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The Trade-Off Between Family Control and Growth

Preliminary Thesis Report

MSc in Business
Major in Finance

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Executive summary

In our master thesis we want to investigate the link between family ownership, capital structure and growth in non-listed Norwegian firms. In our definition of family firm we require one family to have more than 50% ultimate ownership. We use data from the Center for Corporate Governance Research (CCGR) to extract sales data for our dependent variable, growth, as well as several independent variables like management, industry, age, assets, retained earnings and employees. In our first regression we look at family firms as one, before dividing them into two kinds depending on whether the CEO is from the family or not. Furthermore, we investigate how the degree of family control and retained earnings affects growth.

Introduction and motivation

Morch, Wolfenzon, and Yeung (2005) says that the economy in our part of the world is heavily dominated by family ownership. Faccio, Lang and Young (2001) argue that families are probably the most common type of ownership in non-listed firms in every country. Berzins and Bøhren (2009) document that the value creation in non-listed firms is far higher than in listed firms. In another paper, they also find that Norwegian family firms represents a significant proportion of Norwegian economy counted in numbers, employees, revenue and assets (Berzins & Bøhren, 2013). Despite these facts, non-listed firms have barely been addressed in finance literature, which makes it a very interesting area of research. Earlier research often concerns the relationship between family ownership and performance, while in this paper we will emphasize the possible trade-off between family control and growth.

We find it interesting to study the link between family ownership, capital structure and growth in non-listed Norwegian firms. We will examine differences in capital structure and growth across non-family firms and the following two characteristics of a family firm: When the CEO is a member of the family and when the CEO is not a member of the family. Further, we will examine if family firms, where the family is the sole owner, grow differently than family firms with minority shareholders. We will also look into the potential problem regarding self-selection that arises from this examination.

By focusing on non-listed family firms we fill a hole in the literature. Due to lack of data on non-listed family firms, international research almost solely focus on listed firms. To come up with statistically significant results, international research have had to use much lower thresholds when defining what is a family firm to be able to have a sufficiently large number of observations. In this paper we define a family firm as a firm where the ownership of the largest family through blood and marriage must exceed 50%.

Literature review

Earlier literature on family control can be divided into two categories; competitive advantages and private benefits of control (Villalonga & Amit, 2010). The first category covers the competitive advantages that comes with family control, e.g.

why this ownership structure is optimal and how it contribute to align interest among the biggest stakeholders in the company in a way that maximizes value for both family and non-family owners (Bertrand & Schoar, 2006). Under the second category it is argued that value is maximized only for the family at the expense of minority shareholders. This hypothesis leads to value maximization for the family only (Burkart, Panunzi, & Shleifer, 2003). This does not imply that minority shareholders are worse off than they would have been in a non-family firm but that they are worse off than if they would have been in a firm in line with the competitive advantage categorization.

Morch, Wolfenzon, and Yeung (2005) says that the economy in our part of the world is heavily dominated by family ownership. Faccio, Lang and Young (2001) argue that families are probably the most common type of ownership in non-listed firms in every country. Berzins and Bøhren (2009) find that Norwegian family firms represents a significant proportion of Norwegian economy counted in numbers, employees, revenue and assets. They also find that, in Norway, whatever threshold used, family firms are the dominating firm type (Berzins & Bøhren, 2009). While international research often has used 10% or 20% as lower thresholds to be able to get sufficiently large number of observations, using >50% thresholds, Berzins and Bøhren documents a large selection of firms. They also find that the corporate governance of the individual family firm is characterized by an unusually tight connection between ownership, board membership and daily management (Berzins & Bøhren, 2009).

A large part of the existing corporate governance literature on family firms has dealt with listed firms. The reason for this is, in a high degree, due to the availability of data. Two of the most well known papers concerning family firms are conducted on listed firms. Anderson and Reeb (2003) investigated the relationship between family ownership and performance for firms in the S&P 500 and found that family firms outperform non-family firms. Furthermore, family firms where a member of the founder family played the role as CEO performed better than family firms with outside CEO. Villalonga and Amit (2006) used proxy data on the firms in the Fortune 500 during 1994-2000. They found that in order for family ownership to create value, the founder has to be either the CEO or the chairman of the board.

Family-owned and traditional firms may have an especially cautious approach to growth if they are keen to keep the firm under tight control or if they are reluctant to integrate employees and managers from outside the family. They may also be very risk-averse because failure of the enterprise may end up ruining the family tradition (Coad, 2009).

Earlier research often concerns the relationship between family ownership and performance. However, growth is usually included in studies as a control variable. Sraer and Thesmar studied the performance and behavior of family firms listed on the French stock exchange between 1994 and 2004. They found that family firms in general grew, on average, much faster than non-family firms. Family firms managed by the founder had an average sales growth of 16 %, which is 9% above the average non-family firm. Also family firms managed by an outside CEO showed higher growth than non-family firms, with 10%. Further they argued that family firms largely outperformed non-family firms with respect to both performance and growth (Sraer & Thesmar, 2007) .

Based on data from 2000 to 2009, Magnussen and Sundelius (2011) investigated differences in growth in non-listed firms. They defined a family firm as a firm in which the largest family own more than 50% of the firm. Indeed, they found that family firms grow differently than non-family firms and argued that some of the slower growth can be explained by the separation of ownership and control.

The three studies conducted by Anaïs Hamelin in 2007, 2009 and 2013 on French SMEs indicate that growth in sales are negatively correlated with the degree of family control. One of the papers even indicated that family firms grow slower because they deliberately choose to adopt conservative growth behavior rather than as a result of limited financing options. This could imply a possible self-selection issue (Hamelin, 2009, 2013; Hamelin & Trojman, 2007).

Self-selection is a widely known issue in corporate finance literature. Li and Prabhala (2005) says "*corporate finance decisions are not made at random, but are usually deliberate decisions by firms or their managers to self-select into their*

preferred choices". They propose possible solutions to self-selection issues, with Heckman selection model being the most common.

Jensen and Meckling (1976) is a common-cited article discussing agency problems in a financial setting. Agency conflicts between owners (principal) and management (agent) was labeled agency problem 1 (A1). Examples of such conflicts can be if the manager prioritizes an expensive company car or publicity through extreme growth when the owners, on the other side, would rather prefer him to focus on the firm's profitability. The magnitude of this problem is negatively correlated with the amount of incentives and power that the owners hold. Hence, A1 is less prevalent when you have high ownership concentration and/or high management ownership (Berzins & Bøhren, 2013).

Agency problem 2 (A2) is defined as the conflict between the majority owners and the minority owners. It occurs when majority owners who control the firm exploit minority owners by extracting private benefits. An example can be when majority owners sell their own personal assets to the firm for a price above market value. Many papers have discussed the exploitation of minority shareholders, among others, Grossman and Hart (1980).

Research question

For the purpose of this thesis we will investigate the link between family control, capital structure, and growth. To do this we have come up with the following research question:

What is the link between family control, capital structure, and growth?

First we compare all family firms as one to non-family firms. To address this research question further we will look into different sub-questions:

- What effect has family/non-family CEO on growth?
- What effect has the degree of family ownership on growth?
- How does retained earnings affect growth for 100% family firms?
- How does growth change over quartiles with respect to firm size?

Data

We will use data from the Center of Corporate Governance Research (CCGR) database. It includes every firm with limited liability registered in Norway. It covers accounting- and general firm information in the period 1994-2017 and governance data from 2000-2017 (Berzins, Bøhren, & Rydland, 2008). Relevant data will be extracted from year 2000-2017 because governance data (CEO identity, board composition, and ownership structure) is essential for the purpose of this thesis. The dataset is large, in which we will apply several filters in order to produce a relevant sample which includes firms of interest.

Family firm

In our paper, a family needs to own more than 50% of a firm's equity in order to classify it as a family firm. Item no. 15302 tells us the ultimate percentage owned by the largest family; hence we will convert this variable into a dummy variable with a 50% threshold.

Degree of family ownership

There are several family firms where the family has supermajority or even as much as 100% ownership of the firm. This variation in family ownership is linked to the extent of agency problems. The majority owner's incentives to excerpt private benefits is highest when it owns just above 50% compared to a situation where it is a supermajority or the only owner of the firm. The degree of the largest family ownership (Item no. 15302) also affects the likelihood of having a family CEO or not. It's reasonable to believe that the difficulty of implementing a family CEO is negatively correlated with the degree of ownership. This is because the minority shareholders usually like to prevent the majority owner from taking even more control by also having the CEO role. At the same time, the majority owner will be more interested in having the CEO position inside the family when their share of ownership decreases, which is consistent with the above argument concerning private benefits extraction.

Management

Our management dummy (Item no. 15304) will reveal if a family member belonging to the largest family, by blood or marriage, is the CEO of the firm. Our

guess is that families CEO will be less concerned about keeping a high growth rate and instead prioritize other KPI´s like profitability.

Sales and assets

Our proxy for growth will be changes in revenue, which is calculated yearly from item no. 9. Item no. 63 "Total fixed assets" combined with Item no 78 "Total current assets" represent total amount of assets.

Debt ratio

Our proxy for financial constraints will be the debt ratio. We believe this variable to have a negative effect on growth. The share of debt in the capital structure is calculated by total debt over total assets. As we do not have any data for total debt, we will instead calculate debt ratio as 1 minus the equity ratio (1-Equity/Total assets).

Industry

Villalonga and Amit (2006) find that the distribution of family firms across industries is not evenly distributed. In order to control for this in our regression analysis, we create 9 dummy variables, one for each industry. The approach is the same as Hamelin (2009) used. We will use Item no. 11102 to identify the industries. We filter out firms in the finance and real-estate industry, because this industry will bring excessive noise to our results.

Location

Whether a firm is located in central or rural areas of Norway might affect growth. Hence we need to control for this. Item no 505 will reveal if the firm is located in a city or not. We will also control for which district the firm belongs to because regional differences in GDP growth might facilitate for different growth rates. SSB will serve us the GDP growth in each of Norway's 18 districts and we will use item no 504 to see which district the firm belongs to.

Company age

Item no. 13420 gives us the opportunity to control for the firm's age. Villalonga and Amit (2006) find that non-family firms are usually older than family firms. There is reason to believe that as firms get older, employees become settled and established habits and routines become hard to change. This could have a negative

impact on growth. The distribution of age is believed to be exponential. Hence, we use the squared value of age.

Size

We believe the size of the firm affects the growth rate. This is also proven in Evans (1987). Growth rate tends to decrease as firm size increase. Consequently, size is a common control variable in studies concerning growth. In order for the size parameter to be independent of both capital structure and sector, we use the natural logarithm of sales (Item no. 9) as measurement instead of e.g. total assets.

Retained earnings

For a firm who is 100% owned by one family, financing options of new investments become limited. We believe that as the debt ratio reaches its limit, retained earnings (Item no. 86) become an important source for further growth.

Performance measures

We will also look at two popular performance measures; return on equity (ROE) and return on assets (ROA). ROE is calculated by dividing earnings by total book value of equity, while the latter is EBITDA divided by book value of assets.

Employees

We will also control if the number of employees has an effect on growth. This number is found in item no. 113.

We will filter our data in the following way:

1. Remove non-limited liability firms
2. Remove subsidiaries
3. Remove listed firms
4. Remove financial firms
5. Remove firms with no ownership data
6. Remove firms with inconsistent accounting
7. Remove firms without employees
8. Remove firms without assets
9. Remove firms with revenues < 20 million NOK

Our paper's focus is on firms with limited liability. Hence, we start by deleting non-limited liability firms. Filter 2 continues to remove all firms that are a subsidiary of a parent firm. Filter 3 removes all listed firms, as they have cheaper, broader and more liquid financing sources than non-listed firms, which affect investment opportunities and growth (Berzins & Bøhren, 2009) . Furthermore, we use filter 4 to sort out all financial firms as they follow unique accounting regulations and therefore unfit for comparisons. We use filter 5-6 in order to be left with a dataset without missing ownership data or accounting data. Filter 7-9 remove firms who either do not meet our activity requirements during the period or firms who are classified as micro firms. Inactive firms will bring irrelevant data into our analysis, e.g. contribute to a lower average growth rate. Micro firms defined as firms with sales less than €2 million or approximately 20 million NOK, will bias our average growth in the opposite direction (Commission, 2003). It is obviously easier to achieve 10% growth rate when your current sales are below 20 million NOK compared to a medium sized business with 300 NOK in sales, which is why we choose to remove these firms.

Methodology

We will use multi-dimensional data involving measurements over a specific time period. Panel data consists of multiple factors obtained over multiple years.

Dependent and independent variables

Our main dependent variable will be growth, measured as change in sales. We will investigate several independent variables' effect on growth: Ownership, degree of family ownership, management, debt ratio, industry, location, company age, firm size, retained earnings and number of employees.

Descriptive statistics

We will start of by looking at descriptive statistics on our filtered dataset. This will give us an overview of what we are working with. A univariate analysis will reveal central tendency and distribution of each variable.

Regression model

We propose the following multiple regression model:

$$Y = a + \beta_1 X_1 + \beta_2 X_2 + \ldots + \varepsilon$$

Where the variables will vary depending on the analysis. We will test the coefficients simultaneously using an F-test.

Endogeneity issues

Our results could have possible problems with endogeneity (Berzins et al., 2008). A possible issue could be that the decision to have a family CEO or not might affect growth, but growth could also influence the decision whether to employ a family CEO or not. It could be that a family firm who is experiencing high growth might have less incentives to hire an outside CEO. This issue might apply to other independent variables as well. A possible solution could be to classify growth as high, medium or low, and then run regressions within those three categories. This should reduce the endogeneity problem.

There is also a chance that we have omitted variables from our regression. This would result in biased coefficients, which is of little or no value, as the effect we report from one variable might actually origin from a correlated, but omitted, variable. We try to solve this by including several independent variables, which is of no particular interest, such as firm industry. As we are aware of the possible endogeneity issues, we should be careful about proposing causality.

Alternative methods

As a robustness test we could change the definition of the variables. E.g. we could lower or increase the required threshold for our family firm variable, which would change our sample. Another alternative could be to change how we measure the dependent variable growth. Instead of growth in sales we could have used growth in EBITDA. We could also change how we measure the independent variables. For example there is multiple ways to measure the size of the firm; assets, sales, employees etc.

Implementation plan

End of January:

- Feedback on preliminary
- Start of data analysis

End of March:

- Data analysis finished
- Start of main analysis

End of June:

- Finished first version
- Feedback from supervisor

End of July:

- Planned finish of final version

August 31st:

- Delivery

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