BI Norwegian Business School

Preliminary Thesis Report

MSc in Business

Major in Finance

- Survival of CEOs and their succession in family firms -

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Introduction

The purpose of our master thesis is to study the survival of CEOs and their succession in family firms. Family firms are often thought of being very small in size. However, this way of thinking is deceiving. Credit Bank Suisse produced a database containing the 920 largest family businesses of the world. The database is called "CS Universe 900". On the list we find names of big and well known brands such as Nike, Volkswagen, Foxconn, Samsung Electronics, Walmart and

Facebook[1]. The largest family firm was the Swiss healthcare company Novartis with a market capitalization of $279 billion. Examples from our country Norway are firms such as Aker, Gyldendal, Thon Gruppen, Rieber & Søn and Ferd AS (Berzins & Bøhren 2013).

We aim to look deeper into the corporate governance of family firms, and more precisely; family firms in Norway.

We want to investigate the differences in duration of CEOs in family firms when the CEO is non-family and when he is family. We also want to look at the nepotism effect on family firm's performance after succession. That is, we want to see whether firm performance increases or decreases when the firm's incoming CEO is family versus when he is non-family.

There are many different definitions of family firms to consider, but for our paper we say that a family firm is defined as a firm where a family is controlling over half the company, meaning owning over 50% of the shares. (Berzins & Bøhren 2013).

Our first source of motivation is that family firms constitute a great part of the Norwegian mainland economy. It is maybe the illusion of the word "family" that makes most of us picture a tiny store or small business when hearing the expression "family firm". Studies by Berzins and Bøhren (2013) showed that 65% of all Norwegian firms were in fact family firms. Studying family firms can thus give great knowledge and insight of the Norwegian economy using other lenses than just looking at the oil industry which is a known driver of the the country's economy.

Our second reason is that every individual is qualified to start a family business, including us studying this. The study mentioned above, by Berzins and Bøhren, also showed that family firms were much more profitable than non-family firms. They scored on average 2 percent higher in profitability than other privately-owned firms that were non-family firms.

That leads us to our third source of motivation for our study; namely corporate governance in family firms. More specifically, survival and successions of CEOs

[1] http://www.businessinsider.com/the-worlds-21-biggest-family-owned-businesses-2015-7?r=US&IR=T&IR=T/#novartis-21

in family firms. If family firms contribute to a large part of our country's value creation, then studying the successions of these firms into the next generation might be of a high importance. Mismanagement or mistiming of successions can be devastating for the firms, and thus for the national economy as well. The consulting giant KPMG presented statistics showing that only 30% of family firms survive into the second generation and stated that handling succession is one of the greatest "make or break moment" in a company's life[2]. Another study presented by The family Firm Institute (FFI) shows a similar picture by showing that only one third of family firms making it to the second generation of ownership, 12% to a third generation and only 3% to a fourth generation[3].

We are restricting our study to Norwegian family firms. There are many studies on family firms and their corporate governance, however there is very little input on successions and CEO survival. We will contribute by analyzing the CCGR data set to see whether family-related CEOs tend to survive in the company longer than CEOs employed externally from the family's perspective. If our research proves to be significant, we can determine that our study can support future research in this field.

We believe that succession is of a high importance for family firms for reasons mentioned above, our study can be contributing by filling in on the knowledge gap in this area, or by confirming what is already there. Our study can become valuable for those who wishes to either understand this topic or to further dig in to study this with greater granularity.

We are going to review the most recent and prevalent studies in this field and try to replicate studies by using data from the Center for Corporate Governance Research (CCGR) database to narrow in on family firms. We will use the database and its filters to fit our definition of family firms. Thereafter we will look at firm history to see how long it took for CEOS to be replaced, by whom they were replaced and look at performance before and after the succession.
We have limited ways of determining if the successor is family related or not. However, one common way is to look at last names.

[2] http://www.kpmgfamilybusiness.com/succession-planning-family-business/
[3] https://hbr.org/2015/04/leadership-lessons-from-great-family-businesses

Literature Review

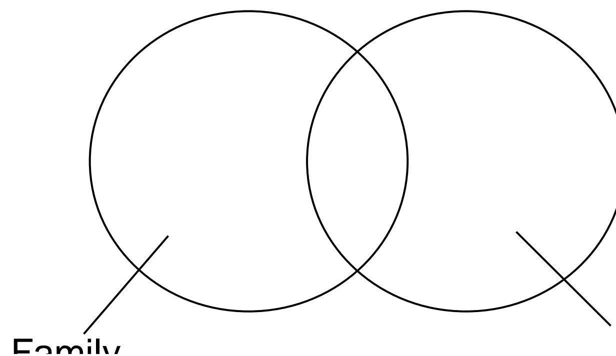
Existing literature in the field of CEO successions in family firms consists mostly of comparing profitability before and after the succession, and comparing efficiency of appointing either a related CEO or an external CEO. There is scarcity of studies concerning CEO survivability.
Appointing a new CEO during a succession is a key organizational decision and a complex, yet important, process (Datta, Rajagopalan, and Zhang 2003). When a family firm is to appoint a new CEO, they are left with the choice of either i) appoint internally in the family, or ii) appoint a professional, externally. Family CEOs could intuitively perform better, as a result of motivation with respect to their family, which externally appointed CEOs do not share (Kandel and Lazear 1992). Instead of having merely money and results as incentive, the related CEO also has his family as incentive to do a good job. However, Bennedsen et al. (2007) has evidence that "family successions have a large negative causal impact on firm performance". Bennedsen et al's study shows that operating profitability falls by at least four percentage points as a result of a family member successing as the CEO. Further they claim that they cannot prove that family CEOs are more likely to file for bankruptcy or to be liquidated, compared to non family CEOs, which is expected due to the lower performance. Bennedsen et al. explains that the reason for the underperformance is due to non family CEOs being more qualified than the family appointed CEOs. Their study's results leads us to our hypothesis, which claims that non family appointed CEO successors have a higher survival rate in firms, than family related CEO successors. We suspect that the survival (duration) of a CEO successor after initially being appointed is heavily dependent on the company's performance after the succession.

When it comes to succession planning in family firms, communication has been identified as a critical factor (Morris, Williams, and Nel 1996). Despite being important, Michael-Tsabari and Weiss (2013) claims that little attention has been given as of literature. In their paper they try to explain the event of succession in a family firm by the use of game theory. Their findings highlights five aspects of communication in succession processes and shows that deficient communication

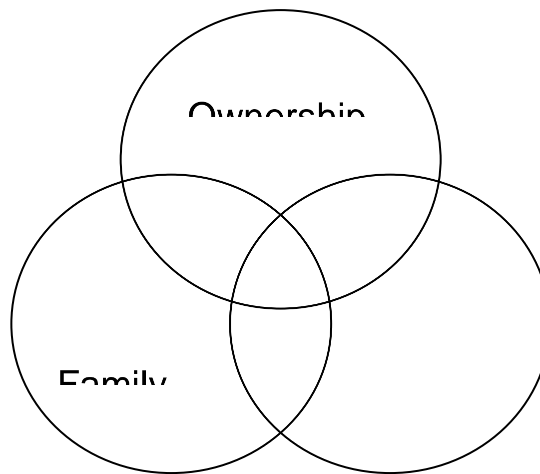
leads to a more problematic dialogue between founder and successor despite having the same attitude towards the succession itself. This paper is simplified, but might help give an insight in why some successions are problematic, while others are not.
There are several well-known theories about corporate governance, but again very little on the specific domains that can only be found in family business niche. We will here explore some of the theories applicable.

System Theory

A lot of research on family firms are based on systems theory. This theory focuses on perceiving the world as interconnected or interrelated objects. A family is a system of itself and so is a business. Early forms of the application of this theory was often utilized to show how the family system affected either positively or negatively on the business system (Barrett 2014). This application of the theory led to a dual system where the family system was interrelated with the business system, represented by two overlapping circles.



This view however has been criticised for being to simplistic and neglecting other sources of influences. This criticism led to development of a multisystem diagram, also known as the three circle model developed by Tagiuri and Davis (1996).They added a third dimension, the dimension of ownership to the Venn diagram. it is the addition of ownership system that introduces agency theory in family firms (Barrett 2014)..



Agency Theory

When studying the field of corporate governance, the agency theory is central in understanding the relationship between principal and agents. The agency theory states that there might occur problems between the agents and the principals. Agency theory tries to resolve these problems. A common example is the relationship between a CEO (the agent) and the owners (the principal): The CEO is supposed to work in the owner's best interest, but his own interests might get in the way. Villalonga and Amit (2006/5) proposes two agency problems relevant for family firms in their paper:

i) The classic owner-manager conflict

Family ownership doesn’t always imply family management as stated earlier in this paper. Many family firms chooses to have an external CEO either due to the absence of the needed competence and experience within the family or because of failing to reach an agreement on which family member that should lead (Kraiczy 2013).

This conflict presents itself as the trivial situation that occurs in non-family firms. There is however a big difference in the complexity of this situation in family firms. According to Villalonga and Amit, this conflict is less prevalent due to the fact that the large shareholder (the firm’s family) has greater incentives to monitor the manager. Family firms are a special type of investor, they are very interested in firm performance and future, they are also often very weakly diversified and have most of their wealth tied up in the company. This is the background of the family’s incentive to monitor the manager. The family, being the largest

shareholder can also appoint new managers and keep the right to take important decisions regarding the firm. These factors limits non-family managers possibilities to use firm resources for their own purpose (Kraiczy, 2013).

ii) Large shareholder extracting private benefits

Villalonga and Amit states, however, that agency problem (ii) has potential to be more prevalent, as the family has greater incentives for expropriation. Agency problem (ii) is only current if they do not own 100% of the firm. This is a problem that occurs when the large shareholder, for example the family, uses it's power to gain benefits privately, while the smaller shareholders bears the costs.

A third agency problem, not mentioned by Villalonga and Amit, but by Kraiczy, is an agency problem that can only occur in family firms:

iii) Family owner versus family manager
This is a special type of problem that can only occur in family businesses. Although family firms hires external managers, most family firms are still run by family members. Ideally the family manager acts in the interest of the family business, agency cost are lowered through the fact that the Principal and the Agent are unified in the family manager (Kraiczy, 2013).
Family managers are said to be emotionally attached to the company, as their and the family's wealth are tied up to it. This is also supported by the stewardship theory. Conflicts that can arise here are problems related to free-riding of other family members, trespass of ineffective managers and a biased parental view of a child's performance (Kraiczy, 2013).

Stewardship Theory

The opposite of agency theory, is stewardship theory. Stewardship is defined as "caring and loyal devotion to an organization, institution, or social group" (Kessler 2013). This can be seen as when the CEO serves the company's, or the owner's', interests before his own. The stewardship theory is, according to Eddleston and Kellermanns (2007/7), "a suitable perspective in viewing the family as a resource". They further state that family firm members is found to be

more committed to the firm. Eddleston and Kellermanns find, in their paper, evidence that altruism has positive effects on a firm's performance, which implies that families might have a positive impact on a firm, if it is properly managed. The same paper states, however, that altruism varies in a fairly large degree among different families, and mending the family relationship is advised for experiencing a positive effect.

Echelons Theory

Another theory that can help understand our problem is the upper echelons theory. Upper echelons theory states that "organizations become reflections of their top executives" (Hambrick and Hambrick 2017). Upper echelons theory views the upper-echelon members as a collective unit, which represents the most important human capital in a firm (Kessler 2013, 918). The upper echelons theory can be useful to see why CEOs in a company do what they do.

Methods

Since we are going to follow firm data throughout several years, we intend to analyze using panel data. This along with descriptive statistics can help us come a long way in our research.

To look at survival we must construct a dataset of successions, and then go into analyzing firm by firm. By survival we mean numbers of years in the CEO position. We must then run a regression of the dependent variable (number of years in position) on an instrumental variable that takes the value of one if successor is of the family or zero when it is otherwise.

To measure the effect of nepotism on performance, which here is hiring a family CEO, We need to use Ordinary least square introducing a dummy variable or instrumental variable that can take the value of one if the CEO is family related and zero otherwise. To adjust for some industrial trends and random events, we will look at performance three years before succession and performance three years after succession to get a more correct average. We also try to adjust for industry benchmarks whenever that data is possible so to also look at performance from a more robust perspective.

Hypothesis 1:
Professional CEO successors have a higher survival rate than family related CEO successors.

The reason is that professional CEO successors tend to have a higher degree of competence than family related CEO successors. They are more likely to have attended college and to be more seasoned. Hence we believe they will do a more successful job and survive longer. (Bennedsen et al 2007.)

Hypothesis 2:
Family firms that hires a professional CEO at the time of succession experience a higher increase of performance than family firms that hires a family-related CEO.

This we believe for the same reasons as for hypothesis 1. According to literature non-family CEO are more likely to have attended college and to be more experienced in management positions than family-related CEO. (Bennedsen et al. 2007).

Hypothesis 3:
Family firm's size affects the outcome of the succession. Larger firms tend to choose non-family CEOs and smaller firms tend to choose family-related CEO.

Bennedsen et al. (2007) found results in Denmark that supported this view. We believe the same is true for family firms in Norway as well and will be investigating that.

Data

We will gather data from the Center for Corporate Governance Research (CCGR), which includes accounting data and financial reports of Norwegian firms. The Norwegian "Folkeregisteret" which contain information about marital status, number of children, divorces etc. is by law not public information, one can not

even retrieve information about oneself. This limits our ability to construct family trees and find our way to family firms by blood or marriage. However we can use filters to fit our definitions of family firms, similar to Berzins & Bøhren (2013) we define a family firm as a firm where a family has an ownership of >50%.
CCGR will also provide us with enough information to determine other factors such as firm size, and time of succession. This way we can construct a dataset of successions.
As mentioned earlier, our ways of determining whether the new CEO is related by blood or marriage is challenging. We would have to look at last names as an indicator. That could become a problem in the case where a female manager has changed her maiden name after marriage. We will try to look into company reports and other sources when it is available, to state whether there's a family tie or not between incoming and outgoing CEO. This must be done firm by firm.
CCGR will also provide us with industry specific variables and benchmark that we can further use when studying the effect of nepotism.

Time plan for completing thesis

The time plan for thesis completion

January February March April May June

January to the end February: Data collection and analysis
In this period we will start to explore the databases at Center of Corporate Governance Research (CCGR) and start retrieving the relevant data for our study. We will also start to sort out this data in order to construct our own dataset which we will start analyzing. At this stage we hope to be able to perform some descriptive statistics on the data retrieved and get some indications of what the data can reveal to us.

March: Presentation of Preliminary Report
Here we present our working project, explain our question and present our findings so far.

March to May: Further data collection and analysis and reviewing of articles
There's a lot of data to be gathered and sorted. In this period we continue to finalize data collection, sorting and work on dataset construction. We analyze our dataset and start extracting results. We review different empirical and theoretical studies to both compare and interpret our results.

May to June: Synthesizing of information finalization report.
In this period we synthesize and put together the findings of our own study and relevant inputs from other studies to start finalizing our report.

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