



## Investment policy in family controlled firms

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### ARTICLE INFO

#### Article history:

Received 17 February 2011

Accepted 26 January 2012

Available online 8 February 2012

#### JEL classification:

G3

L2

K2

M4

#### Keywords:

Family business

Dual class shares

Founders

Heirs

Long-term investments

R&D spending

Capital expenditures

### ABSTRACT

We explore the relation between family ownership and corporate investment policy. Our analysis centers on two incentives, risk aversion and extended investment horizons, which potentially influence the level and type of investments that family firms undertake. We find that family firms devote less capital to long-term investments than firms with diffuse ownership structures. When dividing long-term investment into its two components of R&D and capital expenditures, we note that family firms, relative to nonfamily firms, prefer investing in physical assets relative to riskier R&D projects. Additional tests indicate that family firms receive fewer patent citations per dollar of R&D investment relative to nonfamily firms. Overall, all empirical results indicate that family preferences for lower firm risk, across all family subtypes, affects corporate R&D spending and capital expenditures.

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### 1. Introduction

Finance literature highlights the conflicts of interests that potentially arise between large, powerful owners and the firm's other stakeholders (Crocchi and Petmezas, 2010). For instance, Fama and Jensen (1985) note that large, undiversified shareholders may favor investment rules based on their own risk preferences rather than the market-based rules preferred by nonfamily shareholders. Gompers and Lerner (2000) suggest that influential short-term owners prefer to invest in projects that correspond to their own investment horizons while discounting the interests of other shareholders. Yet, others note that large, influential owners can mitigate agency problems amongst firm stakeholders. Edmans (2009) argues that the presence of blockholders alleviates managerial pressure or incentives to pursue myopic investment decision. Overall, prior literature indicates that large shareholders use their power and influence to affect corporate decision-making; in some instances, extracting private benefits from the firm and in other

instances, providing benefits to the firm's other stakeholders (Berkman et al., 2009).

We explore the relation between large shareholder ownership and corporate investment policy by focusing on the effect, if any, of family shareholders on firms' investment decisions. Families constitute a prevalent and persistent class of large, concentrated shareholder in US publicly-traded firms. Anderson et al. (2009) for instance, observe that families continue to hold substantial ownership positions in nearly one-half of the largest 2000 industrial firms in the US, even decades after going public. These ownership positions thus represent the holdings of long-term, concentrated investors with arguably different incentives relative to managers or shareholders in firms with diffuse equity-ownership structures. We examine two incentives that potentially lead to differences in investment policy between family firms and non-family firms; risk aversion and extended investment horizons.

Family owners represent an important type of large shareholder maintaining an undiversified or concentrated ownership stake in a single firm. Shleifer and Vishny (1986) observe that large, undiversified shareholders may force the firm to seek low risk projects and avoid high risk activities, thereby imposing costs on well-diversified outside shareholders. Compared to nonfamily firms, we argue that family firms can have a particularly strong influence in mitigating firm risk by affecting the firm's long-term investment

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decisions. We focus on both components of corporate investment that regulators require firms to disclose in their accounting reports, namely R&D spending and capital expenditures. Kothari et al. (2002) indicate that R&D spending has a substantially greater impact on firm risk than does capital expenditures, suggesting that it should be particularly sensitive to family risk aversion.

Yet, families' long-term and continuing commitment to their firms potentially indicates an opposing effect. The popular press and academic literature often depict these owners as maintaining long-term horizons that provide powerful incentives to commit substantial financial resources to long-term investment activities. Monitoring of the firm and management by these large, influential shareholders potentially gives rise to longer investment horizons relative to nonfamily firms. Moreover, Anderson and Reeb (2003) indicate that family monitoring reduces asymmetric information problems between shareholders and managers, suggesting that monitoring overshadows any risk aversion tendencies the family may possess. Coupled with families' horizons, this viewpoint suggests that family firms should invest more in R&D because of the opaque nature of the R&D process and families' informational advantage in monitoring. Although the risk preference perspective implies that family firms commit fewer financial resources to long-term investment activities relative to nonfamily firms, the horizon argument indicates that family firms commit more resources to investing activities than nonfamily firms that are controlled by unfettered, myopic managers. We explore family owners' dominant effect – risk aversion or long investment horizon – on firm investment policy.

Using the 2000 largest non-financial, non-utility firms in the US from 2003 through 2007, we find that families hold ownership positions in over 38% of these firms, based on a minimum 5% ownership threshold. Family shareholders hold an average equity stake of nearly 26% of the firm's shares, have maintained these large positions for over 40 years, and exist in all SIC industries. Our empirical analysis indicates that family firms devote fewer financial resources to long-term investing than nonfamily firms even after controlling for differences in financing constraints and industry composition. Relative to nonfamily firms, we find that family firms spend about 7.50% less (as a fraction of total assets) on long-term investments. Our analysis also segregates family firms into distinct sub-components of lone-founder firms and multi-member family firms.<sup>1</sup> The results indicate that both firm types exhibit a negative and significant relation to total investment. An *F*-test indicates however, that lone-founder firms have a significantly larger effect in moderating total investment (*F*-value = 5.29/*p*-value = 0.02) than multi-member family firms. In additional analysis, we examine whether active family management (founder CEO, descendant CEO) versus passive family management (outside, professional CEO) exhibits an incremental influence on firm investment decisions (Anderson and Reeb, 2003). Beyond the general family ownership effect, our tests indicate that CEO type does not exhibit a significant relation to total firm investment.

To further differentiate between the risk aversion and long horizon hypotheses, we examine the investment patterns in firms characterized as high- and low-risk. The results of our analysis indicate no differences in investment patterns between family firms and nonfamily firms that are characterized as low risk. Amongst higher-risk firms however, we document a particularly strong propensity for family firms to limit investment spending relative to nonfamily firms; providing evidence generally consistent with the risk aversion hypothesis.

Focusing on the two components comprising long-term investments, the results provide strong support to the notion that family ownership affects the level of investment in R&D spending and capital expenditures. We observe that as a fraction of total investment, family firms commit significantly less capital to R&D investments than nonfamily firms – about 31% less than nonfamily firms. Additional tests indicate that family firms commit more resources to capital expenditures than nonfamily firms. When comparing R&D and capital expenditure investment patterns between lone-founder firms and multi-member family firms, we note no significant differences between the two groups. However, when segregating R&D expenditures based on CEO type, we note that firms with descendant CEOs appear to be associated with less R&D spending than other types of CEOs (founder or professional manager) and nonfamily firms. Overall, our empirical results indicate that family firms – across all categorizations – commit less (more) capital to R&D (capital) expenditures than nonfamily firms; suggesting that family owners prefer less risky capital expenditures to riskier R&D projects.

Research on family firms often treats family ownership as exogenous. Yet, family ownership is not randomly distributed across firms (Anderson et al., 2012). Modeling family ownership as a function of the benefits of private control using data from US Census Bureau (Helwege and Packer, 2009), we again find that family firms (and lone-founder firms and multi-member family firms) devote fewer financial resources to long-term investing than nonfamily firms. Although our diagnostic tests suggest our IV-2SLS specifications mitigate endogeneity concerns in the relation between family ownership and corporate investment policy, we cannot rule out the notion that these controlling owners stay in the firm because of the firms' investment prospects. If family owners maintain their equity stakes because of the firm's low-risk investment patterns, our results importantly indicate that outside shareholders bear no adverse impact from the firm's investment policies. Still, these tests suggest that risk-aversion appears to be a primary force affecting family owners' investment patterns, rather than the long horizon perspective as often articulated by the popular press.

Our finding that family firms devote fewer financial resources to R&D investments than nonfamily firms provides evidence consistent with the risk aversion hypothesis. However, an alternative explanation for these findings suggests that influential-shareholder monitoring improves investment efficiency; thereby allowing family firms to spend fewer dollars on R&D projects to achieve similar outcomes. Families, as strong, committed monitors – absent in nonfamily firms – may play an especially important role in overseeing and ensuring productive and efficient R&D expenditures. To investigate this proposition, we examine whether outcomes of R&D efforts differ between family firms and nonfamily firms using patent and patent citation data (Hall et al., 2005). The analysis indicates that family firms receive fewer patent citations per dollar of R&D investments than nonfamily firms. Further, we observe that family and nonfamily firms achieve similar number of patents per R&D dollar. These results do not provide evidence consistent with the notion of greater R&D efficiency in family firms relative to nonfamily firms. Rather, by committing fewer resources to R&D spending, family firms appear to trail nonfamily firms in R&D outcomes.

Our analysis thus far indicates that, on average, family firms commit fewer resources to total investing, and especially R&D activity, relative to nonfamily firms. Nonetheless, these differences in investment patterns may not be indicative of conflicts of interests between these large, controlling shareholders and outside shareholders. Prior literature documents that within the S&P 500, family firms exhibit better market and accounting performance than comparable nonfamily firms (e.g., Anderson et al., 2009). Cronqvist and Fahlenbrach (2009) find that greater blockholder

<sup>1</sup> We thank the reviewer for pointing out the distinction between founder firms with and without other family members involved in the firm.

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