**IPRPD**
**International Journal of Business & Management Studies**
**Volume 01; Issue no 02: August 31, 2020**

# An Assessment of Business Failures: A Comparative Study between India and American Family Businesses

**John A. Helmuth**[1]

**Madhukar G. Angur**[2]

**Anubha Singh**[3]

[1] *School of Management, University of Michigan-Flint, USA, E-mail: jhelmuth@umich.edu*
[2 3] *Alliance University, Bangalore, India*

Received: 27/07/2020
Accepted for Publication: 20/08/2020
Published: 31/08/2020

**Abstract**

*Research in family businesses is relatively recent, and most often knowledge creation in this area is limited to western countries. Although some scholars have provided empirical assessments of family business practices in emerging economies, no comprehensive picture is available on most aspects of family business. It is in this context that this research is undertaken.*

*Family business succession is widely studied. This paper addresses the topic by comparing the issue for India and the United States. Our approach is unique in that we study business failures between the countries, which avoids the resulting problems in the measurement of financial performance. A business failure is rather unambiguous, no matter how you measure the failure. We will compare the succession of Indian family businesses and that of the U.S.A. We will also draw the distinction of family business failures and "break-ups," especially with regard to India's family groups and in America, where capital markets more seamlessly accomplish stealth break-ups and provide family diversification. Finally, this paper will address an interesting market anomaly, namely that family businesses are alleged to outperform purely public firms, but foreign capital invested in India prefers firms with the least amount of family influence.*

**Keywords:** Family Businesses, Purely Public Firms, Foreign Capital, Publically Traded Family

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## 1. Introduction[1]

Family businesses dominate the economic landscape in nations around the world. In India, family run businesses account for 95% of all Indian companies (see Pawar, 2009) and account for the vast majority of national output and employment. In the U.S.A., one third-third of the S&P 500 are family businesses or have family members in prominent executive positions (Lee, 2004). It is particularly striking, given the economic importance of family businesses, that the intergenerational transfer rate is abysmally low.

India has a mere 13 percent family business survival rate to the third generation and only four percent beyond the third generation (Pawar, 2009). The alleged primary reason for failure is family conflict. In India, approximately 80-85% of the businesses have more than two members of the

[1]An earlier version of this paper was presented at Cambridge Business and Economics Conference, ABER, Cambridge, UK, June 27-29, 2011.

family in the same business. The drama associated with some prominent family break-ups, such as in the second generation of the Ambani family, the largest private sector family group in India, captures headlines worldwide. The high failure rate and/or break up of family businesses can certainly add stress to an economy. Leahy (2010) speculates that it may also act to deter foreign investment. Khama and Palepu (2006) and Pawar (2009) provide historic overviews of family business in India. Typical reasons for failure, such as poor succession planning, family conflict, lack of independent board of directors, and so forth are provided by Vaarma (2009) and by Bhattacharyya (2007).

In the USA, only one-third of family businesses succeed in transferring the business to the second generation. According to the American Management Services, Inc. only 12 percent succeed in transferring family ownership to a third generation and 3 percent to the fourth. These transfer rates are similar to India. Notoriety and drama abound in U.S. family business too, with the exploits of the Hunt brothers cornering the silver market, or the succession plan for Rupert Murdock capturing tabloid attention. The reasons for American failures are similar to those mentioned for India (family conflict, poor succession planning and so forth). In addition, however, the U.S. tax code is particularly onerous in regard to generational wealth transfer, which can often require dissolution of the family business, especially for small to mid-size firms. Obviously, international comparisons are complicated because of tax or regulatory differences between countries.

This paper compares India and U.S.A. family business failures. We will compare the succession of the top Indian firms and that of the U.S.A. We will also draw the distinction of family business failures and "break-ups", especially with regard to India's family groups and in America where capital markets more seamlessly accomplish stealth break-ups and provide family diversification. Finally, this paper will address an interesting market anomaly, namely that family businesses are alleged to outperform purely public firms, however, foreign capital invested in India prefers firms with the least amount of family influence.

## 2. Literature Review

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. Anderson and Reeb's (2003) seminal study provides evidence that publically traded family owned firms significantly outperform public nonfamily firms. 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.

The academic interest in measuring family firm performance addresses important empirical questions. However, we are perplexed that mutual funds have not been created to trade on such performance, assuming the market has not totally discounted such performance premiums. It is of particular interest 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. We believe 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.

## 3. India and United States Family Business Failures

The success rate of transferring ownership to a second or third generation family member is equally low in both India and the U.S.A. (approximately 12% for third generation transfers in each country). Furthermore, the economic importance of family business is immensely important in both countries. Normative statements such as by Pawar (2009) and others, express the need to increase the life span or intergenerational success of family businesses, which is important for the economy of India.

Publically traded family businesses in India are often organized as "groups" with numerous individual stock companies as members. For instance the Tata group has 24 affiliated companies running ninety businesses (source: Tata web site, 2010). The primary decision maker for the firms is the group. The group can serve several important economic functions. It provides a degree of diversification for the family and it serves as a means of financing new ventures, especially historically, when there were not well functioning capital markets. Family groups have actively encouraged the formation of new ventures. As such, the group concept is an organizational structure that can be viewed to enhance economic growth and wealth formation. According to Khanna and Palepu (2006) there were 1,113 group companies publically listed on various Indian exchanges in 1993 and 1,539 publically listed nongroup companies. The Mumbai Stock Exchange listed 567 group companies and 437 nongroups. The Tata group is perhaps the most renown, a conglomerate invested in sectors such as energy, services, communications and owning brands like Jaguar, Land Rover and Tetley tea.

Since our paper is concerned with failures, it is important to distinguish between an affiliated business that fails but is part of a prospering group. The dissolution of the Ambani family business (Reliance) in the second generation may be viewed as a failure to achieve a third generation of ownership, however, the individual ownership of the assets among the two brothers is substantial. Anil received the finance and power generation units, while Mukesh received Reliance industries, including the oil and gas fields (Leahy, 2010).

Khanna and Palepu (2006) analyze the concentration of economic power in the twentieth century Indian economy. While the existence of economic power was pervasive, the variability of family groups dominating the economy fluctuated widely. The analysis covered the years 1939, 1969 and 1997 for the top 50 groups. For instance, in 1969 thirty-two out of the top 50 were not listed in 1939. Forty-three of the top 50 in 1997 were not listed in 1969. The turnover rate is more dramatic than a side by side comparison to the U.S.A. Of course, the periods under consideration cover dramatic changes in India, much less global changes. The 1947 independence from Britain is reflected in 1969, while the economic liberalization in the early 1990's is reflected by the 1997 data.

Despite the internal changes that occurred in India, the authors attribute the turnover of economic power to either or both of the following effects. First, there is rent seeking activities with favorable governments. Though there is anecdotal evidence of such behavior (and just as likely in the U.S.A.), it does not account for the vast amount of turnover witnessed. The second effect is the entrepreneurship factor that is provided due to institutional voids, such as poorly functioning capital markets. This view reflects the importance of the groups providing diversification for family members and serving as the equivalent of venture capitalist as new corporations are launched by the group. The impact on economic development by filling these voids is substantial.

For the purposes of this study, we see that first, there is turnover in the fortunes of family groups in terms of relative economic power. Furthermore, the failure of family businesses (failure to the next generation of ownership) can just as well mirror the dramatic turnover found in the top 50 group. The lesson is that changes occur but in a vibrant economy new groups achieve ascendancy and generate even greater wealth for themselves and the economy.

The turnover in the top firms in the U.S.A. is likewise dramatic. 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 also show that in 1998 the turnover rate of the S&P 500 is approximately ten percent, which has increased rapidly since the 1920's (1.5%). Elwin (2010) compares the 1999 Fortune 500 to 2009, and notes nearly a 50% change (238 turnovers). Recalling that family business accounts for one-third of the S&P 500, we can infer that the turnover in economic power cited above, is just as likely to affect American family businesses.

A conclusion that can be drawn is that the turnover of relative firm dominance occurs both in India and America, reflecting changes in market based economies. These changes are just as likely to impact family businesses, both in terms of turnover and in resulting in failures. Certainly better succession planning and other endogenous tactics can be employed to enhance family owned business longevity. However, the failure rates that are so uncannily similar in India and the U.S.A., reflect market conditions. The India groups filling market voids in entrepreneurship speaks highly of that organizational efficiency. 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.

## 4. The Indian Foreign Investment Anomaly

A curious market anomaly exists in regard to foreign investment in India. Publically traded family businesses (or groups) are likely to be more profitable than nongroup publically held firms. The empirical evidence from the U.S.A. and several other countries substantiate the relative profitability of the publically held family businesses. Khanna and Palepu (2006) find such evidence in India. The market anomaly is that foreign investments prefer investing in publically held firms that have the least amount of family control (see Prasanna, 2008), which the empirical evidence suggests is less profitable. Prasanna cites literature on foreign investment preferences and speculates that governance issues (large inside family membership on corporate boards) and informational asymmetries can account for the foreign investments in nonfamily group firms. These perceived costs could create enough of a premium to account for the market anomaly of not buying into the more profitable group companies.

India will likely attract much capital in this decade which will create even greater information and transparency in governance. Khanna and Palepu (2010) relate a pertinent example of Blue River Capital. Established in 2005 as a private equity firm dedicated to India, it investigated middle market family business firms. By delving into the markets they found low risk and relatively high profit opportunities. Such equity firms will provide better information and close the capital market voids found in financial intermediation in India.

## 5. Conclusions

The success rate of transferring ownership of a family business to a second or third generation family is equally low in both India and the U.S.A. This is surprising, given the historical and institutional differences (including tax regimes and capital markets) between the two countries.

This paper focused on a unique method to study family business, by analyzing business failures. We believe the forensics of family business failures, especially for international comparisons, is of immense interest and provides valuable insights. 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. Existing studies (Khanna and Palepa 2006) show substantial concentration of economic power in India, along with dramatic turnover rates among the top 50 family groups as measured in 1939, 1969 and 1997. In comparison, the turnover rate among top U.S.A. firms is likewise dramatic.

The lesson learned is that the turnover of relative firm dominance occurs both in India and America, reflecting changes in market conditions. These changes are just as likely to impact family businesses, both in terms of turnover and in resulting in failures. Certainly better succession planning and other endogenous tactics can be employed to enhance family owned business longevity. However, the failure rates that are so uncannily similar in India and the U.S.A., reflect market conditions. The India groups filling market voids in entrepreneurship speaks highly of that organizational efficiency. 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 view obviously echoes Joseph Schumpeter's views regarding business failure and creative destruction.

This paper also observed a curious market anomaly regarding foreign investment in India. Publically traded family businesses (or groups) are likely to be more profitable than nongroup publically held firms. The market anomaly is that foreign investments prefer investing in publically held firms that have the least amount of family control (see Prasanna, 2008), which the empirical evidence suggests is less profitable. Prasanna cites literature on foreign investment preferences and speculates that governance issues (large inside family membership on corporate boards) and informational asymmetries can account for the foreign investments in nonfamily group firms. These perceived costs could create enough of a premium to account for the market anomaly of not buying into the more profitable group companies. We believe that India will attract much capital in the forthcoming decades which will create even greater information and transparency in governance.

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