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The value of family ownership

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PREFACE

This thesis is written as a final part of our Master's degree in business with a major in finance at the University of BI. The task is a mandatory part of the program in the mast semester and counts 30 credits. The purpose of the exercise is to give students the opportunity to specialize in one or more subjects in the study.

The base for this thesis is

Oslo 01.09.2017

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EXECUTIVE SUMMARY

1.0 INTRODUCTION

1.1 Motivation

For our master thesis, we have chosen to look at family firms and their structure. What we want to investigate is if family ownership adds value to a firm, only based on their ownership structure. This topic is interesting because ownership is often brought up in various settings like media, court cases and other issues.

To answer this one must look at other aspects like trust inside the firm. One would be inclined to believe that family relations would mitigate frequent problem and issues since there is a fundamental relationship between the parties involved. It will be interesting to see if problems like agency issues are less present when there is a family structure versus “regular” structure of a firm.

Our initial thoughts, before doing analysis is that family ownership do have a positive impact on how the business is run, profits and agency issues.

To investigate this, we will firstly formulate the problem(s) we are investigating and clarify some definitions. Secondly, we will introduce the topic by setting the scene by looking at earlier research to give a background for our paper. Thirdly, a brief overview of the theories we find most important in regards to family ownership to enlighten our problem formulation and to form the basis for our model. Fourthly, a more detailed explanation of the model and data set that will be used to investigate the hypothesis and research questions we have identified. Lastly, our results from the various analysis with conclusion of our results.

1.2 Problem formulation

The focus for this master thesis will be on profitability and value creation based on ownership structure. We plan to answer this by running valuations on family firms with and equal weight of comparable non-family firms. By value we mean added value that can be attributed to the firm structure. By doing the above we will answer the following question:

Will family ownership bring added value to a company compared to non-family ownership?

To get an answer to our question we will base our analysis on a various of theories regarding corporate governance. These theories are closer described in chapter [3.0 Theory](#) in this paper. We will narrow the data set to Norwegian companies where the company must have had equally or more than 5 historical financial years. We have categorized the data set based on measures like firm size, listed and non-listed. To see more specific how we have divided the data set, see chapter [4.0 Model](#).

1.3 Definitions

Before embarking on this paper, we find it relevant to clarify some of the definitions we will use throughout this thesis. We will only specify the definitions that does not have unambiguous meaning, such that we must specify which of the known variants of the definition we will use throughout this paper.

Family Firms:

There are multiple definitions of family firms/businesses. One example of the definition is that of the European Commission (2017), which is fourfold:

1. The majority of decision-making rights are in the possession of the natural person(s) who established the firm, or in the possession of the natural person(s) who has/have acquired the share capital of the firm, or in the possession of their spouses, parents, child, or children's direct heirs.
2. The majority of decision-making rights are indirect or direct.
3. At least one representative of the family or kin is formally involved in the governance of the firm.
4. Listed companies meet the definition of family enterprise if the person who established or acquired the firm (share capital) or their families or descendants possess 25 per cent of the decision-making rights mandated by their share capital.

Second example is Berzins and Bøhren (2013) definition where a business is a family business if the family owns over 50% of the shares. Where family is a group of people connected through marriage or through kinship in straight line or

sideline. Generally speaking, people who are married, in-laws or related to each other.

As we can see there are various definitions of what classifies a family firm, we find the European Commission's definition to be too broad, whilst Berzins and Bøhren is more specific and much more delimiting. Therefore, we will use the definition from Berzins and Bøhren's paper.

2.0 BACKGROUND

To give our paper context it is interesting to make a timeline showing developments and what generally has been research in regards to family firms and corporate governance. This is only a sort summary of when, what and conclusions from various authors throughout the years.

Questions regarding corporate governance, ownership structure and firm performance is not a modern concept. As we can see, these issues are something that has been researched ever since Adam Smith's *Wealth of Nations* in 1776.

In 1932, Berle and Means draw a conclusion stating that ownership and control should be separated.

In the following years, the issues regarding agency problems were highlighted, Jensen and Meckling wrote a paper in 1976, where they showed that there are multiple problems between the principal of a firm and the agents.

An article written by Pollak (1985) was written to understand what separated family firms from other firms with regards to performance. There is identified several advantages and disadvantages concerning the integration of family and firms.

Shleifer and Vishny (1986) found a positive relationship between block holdings and firm performance. Which they later in 1997 enforced when they stated that the positive correlation was due to the fact that large shareholders have a strong incentive to monitor management and thus reduce agency costs.

La Porta et al. (1999) points out some of the variations in ownership throughout different regions of the world. The article concludes that it often is a family, either the founder or its descendants, who is the controlling shareholder. They have also looked at owning cash flow rights versus voting rights, and indeed

found that families often have control over their firms beyond just cash flow rights. They point out that families often have ownership organized through pyramiding and that they also very often manage the firms they own.

In 2001 Faccio and Lang further enlightens the ownership structure in Western Europe. In fact, they conclude that Norway is amongst the countries with the lowest percentage of family ownership in Europe with 38,55% of companies under family control, only beaten by Ireland and UK with respectively 24,63% and 23,68%. This is also consistent with the findings in La Porta et al. (1999).

A paper in 2002 written by Brailsford et al. looks at the relationship between ownership and capital structure. The main finding from this paper is that there is a positive relationship between external block holders and leverage.

Closing in on more recent years there is an article written by Bertrand and Schoar (2006) regarding controlling family and that they are more likely to care about the firms long-run value.

Lins et al (2013) wrote a paper where they studied whether and how family control affects valuation and corporate decisions during the 2008-2009 financial crisis. They found that family controlled firms underperform significantly, they cut investment more relative to other firms, and these investment cuts are associated with greater underperformance. Their evidence is consistent with families taking actions to increase the likelihood that the firms under their control survive the crisis, at the expense of outside shareholders.

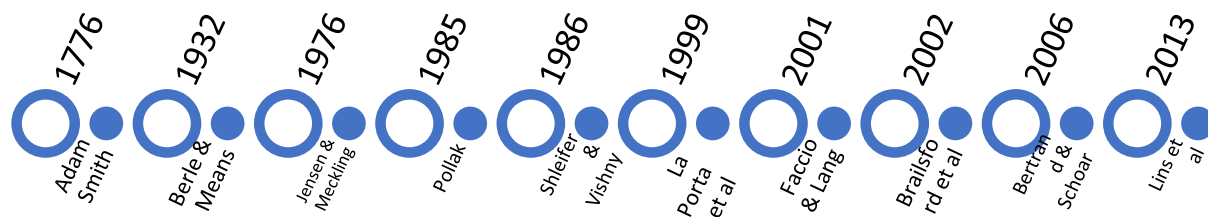


Figure 1 – *Timeline*

From the timeline above one can see that issues regarding ownership structure and family firms is a topic that has widely been researched since the dawn of firms. The above-mentioned theories will to different extents lay a basis for our further analysis and where the theory is relevant we will discuss it in a more broader sense. It is important to keep in mind that there are distinct differences between

countries. For that reason, one cannot automatically assume that the empirical researches that has been previously done regarding ownership structure will also automatically apply for Norway (Randøy and Koekebakker, 2002).

3.0 METHOD

Method relates largely on how one gets information and how this data will be analyzed. One can distinguish between two main types of methods, these are quantitative and qualitative methods.

3.1 Qualitative and quantitative method

Quantitative methods: Using quantitative method is about obtaining statistically figures, this is often presented in tables and / or graphs. The method provides little flexibility, but an advantage is that you get a great selection. The disadvantage is that the result includes limited information from each person who answers and the researcher does not have the opportunity to ask follow-up questions (Larsen, 2008). By this method it is possible to record a large amount of material so that one can read of contexts and tendencies. Execution of this method is often through polls and surveys (Hoffmann, 2013).

Qualitative method: This method contrasts with quantitative data harder to quantify. The qualitative method goes deeper into context, one can say that quantitative research identifies that something is happening, while qualitative research reveals why it happens. The qualitative concerns increasingly about people and the human phenomenon, and studying this. This is interesting when one wishes to examine things that one is not so familiar with (Johannesen, Christoffersen and Tufte, 2011). A disadvantage of the use of qualitative methods are interviewing effect. This means that some individuals may change their minds when they know they are in a situation where they are being observed. On this basis, it is important to consider that interview effect is a reality when interpreting data collected (Larsen, 2008).

This task will increasingly rely on quantitative information, in the form of collecting accounting numbers, key figures and other relevant information. The

qualitative method is used to confirm the quantitative information by executing some interviews of key individuals in the market.

This combination is called triangulation of methods which also helps to strengthen the credibility of the information (Johannesen, Christoffersen and Tufte, 2011).

In our survey, we have largely used quantitative method because we believe that it fits our mission best, but to support the quantitative analysis, we have also adopted qualitative method.

4.0 THEORETIC FRAMEWORK

To answer the research question, we must take use of various theories. Here we will set the research question into context with theories that will form our basis for answering the questions we have set out to answer.

4.1 Agency theory

We use Jensen and Meckling's (1976) definition on an agency relationship as a contract under which one or more persons (the principal(s)) engage another person (the agent) to perform some service on their behalf which involves delegating some decision-making authority to the agent. If both parties to the relationship are utility maximizers there is good reason to believe that the agent will not always act in the best interest of the principal. Where they also linked agency relationship to certain agency costs, such as the sum of:

- (1) The monitoring expenditures by the principal
- (2) The bonding expenditures by the agent
- (3) The residual loss.

Agency theory is important to consider in firms and is described well in articles like Jensen and Meckling (1976). They argue that there could be less conflicts in general because there is an alignment of interest with respect to growth opportunities and risk preferences.

Jensen and Meckling identifies four agency problems which could be present in a firm:

A1 – Shareholders versus Managers

Daily and Dollinger (1992) studies the effect agency theory has on family firms compared to professionally managed firms. They point out that when the owner is in a managing position, he or she would almost never pursue strategies which does not maximizes firm value. This implies that the first agency problem is mitigated because owner and manager are the same person. He also highlights the difference between professional and family in management. A professional manager is bounded by the employment contract, and rarely extends effort beyond this. If the firm goes under, the professional manager will simply find a new job. Family management however, are more tied to the survival of the firm. Daily and Dollinger further examines whether professionally firms rely more on internal control than family firms do. This can be viewed upon as a consequence of A1, the conflict of interest between owners and shareholder. Theory suggests this to be lower in family firms due to the link between ownership and managing. Their article concludes that professionally managed firms rely on the use of internal control than firms under family control do

A2 – Small shareholders versus large shareholders

Villalonga and Amit (2006) explains A2 problem to concerning situations where the large shareholder use its controlling position in the firm to extract private benefits at the expense of the small shareholders. If the large shareholder is an institution such as a bank, an investment fund, or a widely-held corporation, the private benefits of control are diluted among several independent owners. Thus, the large shareholder's incentives for expropriating minority shareholders are small, but so are its incentives for monitoring the manager, and thus we revert to A1. If the large shareholder is an individual or a family, it has greater incentives for both expropriation and monitoring, which are thereby likely to lead A2 to overshadow A1

As we can see, there is a presence of different agency problems that could potentially explain additional value to a family owned firm. Since families often manage the firms they own (La Porta et al., 1999), we will primarily focus on agency problem one (A1), and agency problem two (A2) for the rest of the thesis. It is worth mentioning that there are two other agency problems, where A3 is

regarding shareholders versus creditors and A4 is other stakeholders versus shareholders. As stated above, we will mainly focus on A1 and A2, therefore we do not find it beneficial to give the remaining two that much weight here.

4.2 Challenges in business

To have another basis for comparison we find it interesting to see a list The European Commission (2017) made in regards to main challenges faced by family businesses. This is for the purpose to see if these challenges is present in our data set.

- policy makers are unaware of the needs of family businesses and their economic and social contribution to society;
- access to finance and taxation issues
- the importance of preparing business transfers early;
- family governance - balancing family, ownership, gender balance rules, and business aspects;
- attracting and retaining a skilled workforce;
- entrepreneurship education and family-business-specific management training.

4.3 Advantages and disadvantages of the integration of family and firms

To enlighten how agency theory plays a role in family firms, we look closer into the article written by Pollak (1985). As stated above, this article was written to understand what separated family firms from other firms with regards to performance. There is identified several advantages and disadvantages concerning the integration of family and firms.

The **advantages** can be divided into four categories; incentives, monitoring, altruism and loyalty.

Incentives: is related to the fact that members of a family have claims on family wealth. When family members are either in a managing position or enforce strict ownership, their actions will affect family wealth, thus incentivizing them to maximize. However, in large families with equal sharing or in families with

preferred distribution of wealth, this effect tends to wear off. In the longer run, family members are expected to have claims on family wealth through their entire lifetime. This incentivizes decisions which focus on long term pay-offs rather than short term profit. In addition, family members may value family wealth beyond their lifetime, passing on wealth to the next generation. Furthermore, Pollak argues that underperformance or value destroying activities in a family firm may lead to family exclusion in addition to financial loss. This extra dimension acts as an incentive to minimize risk for the long run.

Monitoring: in regards to work patterns, lifestyle and consumption are more easily observed within the family. This effect is even greater if the family lives together or are relatively close. The intuition is that a family knows one another, and can therefore more easily observe for instance whether someone in a managing position is shirking or working hard, or if a member extracts private benefits from the firm at the cost of the shareholders (other family members).

Altruism: is based on affections and love between family members, such as the bonds between spouses or parent-child. Pollak argues that these kinds of relationships serve to limit opportunistic behavior within the family.

Loyalty: Family member who fulfill their duties gain benefits such as respect within the family which can give pride and satisfaction. Similar if one does not fulfill the family obligations, one is punished by loss of popularity within the family.

Pollak also lists four important **disadvantages**.

Firstly, in regards to decision making in the firm, since social and professional lives are not intertwined it can lead to conflicts within the family. Other literature (Davis, 1983) gives examples like sibling rivalry or conflicts between parents and children. A stable family may provide a stable foundation for managing a firm, but an unstable family can be destructive.

Secondly, altruism and affection may bias negative results, preventing that the correct actions are taken against underperformance or slacking of managers within the family. The ability to make objective decisions are often lost when good relations are on the line.

Thirdly, if there is a wish to keep family members in management, that wish may come at the expense of outside professional competence. Simply said,

just because one is related does not mean they have the necessary skills required to manage the firm well.

Lastly, the wish to keep the firm within the family may put limitations on the firm's size, resulting in the economies of scale necessary to stay competitive not being obtained. This can be illustrated by a large firm investing in costly machinery to produce a certain good at a low price. The family firm, due to its size and production volume, will simply not find it economically viable to do the same investments.

As seen above, there are several advantages of family governance that implies excess returns over non-family firms. However, conflicts within the family can arise, and it might result in family relations prohibit competitive performance.

5.0 MODEL

5.1 Description

We are to analyze whether one can add value to the firm just by having a different ownership structure than other comparable firms. From our research question, one can see that we believe that this family structure will lead to added value for a firm and it will be interesting to see whether this is true or not. To get a clearer picture of how we will test answer our research question we will look at different hypothesis and valuation techniques and try to see that in context of the theory we have chosen earlier.

To separate the data in this thesis we will first divide into two categories: Family firms and non-family firms. In these two categories, we have again divided into listed and non-listed firms, hereunder, the firms are divided based on firm size. The intervals for our analysis based on the fact that 99.5% of all Norwegian companies has less than 100 employees, and 93% has less than 10 employees (Regjeringen 2016).

We choose to do this to catch the whole specter to see if the value is more/less

depending on whether you are listed or not, and provide explanation as to why this is depending on the result from our analysis.

The intervals we will use for firm size in this model is:

- 0 – 19
- 20 – 99
- 100 <

5.2 Hypothesis and execution

For this section we have chosen to divide the hypothesis into one overarching hypothesis which will be the main hypothesis and added some subordinate hypothesis to try to explain what lies behind the numbers and conclusion for the overarching hypothesis.

Overarching hypothesis:

“Companies that are family owned have higher added value because of the structure of ownership”

To determine whether there is added value we will do a basic valuation of all firms and compare the results. Keep in mind that to be able to do this we compare only firms that are comparable in size and other factors. Here we will use DCF to get an overview if there is added value or not, then later we will use other hypothesis to see what factors that gave the added value.

Subordinate hypothesis (1):

“There is a higher return on total assets/equity (ROA/ROE) in family firms than in similar companies that are not family owned”

Here we will use multiples to compare the findings XXXXX

Subordinate hypothesis (2):

"Family firms have less growth than average similar firms"

To answer this hypothesis, we will look at ROIC

5.3 Data collection

When one is collecting the data it is important to remain objective, so that own feelings do not affect the outcome of the analysis, also known as understanding horizon (Johannesen, Christoffersen and Tufte, 2011). One usually have a sense of what is to be investigated and expectations of what the results are, therefore it is important to be aware that one not only collects data that support their own opinions, but rather a representative sample of what reality is. In line with the chosen topic it has been necessary to create our own primary data, to interpret the effects of having a family owned company.

5.4 Scope of family firms

5.5 Consistency conditions

5.6 Ratios

$$\text{Return on assets (ROA)} = \frac{\text{Net income}}{\text{Total assets}}$$

$$\text{Return on equity (ROE)} = \frac{\text{Net income}}{\text{Shareholder's equity}}$$

$$\text{Return on equity} = \frac{\text{Net profit margin} * \text{asset turnover}}{\text{Financial leverage ratio}}$$

$$\text{Return on invested capital (ROIC)} = \frac{\text{NOPLAT}}{\text{Invested capital}}$$

Return on invested capital measures the ratio of NOPLAT to invested capital. ROIC is the return the company earns on each dollar invested in the business. Since profit is measured over an entire year, whereas capital is measured only at one point in time, it is recommended that one averages starting and ending invested capital. ROIC is a better analytical tool for understanding the company's performance than ROE or ROA because it focuses solely on a company's operations. ROE mixes operating performance with capital structure, making peer group analysis and trend analysis less meaningful. ROA is an inadequate measure of performance because it not only includes non-operating assets but also ignores the benefits of accounts payable and other operating liabilities that together reduce the amount of capital required from investors (Koller, Goedhart and Wessels 2010).

$$\text{Debt to equity ratio} = \frac{\text{Total debt}}{\text{Total equity}}$$

$$\text{Financial leverage ratio} = \frac{\text{Average total assets}}{\text{Average total equity}}$$

6.0 REQUIRED RETURN

We need to calculate a required return such that we have a discount rate for the cash flows in the different periods. This is associated with much uncertainty, because the figures that the required return are based on is historical data, and therefore it is often normal to process the result in an interval approximately around the number the calculations has given.

6.1 Expected return

$$E(R_i) = R_f + \beta_i [E(R_M) - R_f]$$

Figure X – CAPM

$E(R_i)$: Return required on financial asset i

R_f : risk-free rate of return

β_i : beta value for financial asset i

$E(R_M)$: average return on the capital market

We will use the CAPM to calculate expected return, as seen from the formula above. The model looks at the relationship between risk and expected return to find a rate of return (Bøhren og Michalsen, 2012).

6.1.1 Risk-free rate

6.1.2 Market risk premium

6.1.3 Beta-coefficient

6.2 Weighted average cost of capital (WACC)

6.3 Evaluation of the return

6.4 Critique of the required return

7.0 ANALYSIS

In this section we will go through the analysis that has been done to answer each of the hypothesis and also the results.

7.1 Overarching hypothesis

“Companies that are family owned have higher added value because of the structure of ownership”

7.1.1 *Description*

7.1.2 *Results*

7.2 *Subordinate hypothesis (1)*

“There is a higher return on total assets/equity (ROA/ROE) in family firms than in similar companies that are not family owned”

7.2.1 *Description*

7.2.2 *Results*

7.3 *Subordinate hypothesis (2)*

“Family firms have less growth than average similar firms”

7.3.1 *Description*

7.3.2 *Results*

8.0 CONCLUSION

9.0 GENERAL CRITIQUE OF THE THESIS

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ATTACHMENTS

Attachment 1 – XXXX