The role of corporate philanthropy in family firm succession: A social outreach perspective

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\textbf{ABSTRACT}

We propose and test a social outreach hypothesis of family firm succession. We argue that family firms proactively engage in social outreach activities as a strategy to ensure smooth succession. We focus on corporate philanthropy (CP), a social outreach activity, in a family firm succession to test our hypothesis. The results show that family firms engage in a strategy of using more CP in connection to family firm succession, especially when the successor is from the second generation. The findings are robust to alternative specifications of CP activities, various sub-sample analyses, using a difference-in-differences analysis, a two-stage least square approach, strategic choice on timing of succession, and accounting for the successor’s education and experience of working for the family firm before succession. We document that despite generally poorer performance after succession, a family firm with a second-generation CEO that engages in CP exhibits better market and accounting performance relative to other types of transitions, suggesting a strategy in which CP reduces the magnitude of poor performance after succession.

\section{1. Introduction}

Family firms make up a significant part of their respective economies. Anderson and Reeb (2003) show that 35% of Standard & Poor’s 500 firms are family owned in the US. The proportion of family ownership among public firms rises to 67% in East Asian countries (Caessens et al., 2000). These firms are an integral part of an economy and their success contributes to the economic development of their countries. The most important feature of family firms is their control by founders and/or their family members.

Burkart et al. (2003) note that the largest challenge for family firms is succession, especially those between genera-

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cialized asset preservation in the succession (Bennedsen and Fan, 2014; Bennedsen et al., 2015; Xu et al., 2015). However, few studies examine the social outreach behavior of a family firm during the succession process. Engaging in social outreach activities is a strategy that can preserve a family firm’s specialized assets and enhance the successor’s visibility, such as its social image and social networks, and improve or build new relational and reputational capital. Hence, these social outreach activities can ease the transition challenges, especially those involving generational transfers. We argue that to preserve or enhance a family firm’s performance during the succession and raise the visibility of the successor, a family firm uses social outreach activity as a strategy to enhance its chance of success in the transfer. As explained later, the strategy is particular useful when the transfer is between generations. We examine the social outreach hypothesis of family firm succession using a sample of Chinese family firms.

The transfer cost and business road map hypothesis of Bennedsen and Fan (2014) and Bennedsen et al. (2015) presented part of the conceptual framework that was used to develop our hypothesis. Bennedsen and Fan (2014) and Bennedsen et al. (2015) suggest that the transfer of specialized assets between generations is critically important during the succession process. The authors contend that specialized assets are intangible and firmly tied to the founder (or the current family member CEO) of the family firm. Given the nature of intangible assets, it is costly to transfer these assets between individuals. A successful family firm generational transfer requires lowering the transfer cost of specialized assets so that the successor can seize a significant portion of the value of these specialized assets. In Bennedsen et al. (2015), a family firm faces a road map in which the firm needs to organize the specialized assets and overcome roadblocks to ensure a successful succession. The transfer cost and family road map hypothesis indicate the importance of specialized assets and the cost associated with the generational transfer in the family firm succession. In addition to the specialized assets argument, the strategic CP literature (e.g., Sánchez, 2000; Saia et al., 2003; Zhang et al., 2010a, 2010b; Wang and Qian, 2011) suggests that CP can raise the visibility of a firm. Knowing a potential challenge in the family firm succession, we argue that the successor will use CP to preserve the value of specialized asset as well as raise her visibility, i.e., the successor conducts social outreach activities to smooth family firm transition. Both specialized asset preservation and visibility are channels of our proposed social outreach hypothesis.

Our social outreach hypothesis advances the work of Bennedsen and Fan (2014) and Bennedsen et al. (2015) and the related strategic CP literature. A strategy of engaging in social outreach activities raises the profile of the firm, attracts positive publicity, and helps the successor to enhance her visibility. All else being equal, these social outreach activities help the successor keep or enhance the relational and reputational capital (one of the most important specialized assets) established by the founder as well as let the successor to be more visible in the business community. Therefore, we posit that family firms proactively implement social outreach activities to encourage the successor to preserve or enhance the values of these specialized assets and enhance her personal visibility. Social outreach activities are particular useful during the first year of the new successor so that the family firm can facilitate a smooth transition. That is, social outreach activities make two contributions in a family firm succes-

1 For instance, De Vries and Miller (1984) contend that, due to age and experience differences, second-generation successors and founders may have a tense relationship. Smith and Amoako-Adu (1999) suggest that the market casts doubt on the ability of the second generation in family firms. Hence, the stock price reacts negatively when succession announcements are made.

sion. First, it helps to lower the transfer cost of specialized assets. Second, it enhances the successor to be more visible in the business community. Both channels can lead to a smoother family firm generational transfer. Our hypothesis is also consistent with the strategic CP literature. We note that visibility and preservation of specialized assets are not mutually exclusive. They both contribute positively to the family firm succession. Dyck et al. (2008) show that visibility and reputation are related. When the family firm or the successor has high visibility, the reputation cost to the firm is high. Our social outreach hypothesis describes how a family firm uses CP to smooth a family firm succession. The CP can help to raise the visibility of the successor and the family firm as well as helping the successor to preserve a founder’s specialized assets.

To test the social outreach hypothesis, we use corporate philanthropy (CP) to quantify a family firm’s social outreach activities and examine the role of CP in a family firm succession. CP is a direct and quantifiable social outreach activity. In sum, CP can help the newly appointed CEO preserve the values of specialized assets from the founder or earlier generations and raise the visibility of the successor. Overall, CP activity is a good social outreach strategy and is helpful in a family firm succession. Hence, the social outreach hypothesis predicts that (a) family firms with succession engage in more CP than those without succession, especially for firms with second-generation succession; (b) ceteris paribus, a family firm’s level of CP is positively correlated with its future performance due to better preservation of the value of specialized assets.

There are three different forms of successions among first-generation family firms: (a) the founder transfers control to an outside professional manager; (b) the founder transfers control to another first-generation family member, such as a brother, sister, or spouse; and (c) the founder transfers control to a second-generation member. Among the three forms of successions, we argue that the transfer from the first to second generation, in particular, requires more assistance for the preservation of relational and reputational capital to maintain the value of specialized assets and bring visibility because the second generation is usually younger and more inexperienced relative to a professional manager or a first-generation family member; thus, her own relational and reputational capital is weaker than those in other types of transfers. Thus, if a family firm does nothing, the value destruction for specialized assets is highest for the second-generation succession among the three forms of successions. Similarly, the second generation needs more help to raise her visibility. Thus, CP is a natural tool to do so. Therefore, the social outreach hypothesis also predicts that the use of social outreach activity as a strategy is the most popular for the second-generation successions.

We use a sample of Chinese firms from 2004 to 2013 to test the social outreach hypothesis.

The Chinese environment offers a powerful setting for our investigation for three reasons. First, family firms do not have a long history in modern China. Many Chinese family firm founders started their businesses in the 1980s and 1990s after economic reform was implemented in the 1980s. A significant portion of these successful founders began to conduct family firm succession transitions from 2004 to 2013. Hence, we see a good mix of family firm successions and no successions. Moreover, firms engaged in succession transitions shift control from founders to professional managers and to other first-generation family members or second-generation members. Unlike other countries, few cases of multi-generation successions in China have been seen. Second, for first to second generation succession, the one-child policy in China leaves the founder with no choice but transfer control to a single heir (Xu et al., 2015). Inighting among different heirs seldom occurs. Therefore, the Chinese samples do not have the complications of value destruction due to conflicts among second-generation fam-
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