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Family firms and financial performance: The cost of growing

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ABSTRACT

This study examines the relationship between financial performance and family involvement for 523 listed and non-listed Colombian firms over 1996–2006. Using a detailed database and performing several panel data regression models, we find that family firms exhibit better financial performance on average than non-family firms when the founder is still involved in operations, although this effect decreases with firm size. With heirs in charge, there is no statistical difference in financial performance. Both direct and indirect ownership (control through pyramidal ownership structures within family business groups) affect firms' financial performance positively. However, this positive effect decreases with firm size. The results suggest that some kinds of family involvement appear to make firm growth expensive.
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1. Introduction

Financial research highlights the prevalence of family firms worldwide as an important component of capital markets even in the most developed economies. Accordingly, numerous studies examine problems of ownership, management, and control that emerge from this organizational structure. An important open question in the literature is whether and how family management, ownership, and control affect firms' financial performance. The international evidence is mixed. From the agency theory perspective, combining ownership and management could prove advantageous, given the alignment of interest between shareholders and managers, and several studies show that family businesses exhibit better

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financial performance on average than non-family businesses, even those with other types of majority shareholders.

Other studies link family businesses with poorer financial performance. For instance, families may value firm survival over wealth maximization, viewing their firm as a valuable asset to pass on to future generations. Or families favoring firm growth might employ investment rules other than wealth maximization. Of course some of these mixed results could come from the absence of a widely accepted definition of what a family firm really is.

Rather than employing a single definition for family firms, we build our argument by examining the relationship between financial performance and family involvement in each of three dimensions: management, ownership, and indirect control following the approach of Villalonga and Amit (2006). Our study examines the effect of family involvement on performance based on a comprehensive dataset of Colombian firms, for the most part non-listed, yet covering this emerging economy's largest non-financial business groups. We gathered information for the eleven-year 1996–2006 period on 523 domestic firms (5,094 firm-year observations); 120 (20 percent) of the firms are security issuers (bonds or stocks) and about 90 percent of the sample is represented by affiliate firms.

The central finding of this study is the existence of a non-monotonic relationship between firm performance and family involvement. Econometric results show the positive effect of family involvement is robust when firms are small and young, especially when the founder is still active in management; but as firms grow, the results suggest family involvement must be avoided to increase efficiency and improve overall corporate governance practices.

This work contributes to the literature on corporate governance of family firms in several ways. First, the study is among the very few to use a sample of mainly private firms; hence our findings go beyond previous studies of financial performance of family-controlled firms (Anderson and Reeb, 2003; Villalonga and Amit, 2006; among others), featuring samples of large, listed firms.

Second, even though the sample is restricted to Colombia, this paper contributes to better understand family-firms for emerging markets in general. Family-firms are an important yet highly understudied subject, as noted in recent surveys of the state of corporate governance research for emerging markets (Claessens and Yurtoglu, in press; Fan et al., 2011; Kearney, 2012). Most family-owned firms are privately-held and firm level data are not publicly available. Colombia institutional characteristics make access to this information available for this paper.[1] Moreover, Colombia is a representative capital market in Latin America from a financial development perspective; Colombia features the fourth largest equity market in the region, and has been included in the CIVETS[2] group of countries.

Third, this is among the first studies on corporate governance of family firms for a Latin American country, based on firms' level micro-data with detailed information on management, ownership and control, board structures, and financial characteristics.

Colombia is not different from other Latin American and emerging countries in terms of the quality of its corporate governance. La Porta et al. (1997) discuss a cross country comparison regarding anti director rights, listed firms to country population, and external capitalization to the country GNP, among others. Colombia showed a low anti director rights index (1 of 5 possible points), similar to Egypt, Ecuador, Mexico, Turkey, Uruguay, and Venezuela. The external capitalization to the GNP was lower than 0.2 and similar to Argentina, Brazil, Indonesia, Turkey and Venezuela; and the number of listed firms per capita (million) was 3.13 and similar to Argentina, Brazil, Egypt, Mexico, Indonesia, Turkey and Venezuela. La Porta et al. (1998) also show a high level of ownership concentration for Colombia (0.68 of ownership by three largest shareholders) similar to Brazil, Egypt, Indonesia, Mexico, Turkey and Venezuela.

With more recent data, Chong and López-de-Silanes (2007) state that the implementation of corporate governance reforms in Colombia has been poor and do not seem to be fostered by the average Colombian

[1] One exception is Bertrand et al. (2008) for Thailand that collects information of complete family trees over 90 business groups and also assesses family ownership and control on firm performance; another is González et al. (in press) who studied the impact of family involvement on firms' capital structure in Colombia.

[2] According to The Economist Intelligence Unit (EIU), Colombia is part of a second generation of emerging markets with an increasingly young population, controlled inflation and a stable financial system. Some economic analysts are expecting that this second tier of emerging countries, after the BRICs (Brazil, Russia, India and China), will drive growth over this decade. This group of countries was called The CIVETS (Colombia, Indonesia, Vietnam, Egypt, Turkey and South Africa) by Robert Ward, Global Forecasting Director for the EIU.

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