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How do managerial successions shape corporate financial policies in family firms?

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ABSTRACT

Despite recent evidence on the importance of chief executive officer (CEO) successions in family firms, we still know little about the differences in corporate strategies entailed by family and professional managers around transition. We investigate the consequences of managerial successions for the financial policies of Italian family firms. Our findings indicate that the appointment of non-family professional CEOs leads to a significant increase in the use of debt, primarily driven by short-term maturities. We document substantial heterogeneity in the impact of professional successions on debt financing: the increase in debt is particularly pronounced for young firms, firms with a high level of investment, and firms in which the controlling family maintains a dominant representation on the board of directors. Examining the importance of financial flexibility, we find that the increase in debt occurs primarily when firms are cash-poor, and when incoming CEOs can exploit spare borrowing capacity.

1. Introduction

Top executives have long been considered a key determinant of a firm's strategies (Bertrand and Shoar, 2003) and ultimately of its corporate performance (Bennedsen et al., 2009; Hambrick, 2007; Hambrick and Mason, 1984). As such, the selection of a new CEO represents one of the most critical decisions for a firm's future direction and effectiveness (Shen and Cannella, 2002, 2003; Zhang and Rajagopalan, 2004, 2010).

Because of the role played by family ties, personal objectives and conflicts on a firm's organization and governance (Bertrand et al., 2008; Bertrand and Shoar, 2006), the choice of appointing either a family or a professional CEO has acquired special meaning in family firms. On the one hand, the typical overlap between executive and ownership positions at the apex of families makes successions a traumatic moment (Gomez-Mejia et al., 2001) posing a threat to factors such as longer investment horizons, reputational concerns and diminished agency conflicts between managers and owners, which often lead to superior performance compared to non-family firms (Anderson and Reeb, 2003a; Andres, 2008; Maury, 2006; Sraer and Thesmar, 2007). On the other hand, naming a family heir to enjoy the private benefits of control might be an inferior decision in terms of managerial talent (Perez-Gonzales, 2006), inducing lower performance (Villalonga and Amit, 2006) and productivity (Barth et al., 2005).[1]

Motivated by such arguments, a growing literature compares the impact of incoming family heirs and professional CEOs on firm performance around transition (Bennedsen et al., 2007; Cucculelli and Micucci, 2008; Perez-Gonzales, 2006). While this

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[1] Revisiting this strand of research, Miller et al. (2007) argue that whether family firms outperform non-family firms hinges crucially on the definition of family firm and the governance variables considered.

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evidence demonstrates that successions outside the family are typically associated with an improvement in operating returns, we still know little about the differences in decision-making between family and professional CEOs in family firms.

In this paper, we start by testing the differences between family and blood-unrelated professional CEOs on corporate financial policies around transition. We then investigate how firm and governance characteristics matter in shaping the effect of professional CEO appointments on financial policies. Finally, by employing professional successions to identify changes in a firm's investment opportunity set, we examine in the context of family firms the recent notion that financial flexibility and unused debt capacity are helpful to enhance investment ability and firm performance through subsequent debt financing (Denis and McKeon, 2010; Mura and Marchica, 2010). The empirical analysis is conducted on a unique dataset covering listed and unlisted Italian family-held companies. Despite family's influence on the corporate sector in Italy is pervasive (Faccio and Lang, 2002; La Porta et al., 1999), Italian family firms remain significantly underexplored, mainly because of the lack of reliable data for privately-held firms.[2] Yet, Italy represents a unique setting to investigate family firms and, in particular, their capital structure decisions. While family firms in other institutional settings have been found to maintain a low leverage (see Bach, 2010 for France and Bennedsen et al., forthcoming for Denmark), anecdotic evidence indicates that Italian family businesses have historically adopted a high-debt policy as a source of financing. For example, *The Economist* (March 2nd, 2000) writes that "Typically, Italian entrepreneurs have been loth to surrender even a small part of their equity capital to stock market investors. Instead, financing came from cash flow or bank loans".[3] This picture is in line with cross-country evidence in Ellul (2008), who argues that families shape firms' capital structure by trading off the need to raise external finance and the aversion to diluting control through equity issuances; debt represents a suitable solution being a source of finance that does not dilute control.

Applying difference-in-differences models, we show that professional transitions lead to a much more aggressive debt policy: firms controlled by families and headed by professional CEOs experience, on average, a 6.5% leverage increase around transition. This effect is robust to the inclusion of several controls that are considered to influence debt choices. Moreover, the result remains after we conduct several robustness tests, including the adoption of a propensity-score matching strategy (as in Cucculelli and Micucci, 2008) to mitigate concerns about endogeneity.

Our interpretation is based on the view that CEO successions exacerbate capital structure decisions in family firms. Managers selected from outside the family typically have superior skills (Bennedsen et al., 2007; Caselli and Gennaioli, 2005; Perez-Gonzales, 2006) and thus are better able to bring on attractive growth opportunities after the transition. Chua et al. (2003) argue that "nonfamily managers are necessary for the firm to grow and may, in fact, accelerate that growth by providing needed skills and new ideas". For a family that hires a professional manager to drive company's growth while being reluctant to issue equity and lacking enough internal resources, the use of a security that does not dilute control such as debt should be more intense. Thus, the debt increases we document may reflect a need for funds to cope with the expansion of a firm's investment opportunity set determined by incoming professional CEOs. In line with this interpretation, we find that, while professional CEOs foster investment for the average firm, there is a positive and significant association between debt increases and investment around transition. This result is consistent with recent evidence that debt increases often are a response to operating needs, mostly associated with investment (Denis and McKeon, 2010). Also, we find that debt ratios increase more among young firms, which typically have a high growth potential, and firms in which the family plays an active role in managerial decisions through the board of directors. When analyzing debt maturities, we find that the increase in leverage stems from short-term debt, in line with existing evidence (Barclay and Smith, 1995; Johnson, 2003) that shorter maturities are particularly suited for firms with growth opportunities.

Previous research shows that excessive debt financing may ultimately expose firms to bankruptcy risk and ex-ante underinvestment (Myers, 1977). We find that the positive impact of professional CEO successions on leverage arises primarily among firms that attain spare debt capacity in the pre-succession period. As recently argued (Denis and Sibilkov, 2010; Faulkender and Wang, 2006), liquidity holdings represent an alternative channel to ensure financial flexibility and enable firms to invest in value-enhancing projects, especially when other sources of finance are too costly or not available. Consistent with this notion, we find that, while existing liquidity does not differ between succession types, the increase in debt is higher for firms that are cash-poor in the pre-succession period.

Succession models may affect debt for reasons different than the combination of investment opportunities brought on by professional CEOs and constraints imposed by control-motivated families on the type of funds chosen to finance growth. From an agency perspective, leverage can be used as a device to limit managerial slack (Jensen, 1986) or informational risks associated with non-family management, which may be relevant in a multiple agency perspective (Bruton et al., 2010; Filatotchev et al., 2011). Also, family owners might shape leverage to limit corporate risk undertaken by professional CEOs. In an attempt to explore these alternative hypotheses, our results show that debt increases do not significantly differ between firms with high or low overinvestment potential, as proxied by the level of assets in place (Harvey et al., 2004) prior to succession. Moreover, we find that debt increases do not relate to changes in profit volatility around transition, in line with the evidence in Anderson and Reeb (2003b) that families do not seem to significantly influence a firm's capital structure as a risk reduction strategy.

[2] A few recent exceptions are Cucculelli and Micucci (2008), who collect survey data on small manufacturing firms to analyze the impact of family successions on profitability, and Minichilli et al. (2010), who use survey data to test how top management teams contribute to family firms' performance. However, none of these works analyzes financial flexibility and capital structure decisions.

[3] More recent evidence along this line is provided by the 1st Report of the "AUB (AIdAF-Unicredit-Bocconi University) Italian Observatory on Family Firms", (2009).