and utilize business and family assets, ultimately ensuring long-lasting prosperity.

Office locations

Beijing
12/F China Life Financial Center
No. 23 Zhenzhi Road
Chaoyang District
Beijing 100026, PRC
Tel: +86 10 8520 7788
Fax: +86 10 6508 8781

Changsha
20/F Tower 3, HC International Plaza
No. 109 Furong Road North
Kaifu District
Changsha 410008, PRC
Tel: +86 731 8522 8790
Fax: +86 731 8522 8230

Chengdu
17/F China Overseas
International Center Block F
No.365 Jiaozi Avenue
Chengdu 610041, PRC
Tel: +86 28 6789 8188
Fax: +86 28 6317 3500

Chongqing
43/F World Financial Center
188 Minzu Road
Yuzhong District
Chongqing 400010, PRC
Tel: +86 23 8823 1888
Fax: +86 23 8857 0978

Dalian
15/F Senmao Building
147 Zhongshan Road
Dalian 116011, PRC
Tel: +86 411 8371 2888
Fax: +86 411 8360 3297

Guangzhou
26/F Yuexiu Financial Tower
28 Pearl River East Road
Guangzhou 510623, PRC
Tel: +86 20 8396 9228
Fax: +86 20 3888 0121

Hangzhou
Room 1206
East Building, Central Plaza
No.9 Feiyunjiang Road
Shangcheng District
Hangzhou 310008, PRC
Tel: +86 571 8972 7688
Fax: +86 571 8779 7915

Harbin
Room 1618
Development Zone Mansion
368 Changjiang Road
Nangang District
Harbin 150090, PRC
Tel: +86 451 8586 0060
Fax: +86 451 8586 0056

Hefei
Room 1201 Tower A Hua Bang ICC Building
No.190 Qian Shan Road
Government and Cultural
New Development District
Hefei 230601, PRC
Tel: +86 551 6585 5927
Fax: +86 551 6585 5687

Hong Kong
35/F One Pacific Place
88 Queensway
Hong Kong
Tel: +852 2852 1600
Fax: +852 2541 1911

Jinan
Units 2802-2804, 28/F
China Overseas Plaza Office
No. 6636, 2nd Ring South Road
Shizhong District
Jinan 250000, PRC
Tel: +86 531 8973 5800
Fax: +86 531 8973 5811

Macau
19/F The Macau Square Apartment H-L
43-53A Av. do Infante D. Henrique
Macau
Tel: +853 2871 2998
Fax: +853 2871 3033

Mongolia
15/F, ICC Tower, Jamiyan-Gun Street
1st Khoroo, Sukhbaatar District
14240-0025 Ulaanbaatar, Mongolia
Tel: +976 7010 0450
Fax: +976 7013 0450

Nanjing
40/F Nanjing One IFC
347 Jiangdong Middle Road
Jianye District
Nanjing 210019, PRC
Tel: +86 25 5790 8880
Fax: +86 25 8691 8776

Ningbo
Room 1702 Marriott Center
No.168 Heyi Road
Haishu District
Ningbo 315000, PRC
Tel: +86 574 8768 3928
Fax: +86 574 8707 4131

Sanya
Floor 16, Lanhaihuating Plaza
(Sanya Huaxia Insurance Center)
No. 279, Xinfeng street
Jiyang District
Sanya 572099, PRC
Tel: +86 898 8861 5558
Fax: +86 898 8861 0723

Shanghai
30/F Bund Center
222 Yan An Road East
Shanghai 200002, PRC
Tel: +86 21 6141 8888
Fax: +86 21 6335 0003

Shenyang
Unit 3605-3606,
Forum 66 Office Tower 1
No. 1-1 Qingnian Avenue
Shenhe District
Shenyang 110063, PRC
Tel: +86 24 6785 4068
Fax: +86 24 6785 4067

Shenzhen
9/F China Resources Building
5001 Shennan Road East
Shenzhen 518010, PRC
Tel: +86 755 8246 3255
Fax: +86 755 8246 3186

Suzhou
24/F Office Tower A, Building 58
Suzhou Center
58 Su Xiu Road, Industrial Park
Suzhou 215021, PRC
Tel: +86 512 6289 1238
Fax: +86 512 6762 3338 / 3318

Tianjin
45/F Metropolitan Tower
183 Nanjing Road
Heping District
Tianjin 300051, PRC
Tel: +86 22 2320 6688
Fax: +86 22 8312 6099

Wuhan
Unit 1, 49/F
New World International Trade Tower
568 Jianshe Avenue
Wuhan 430000, PRC
Tel: +86 27 8526 6618
Fax: +86 27 8526 7032

Xiamen
Unit E, 26/F International Plaza
8 Lujiang Road, Siming District
Xiamen 361001, PRC
Tel: +86 592 2107 298
Fax: +86 592 2107 259

Xi'an
Room 5104A, 51F Block A
Greenland Center
9 Jinye Road, High-tech Zone
Xi'an 710065, PRC
Tel: +86 29 8114 0201
Fax: +86 29 8114 0205

Zhengzhou
Unit 5A10, Block 8, Kailin Center
No.51 Jinshui East Road
Zhengdong New District
Zhengzhou 450018, PRC
Tel: +86 371 8897 3700
Fax: +86 371 8897 3710

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