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"Family Business: Measuring Performance in an Imperfect World"

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Abstract

Family business is a pervasive global form of business organization. In the United States alone, one-third of the S&P 500 are family businesses. It is particularly striking, given the importance of family business, that the intergenerational transfer rate is so abysmally low. This paper considers the analytical issues of measuring family business performance and organizational structure for both public and non-publically owned business performance and suggests areas for further empirics. A bevy of issues have not been fully addressed by researchers, issues such as the likelihood of family business owners being poorly diversified, especially compared to well diversified shareholders. These problems can be magnified if the firm is not publically traded, which also eliminates the market discipline regarding debt and equity. Also introduced is the forensics of business failures as a method to view performance, where family businesses are renowned for the difficulty in achieving intergenerational firm transition. Important empirical issues and opportunities are explored.[1]

Keywords: Family business, Authoritative allocation, Competitive market, Diversification

I. Introduction

Family business is a pervasive global form of business organization. In the United States alone, one-third of the S&P 500 are family businesses. It is particularly striking, given the importance of family business, that the intergenerational transfer rate is so abysmally low. The seminal performance study by Anderson and Reeb (2003) provided evidence that publicly traded family owned business outperformed publically owned non-family business.

This paper considers the analytical issues of measuring family business performance and organizational structure. In the same sense that monopolistic competition is a special case of competitive market structure, this paper views family business as a special case of the modern theory of the firm, where family conflicts can be legendary and no apparent market solution exists; a quintessential display of not having markets providing prices to allocate resources within and for the family, but rather the potential for family structure providing authoritative allocation, which reflects Coase's (1937) contribution to the modern theory of the firm.

This paper considers the organizational structure of family business for both public and non-publically owned business performance and suggests areas for further empirics. A bevy of issues have not been fully addressed by researchers, issues such as the likelihood of family business owners being

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poorly diversified, especially compared to well diversified shareholders. These problems can be magnified if the firm is not publically traded, which also eliminates the market discipline regarding debt and equity. The diversification issue is explored from a U.S.A. domestic perspective and an internationally perspective, where there appear to have greater historic avenues for family businesses to diversify. Important empirical issues and opportunities are explored.

Section II will provide a literature overview that includes the theoretical underpinnings of the modern theory of the firm as it relates to family business. The empirical findings regarding family business performance will include the accounting based empirics and the empirics that employs financial economics. Perennial issues, some of which are unresolved, will be explored. Section III will discuss issues that have not been addressed or fully addressed. This will include family business diversification, the absence of a family business ETF and a new way of analyzing performance-business failures. Section IV will provide conclusions.

II. What We Think We Know About Family Business Performance

In the same sense that monopolistic competition is a special case of competitive market structure, this paper views family business as a special case of the modern theory of the firm, as first presented by Coase (1937). His view of the firm, as a nexus of contracts coordinating various inputs that produce a good or service, is particularly relevant to a family business. Management monitors productive actives, employees and various inputs. And if market prices are not allocating resources, then a family structure can provide authoritative allocation. Thus issues like governance, board of directors for publically held family businesses, advisory boards for non-publically held, succession issues and planning, diversification, and so forth are critical to a family business and have been written about extensively.

An impressive body of literature surrounds family business performance. Analytically, an agency argument, as provided by Fama and Jensen (1985) would posit that family owners of publically traded firms would pursue personal agendas at the expense of minority shareholders. The Riga family's conviction for abuse of resources ($715 million financial fraud) in Adelphia Communications Corp. is a pristine example. Alternative arguments can be explored in favor of family ownership, leaving the issue of performance an issue to be settled empirically. Villalonga and Amit (2006) provide an excellent overview of the development of various agency hypothesis in the literature. Anderson and Reeb's (2003a) seminal study provides evidence that publically traded family owned firms significantly outperform public nonfamily firms. Villalonga and Amit (2006) incorporate greater specificity regarding the founding family member serving as CEO or president of the board. Generally, when limited to publically traded family owned versus publically traded firms, the evidence indicates that family owned outperform public; there is mixed results when the data includes family owned that are both private and public (see Martinez, Storh, Quiroga, 2007). Performance is generally measured in these studies by stock price returns or Tobin Q ratios, as would be suggested by contemporary finance methodology. However, there are often tendencies to use accounting performance measures, such as in the Martinez study above. Even papers using stock price returns can be criticized for using control variables, such as beta for risk, that are calculated from different data sets and time periods than those in the study. The implementation of the methodology is not perfect, however, there appears to be widespread agreement that publically traded family owned firms outperform publically owned firms.

Some studies, like Kachaner, Stalk and Block (2012), collect family business data for comparative analysis. In this case, 149 publically traded family business with revenues in excess of $1 billion were analyzed versus comparable non-family businesses. Their conclusion was that family long term financial performance exceeded that of non-family business. They attribute this difference to family business having a deep affinity for the family itself even in situations where the executive compensation would be comparable to that of non-family business.

III. Methodologies and Remaining Issues

The scope of the current literature, at best, is just briefly addressed above. The focus and academic rigor continues to be impressive, though one might suspect that diminishing returns will set in on the current issues being studied. This section addresses some issues that have not been addressed or not addressed fully.

One recurring issue is the low intergenerational transfer rate found in the U.S. and other countries. This often elicits normative statements such as by Pawar (2009), Lee (2006) and others, that express the need to increase the life span, increase intergenerational success of family businesses, and that the intergenerational failure reflects an inherently flawed method of business organization. These normative statements, though popular, do not necessarily reflect conditions in a market economy. Helmuth, Angur and Singh (2011) have shown that both in the U.S. and in India the turnover rate of businesses reflect market conditions. They show that failure rates in general are high and similar in both countries. They point out that Foster and Kaplan (2001) reveal that in 1987 only eighteen firms on the Forbes 100 firms list remain as holdovers from the 1917 list. Only two of those firms, GE and Eastman Kodak, outperformed the average growth in market capitalization for that period. They show that the failure rates that are so uncannily similar in India and the U.S.A., reflect market conditions. In both countries the failure rate should not be such a great concern, provided that market mechanisms, market freedoms and capital access allows replenishing of the failed firms with new ventures to create even more wealth. This perspective obviously echo's Joseph Schumpeter's views on creative destruction.

A methodological issue of particular interest is that the academic literature is absorbed with performance issues, when in all likelihood a vast majority of family firms will not survive anyway. This would be akin to the medical field charting all the good outcomes but ignoring the cadavers. The forensics of business failures, especially for international comparisons, is of immense interest and provides valuable insights. In terms of the methodology of performance, business failure is unambiguous. This is a central theme of the Helmuth, Angur, Singh paper (2011), which focused on a unique method to study family business, by analyzing business failures. This contrasts sharply with the academic literature's focus on comparing performance measures of family business, which inevitably includes financial measurement issues. A business failure is rather unambiguous, no matter how you measure the failure.

An interesting phenomena is the weight of the academic literature (reviewed earlier) that provides evidence that publically held family businesses outperform non-family business, however, no one in the market has established a mutual fund or ETF to capture this profitability. Studies by Villalonga and Amit (2006), Han and Suk (1998) and Anderson and Reeb's (2003a) (2003b) directly speak to this profitability. Finance has an array of anomalies and the lack of a family business ETF can be considered a candidate for this status.

Diversification is a relevant issue for families in a family businesses. In a stereotypical sense one can imagine a family ill diversified. They own the family business and possibly other assets, personal real estate and even human capital that is tied to the business or their community. In an agency sense this could result in ill-diversified families being overly risk averse relative to well diversified shareholders who are not in the family business. Anderson and Reeb's (2003b) find that family business ownership does not appropriate wealth from minority shareholders but actually enhances their position. Schmid, Ampenberger, Kaserer and Achleitner (2009) studied currency hedging in German family business and found that founding family management was associated with reducing agency costs, leading to lower levels of business segment diversification and less currency hedging. Family ownership leads to risk aversion and more business segment diversification. They find that family management aspect is more likely to dominate the family ownership aspect. Kachaner, Stalk and Block (2012) find that family businesses themselves are relatively well diversified. The literature is rather well defined and established regarding family business diversification, but additional evidence and opportunities for research might exist. One aspect that has not been studied is diversification of non-publically traded family businesses. In this case, the stereotypical ill-diversified family business (mentioned above) might be prone to more risk averse management that impedes wealth creation.

IV. Conclusions

The methodology of modern financial economics and applications of agency theory have provided a significant body of literature regarding publically traded family business firms. The evidence supports family businesses outperforming non-family businesses. This paper has addressed the normative statements that are often found in the literature that support the notion that failed family businesses necessarily are contrary to a sound economy. The argument is made that as long as markets are allowed to clear then market mechanisms, market freedoms and capital access allows the economy to replenish the failed firms with new ventures to create even more wealth.

The forensics of business failures was introduced as a way to view performance, or better yet, to supplement the literature that is deeply steeped in traditional financial performance. In terms of the methodology of performance, business failure is unambiguous. This is a central theme of the Helmuth, Angur, Singh paper (2011), which focused on a unique method to study family business, by analyzing business failures. This contrasts sharply with the academic literature's focus on comparing performance measures of family business, which inevitably includes financial measurement issues. A business failure is rather unambiguous, no matter how you measure the failure.

An interesting fact is, that despite the evidence regarding publically held family businesses outperforming non-family businesses, the market has not created a family business mutual fund or ETF. This curious fact might find itself as a niche in the pantheon of financial anomalies.

Finally, arguments were made about the importance of diversification in family businesses. The literature is well developed regarding publically traded family businesses not suffering from overt risk aversion as a result of being ill-diversified. However, there is no evidence regarding non-publically traded family businesses. The effects of being ill-diversified in this case, especially among mid to small size firms, could create risk averse management that impedes wealth creation. This is a potentially important topic for future research.

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