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## Are founding families special blockholders? An investigation of controlling shareholder influence on firm performance



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#### ABSTRACT

This paper examines how family and non-family ownership affects the performance of Swiss listed firms from 2003 to 2010. We distinguish between these two types of controlling shareholders since they have different objectives. We hypothesise that only family shareholders have a real incentive to reduce agency costs whereas non-family blockholders are similar to widely held companies. Our results show that family firms are more profitable than companies that are widely held or have a non-family blockholder. For market valuations we find that the family stake plays a critical role and document a concave relationship between family ownership and Tobin's Q. We also investigate the impact of different features of family firms on performance, and document that the generation of the family and the active involvement of the family play an important role for market valuation.

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#### 1. Introduction

This paper examines how founding family ownership affects the market and accounting performance of public companies as compared to companies with other types of ownership structures. It pays special attention to three features of family ownership: the level of the family stake, the generation of the family and the degree of involvement of family members. The paper relates to the recent stream of empirical literature on the effects of concentrated ownership on firm performance.

Until recently, the dominant paradigm in academic literature was that most public companies were widely held. The main challenge was to provide remedies to the classical agency problem present in such corporations. Berle and Means (1932) and later Jensen and Meckling (1976) are among the first to state that the separation between ownership and control can cause problems and incur important costs to shareholders. However, a series of recent studies on ownership structure reveals that in most markets a large number of listed companies do not have a widely dispersed ownership structure. In general, they have one or more large share-

holders that can be categorised as families, states and other industrial or financial companies. Among these types of owners, family firms appear to be the most common form of ownership. In an international study, La Porta et al. (1999) find that 30% of firms are family controlled while 36% are widely held. Faccio and Lang (2002) show that family firms are the predominant ownership structure in continental Europe wherein 44% of the companies are family controlled. They also show that firms with non-family blockholders represent 20% of the sample. Claessens et al. (2000) observe that in Asian countries approximately two-thirds of firms are owned by families or individuals. Even in the US, a market considered to have a majority of companies with a dispersed ownership, Anderson and Reeb (2003) establish that around 35% of companies in the S&P 500 are family controlled. This result has extensive repercussions on agency conflicts between owners and managers. This new view on ownership structure calls for a careful analysis of the consequences family ownership has on agency theory and company performance. Early literature on family firms finds that these firms seem to be more profitable and have a higher market valuation than non-family firms. It seems therefore that family ownership might be a way to reduce agency costs existing between managers and shareholders, and thus contribute to more value creation. The potential benefits associated with the presence of a majority shareholder are not new. Berle and Means (1932)

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already considered this possibility. Such a shareholder would have a far bigger incentive to control management since a large part of his wealth is invested in the company. As a result, every shareholder would benefit from this situation.<sup>1</sup>

The presence of a large shareholder can diminish or at least not aggravate the classical conflict between firm owners and managers, and thus reduces agency costs (agency costs I). However, the potential benefits of having a large shareholder in a company can be limited by the appearance of another type of agency problem. Large shareholders can use their power (in terms of votes and insider knowledge) to extract private benefits from the company. This will result in agency costs shifting from those between managers and owners to those between large shareholders and minority shareholders (agency costs II), which might be even more detrimental to minority shareholders. The extraction of private benefits is in the centre of this problem. Since the seminal paper of Grossman and Hart (1980), different authors have tried to quantify the magnitude of private benefits. Based on a sample of 39 markets worldwide, Dyck and Zingales (2004) observe that, on average, private benefits of control amount to 14% of equity value. These results indicate that agency problems between large and minority shareholders are a relevant issue. Problems are aggravated by the fact that many classic corporate governance mechanisms such as takeover threats or monitoring from institutional investors may become partly or completely ineffective especially if the controlling shareholder exercises a management position in the company or holds a majority stake. This position of knowledge and therefore power will also translate itself into the possibility to extract private benefits. From a theoretical point of view, it is not clear which of the two effects prevails in companies with a large shareholder. An increased monitoring of management that results in a better alignment of interests between owner and manager is positive, while the extraction of private benefits or entrenchment of a large shareholder is harmful to minority shareholders.

We believe that it is essential to consider the identity of the controlling shareholder and especially the distinction between family and non-family blockholders to determine which of the two effects prevails. Different types of blockholders have different incentives and motivations that will affect their way of perceiving the company and minority shareholders. Considering family firms, Arregle et al. (2007) suggest that families do care about their companies as they constitute the majority of their wealth and are part of their identity and patrimony. This and the fact that the reputation, professionalism and perception of the family within its social environment are directly linked to the company works as a strong incentive to follow a long term strategy and behave in a way that is not purely self-centred (Ward, 2004; Miller and Le Breton-Miller, 2005). Thus, family members may expropriate less as their main interest is not primarily pecuniary (Corbetta and Salvato, 2004) and may control outside managers more thoroughly. It is therefore likely that agency costs I and II are of less importance in these firms. For companies with other types of large shareholders, the above-mentioned incentives are less stringent. For example in a company in which the state is a large shareholder, the person representing the state does not have as high an incentive to monitor managers as a family member. He himself is only an employee of the state and as such his own wealth is not directly affected by suboptimal decisions of company management. Moreover, this person will probably have other mandates that will ask for his time, and he will not be able to fully concentrate on a specific company. Furthermore, negative news will not impact him as much as it would a family that is closely linked to the company and for whom company reputation equals family reputation. We consequently posit that family companies will behave very differently from companies with non-family blockholders which should have an impact on firm performance. Despite the considerable research conducted in the field of family business, the distinction between the family and non-family blockholder has not attracted much attention yet.

In this paper, we try to fill this gap by using panel data over the period 2003-2010 for a comprehensive sample of companies listed on the Swiss exchange. The Swiss market is characterised by a high ownership concentration, with owners ranging from founding families to private investors, the State or other corporations. The law and finance literature relates concentrated ownership to the quality of legal protection of investors provided by the commercial law of a country. La Porta et al. (1998) observe that Switzerland is a German-origin civil law country and find that it offers relatively weak investor protection. Switzerland, moreover, ranks low on the anti-self-dealing index proposed by Djankov et al. (2008). These results indicate that minority shareholders are potentially exposed to private benefit extraction by controlling shareholders. However, despite this low investor protection environment, the Swiss market is a very developed financial market according to several indicators. For instance, the total market value to GDP ratio, is the second highest in the world after Hong Kong. This can be explained by the fact that Switzerland is a small open economy with a limited scope to grow domestically. It, therefore, has to create a favourable business environment to attract foreign capital and at the same time companies have to look abroad to expand their market and spur their growth. This might lead to the voluntary adoption of good corporate governance practices that go beyond law requirements and/or to lower levels of rent extraction to attract international capital. In this specific corporate governance context the impact of a family shareholder on firm performance is an open

In view of the above, we examine whether founding family owners have a different impact on accounting and market-based performance as compared to companies with a different blockholder type. In our research, we consider Tobin's Q and Return on Assets (ROA) as performance measures. Employing a fixed effect model, we analyse the different characteristics of founding family firms to study the difference in performance. First, special emphasis is put on active management and generation of family members. The employment of family members as CEO or as Chairman should have an influence on performance, as a family member's decisions can have a strong impact on the company. It equally helps the family to either better control outside managers and therefore mitigate agency costs I, or to extract even more private benefits which would increase agency costs II. Generational differences might equally impact performance as descendants might have different motivations and values than founders and be more prone to expropriation. We also examine the distinction between companies with a single individual or with multiple founders or family members having a key role in the firm. Furthermore, we take a closer look at companies in which families have a very large stake (more than 80% of voting rights) as this might increase agency costs II as nobody can contest their decisions, and they are free to do what suits them best.

Our main results show that founding family firms (i) systematically have a higher accounting-based performance as compared to widely held companies and those with a non-family blockholder and (ii) do not have a higher market-based performance than non-family firms. We also find that the effect of family ownership on firm performance appears to be different depending on the percentage of voting rights controlled by the family. It appears that

<sup>&</sup>lt;sup>1</sup> An alternative view on the presence of a majority shareholder is proposed by Demsetz (1983). He argues that ownership concentration does not have an influence on firm value and that companies choose the form of ownership that minimises agency costs. This approach is further developed by Himmelberg et al. (1999) and Demsetz and Villalonga (2001).

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