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The financial structure and performance of owner–managed family firms: Evidence from the UK economy

Estructura financiera y rentabilidad en empresas familiares gestionadas por la propiedad: evidencias de la economía inglesa

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1. INTRODUCTION

Empirical evidence suggests that OMFBs predominate across the corporate landscape. (Shanker and Astrachan, 2003). Indeed, families are present in one third of the S&P 500 and hold nearly 18 percent of firms' equity stake (Anderson and Reeb, 2003). In the UK, the family business sector is estimated to represent 75% of all enterprises, including about 10% of quoted firms (Poutziouris, 2006; Capital Economics 2008).

In 2009, the European Commission, following deliberations of the family business expert group, published report outlining the key issues pertinent to the long-term development of the family business economy. More specifically, amongst others, the experts argued for family enterprise tailored schemes in order to channel better finance in order to help OMFBs unleash their growth potential and safeguard their sustainability across generations.

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EXECUTIVE SUMMARY

This paper offers a brief review of theoretical and empirical trends of the financial affairs of owner–managed family businesses [OMFBs] across their business life cycle – from closely held private SMEs to open quoted corporations. Comparative analysis of the financial structure and performance of family controlled firms versus the experience of their peers, establishes that OMFBs adhere fiercely to the principles of the pecking order theory – they prefer to finance their development in a hierarchical fashion using internal funds followed by external financing. In conclusion, some tentative policy implications from the perspective of owner/managers, service providers (financiers and advisors) and policy makers, are discussed.

RESUMEN DEL ARTÍCULO

El artículo ofrece una revisión de la investigaciones teóricas y empíricas en materia de finanzas de empresas familiares gestionadas por el propietario (OMFBs), a lo largo del ciclo de vida de la empresa, desde las PYMEs no cotizadas hasta las empresas cotizadas. Un análisis comparativo de la estructura financiera y rentabilidad de las empresas familiares *versus* las no familiares establece que las empresas familiares gestionadas por el propietario cumplen fielmente la teoría de jerarquización financiera, prefiriendo financiar su desarrollo de forma jerárquica utilizando fondos propios seguidos de financiación externa. A modo de conclusión, el artículo recoge algunas posibles implicaciones del trabajo para los dueños/gestores, los proveedores de servicios (financieros y consultores) y los agentes políticos.

The rationale of this paper is to offer an academic treatise of the topic, based on both theoretical principles and empirical trends, so that we can better inform the policy debate. It continues with a brief theoretical debate as to what governs the financing of growing SMEs at large, including family firm. This is followed by findings of empirical investigation into the financial development of UK privately held family companies (Poutziouris - 2001) and the financial structure and performance of UK family business PLC economy (Poutziouris - 2006). It concludes with a brief discussion on certain policy initiatives that can stimulate the flow of long-term growth capital to OMFBs.

Family business owner-managers often jeopardize their growth potential because they fail to systematically address evolving growth barriers on the financial, managerial, technological and marketing side

2. THE DEVELOPMENT OF SMALLER OWNER-MANAGED FAMILY ENTERPRISES

The morphology of the SME- family business economy is very heterogeneous. Smaller firms tend to be owner-managed, and whether concentration of ownership control is in the founder, or successive generation of family owner-managers, the family culture overshadows strategic development orientation. Because the family in business often plays a central role in the provision of entrepreneurial, human and financial capital, the future business growth and continuity plan is influenced by interwoven social and familial driven behavioral motives which are not always aligned with economic rationale.

Non-paradoxically, a minority of OMFBS are geared to develop their business model and embark on growth inspired strategies.

Building on growth stage models Gersick *et al.* (1999), developed the 3 axis development model which portrays critical transition periods during the development of family enterprises, across the business, ownership and family in business axis. While the most important factor impacting on growth of the business across the stages of development is the overall market demand for its products/services, innovation capabilities, capacity and attitude of owner-managers towards strategic growth planning, the mastering of financing, governance (schemes to ensure goal alignment between active and passive family shareholders) and succession planning are vital for sustainable business success across generations. Not surprisingly, family business owner-managers often jeopardize their growth po-

tential because they fail to systematically address evolving growth barriers on the financial, managerial, technological and marketing side; or they may even eschew entrepreneurial growth opportunities in favour of other familial driven agenda that often include independence, oligarchic familial control, altruism, etc.

KEY WORDS
Family business, financial structure, performance

PALABRAS CLAVE
Empresa familiar, estructura financiera, rentabilidad

3. FINANCIAL AFFAIRS OF SMALL-MEDIUM SIZED ENTERPRISES - THEORETICAL PERSPECTIVES

It axiomatic that at the early stages of the business development, smaller family firms in particular, often draw social, human, financial capital from their families and friends (Sorenson and Bierman, 2009). However, as smaller companies embark on growth they suffer from a disadvantage in obtaining long-term debt and external equity. This may be triggered by the overlapping owner-managerial dynamics, business characteristics and financial market imperfections (Ang, 1991; Poutziouris *et al.*, 1998; Matthews *et al.*, 1994)

When growing owner-managed family firms access external finance they tend to experience relatively more restrictive transactional and behavioural costs (Pettit and Singer, 1985). Owner-managers of family firms (agents) given their protagonistic role in running their firms could develop an empathy gap between them and other minority equity investors and lenders (principals). This is due to problematic information asymmetries and morale hazard, which increases agency costs. As a result, owner-managed family firms tend to incur higher costs when they consider external capital options.

Thus, in accordance with the *pecking order theorem*, OMFBs tend to finance their capital requirements in a hierarchical fashion. First, using personal savings and internally generated funds, followed by short and long-term debt, and then finally external equity that could erode control (Myers, 1984;). Furthermore, a stock market flotation and exit option (to family and non-family) minority shareholders would widen the share ownership of the firm, and could lead to loss of control by the founding family or even a trigger a hostile takeover.

As such, the rational response of owners-managers of smaller private (family and non-family) companies is to avoid the use of external equity capital and to rely more heavily on retained profits and short-term bank loan finance as these respect the antithesis of the family to outside intrusion into their business (Gallo and Vilaseca, 1998; Poutziouris, 2001).

4. EMPIRICAL EVIDENCE: HOW UK FAMILY COMPANIES FINANCE THEIR DEVELOPMENT

In empirical investigation Poutziouris *et al.* (1998) established that the financial development of private companies is influenced by the state of the economy, conditions in the capital markets, internal business characteristics, and the attitudes of owner/directors towards financial independence, business risk and family control. Moreover, they reveal that OMFBs have a hierarchical preference for sourcing capital to finance their development.

Table 1. **Comparative Analysis of Funding Structure of Private SMEs**

	FAMILY COMPANIES		NON-FAMILY COMPANIES	
	% OF ALL FUNDING	% OF EXTERNAL FUNDING	% OF ALL FUNDING	% OF EXTERNAL FUNDING
Retained profits	51.5	---	42.8	---
Bank Overdraft	17.9	52.4	15.5	37.5
Owners Equity	14.4	---	15.7	---
External Loans	6.2	18.2	8.5	20.4
HP / Finance leasing	4.7	13.8	10.9	26.3
Factoring	2.6	7.6	3.8	9.2
External Equity	0.8	2.3	1.3	3.1
Other	1.9	5.6	1.5	3.5

Source: Poutziouris *et al* (1998) The Financial Affairs of Private Companies, Tilney, Liverpool.

Table 1 demonstrates the importance of retained profits as the overriding source of capital -- a very prudent practice. Moreover, the main source of external financing is bank overdraft. Evidently, there is an aversion towards long-term finance (both debt and risk equity capital); this antipathy is particularly strong in family companies.

Table 2 extends multi-facet comparative analysis, comparing the funding and asset of private family firms versus non-family peers (columns A and B); then we can have a comparison of family controlled quoted firms versus the FTSE All Shares–PLCs (columns C and D); This allows us to also compare the financial and asset structures of OMFBs, across the business life cycle as they evolve from smaller privately family firms into more sizeable quoted family firms.

Table 2. **Balance Sheets of Family Firms: Private versus PLCs (%, averages), 1995-2004**

VARIABLES	A. PRIVATE FAMILY FIRMS	B. OTHER PRIVATE FIRMS	p	C. FOMB PLCs	D. FTSE ALL SHARES+	p
Fixed Assets						
Tangible Assets	*30.70*	*26.87*	*.028**	42.25	35.67	0.003*
Intangible Asset	*.03*	*.09*	*.001**	10.22	14.97	0.000*
Total Fixed Asset	32.56	29.41	.083	*59.87*	*53.77*	*0.002**
Current Assets						
Stock & WIP	*20.55*	*17.35*	*.021**	10.42	12.47	0.048*
Trade Debtors	*32.76*	*36.48*	*.014**	12.78	14.11	0.243
Bank and Deposit	*10.0*	*10.77*	*.353*	7.59	9.80	0.002*
Total Current Asset	67.63	70.97	.066	*40.13*	*46.23*	*0.002**
Current Liabilities						
Trade Creditors	*23.07*	*27.63*	*.002**	11.43	10.64	0.389
Short term Loan	*14.69*	*14.13*	*.634*	5.30	5.99	0.162
Current Liabilities	52.60	60.78	.000*	*31.51*	*33.77*	*0.118*
Long term Liabilities						
Long term Loan	10.00	13.37	.133	18.35	17.21	0.372
Other LR Liabilities	1.53	1.79	.47	5.43	5.26	0.811
Total LR Liabilities	11.53	15.16	.029*	*24.84*	*23.10*	*0.239*
Capital & Reserves						
Issued Capital	6.0	7.0	.342	5.90	7.34	0.009*
Share Premium	1.0	3.0	.029*	10.62	26.24	0.000*
Retained Profits	26.77	15.20	.000*	5.93	2.59	0.000*
Revaluation Rerserves	.04	.02	.015*	17.07	1.59	0.000*
Shareholders Funds	37.49	25.63	.000*	*43.65*	*43.12*	*0.780*

Note: The table offers key items of the asset base and funding structure, as % of total assets.
* t-statistic techniques: statistically different at 5% level of significance.; + excluding financial firms.

5. THE FUNDING STRUCTURE OF FAMILY VERSUS NON FAMILY PRIVATE COMPANIES

Comparing the balance sheet of (353) family companies (column A) and (225) non-family companies (column B), a number of statistically significant differences emerge. Herewith in summary some of the key highlights pertinent to the funding of family companies, which tend to:

- Invest relatively more in tangible and less in intangible assets;
- Have lower long-term liabilities (*i.e.* long-term bank debt, directors loans etc.)
- Retain more profits (this over-time build a stronger equity base.

Poutziouris *et al.* (2000), employing analysis of covariance models, re-examined the association of family ownership control and balance sheet structure (controlling for size, sector and capital intensity) and found that OMFBs (in contrast to non-family companies) tend to invest less in intangible assets, to borrow less long-term funds and to re-invest more profits. An extension of the comparative analysis into performance, revealed that family companies exhibit weaker growth rates, in terms of sales turnover, employment and asset base, but tend to outperform their peers in terms of profitability measurements.

It is axiomatic that the majority of family-controlled ventures as they are not in business of fast growth and profit maximization, are more conservative in their strategic growth plans, and thus they tend to have lower gearing. This is symptomatic of their aversion towards sizeable term loans. However, this short-termist attitude to financing could lead to capital deficiencies, especially during a downturn in the economy, as profits diminish .

Arguably, the sustainable development of the family company necessitates the steady flow of long-term capital, particularly when there is a need to finance certain strategic transitions (such as accelerated growth; internationalization; transfer of ownership to successive generations, exit of certain owners etc.). In the light of the above trends, it can be posited that certain groups of family companies - especially growth-oriented ventures, with a more open culture - appear to be bankable and could benefit from the advantages of venture capital as they embark on growth horizons, provided the private equity deals address certain restrictive aspects which are not compatible to their ethos *e.g.* control, deal structures and exit options.

Indeed, owner –managers of growth inspired family businesses tap into to long-term external capital -- private and public equity options -- in order to invest in new technologies and marketing strategies that can enable innovation based growth and development across frontiers. Historically, plethora of industrial and commercial families did float their firms on the London Stock Exchange, opening up their ownership regimes to embrace *insiders* (extended relatives

but also loyal managers) and *outsiders* (professional managers and investors) in order to strengthen both their human and financial capital base.

6. THE FINANCIAL STRUCTURE OF FAMILY FIRMS - PRIVATELY HELD VERSUS QUOTED PLCS

In an empirical investigation into the structure and performance of UK Family Controlled Quoted Companies, Poutziouris (2006) provided evidence on the funding structure, growth, financial performance (profitability) and market performance (shareholders returns) of family controlled PLCs versus the experience of their peers. Basically, through the prism of a Family Business Index, family controlled PLCs were found to outperform the FTSE All-Share index by 40%. **Table 2** demonstrates a series of statistically significant differences in terms of the financial structure of family controlled PLCs versus that of their peers . In summary, OMFB –PLCs tend to:

- Invest more in tangible assets –regarded as symbol of financial autonomy – and can be used as collateral for loans.
- Use more long-term loans – perhaps because they can secure better deals, and more importantly they can refrain from issuing more equity, at the cost of family control.
- In line with *pecking order principles*, family controlled PLCs tend to issue relatively lower share capital, including additional rounds; and of course are more prudent with profits – as they enthusiastically re-invest it.

Following an extension of the comparative analysis into the performance, it emerged that family controlled PLCs, tend to be more profitable, grow slower and have lower gearing levels.

7. WHAT IS THE ROLE OF THE FAMILY IN SHAPING PERFORMANCE?

Scholars have been arguing that family firms possess certain dynamic capabilities, value-adding familiness and access to idiosyncratic social capital advantages which fuel their competitive advantage. The competitive edge of family controlled companies is more evident when the economy and capital markets under perform and is relatively suppressed when market conditions are buoyant. Stein (1988) demonstrated that quoted companies shareholders characterized with longer investment horizons suffer less from managerial myopia and opportunism, as they are less likely to forego good in-

vestments for the sake of boosting short-term profits. James (1999) argued that family firms, because of family commitment to perpetuating ownership onto succeeding generations, provide inherent incentives to invest more efficiently and prudently according to the market rules. Anderson, Mansi, and Reeb (2003), found that one implication of families maintaining a long-term presence in family firms is that the firm will enjoy certain economies, such as a lower cost of debt financing.

8. EMPIRICAL EVIDENCE FROM CASE STUDIES FEATURING THE FAMILY BUSINESS PLC MODEL

Poutziouris (2006) in the report, The UK Family Business PLC Economy, offers evidence from cross case studies featuring the following success stories: Associated British Foods PLC - the global food masters; Caledonia Investments PLC - the long-term investors in growth; Huntleigh Technology PLC - the innovators; and Town Centre Securities - the builders of value

The interview based case study research revealed that quoted firms with dominant owning families on board were characterized with effective mechanism to address agency costs, were endowed with RBV-based familiness (enduring trust based relations and social capital) (Habbershon, T., Williams, M., 1999), paradigmatic elements of stewardship, financial prudence, devotion and long-term commitment. Quoted family firms have evolved their own approach to master their long-term development, to align goals of owners and managers, to build relationships with financial agents, to mitigate risk and to chart effective strategic decision-making.

More recently, Poutziouris and Savva (2011) using a panel dataset from 1998 to 2008, evaluated the relation between founding-family ownership and firm performance controlling for a number of external to the firm conditions and business characteristics. They report that family involvement is associated with superior accounting performance and inferior market performance – based on Tobin's Q ratio. Once non-linearities are included in the model, the performance of family firms using Tobin's Q is in line with the results of accounting performance measures. Moreover, they identify the inflection point where the positive association of family ownership and performance tapers off; it is 31% when using profitability measurements, and 42% when using Tobin's Q. Their results mirrors US findings where quoted family firms (with founding families playing an active

role in ownership and management control) exhibited superior-performance than their Standard & Poors counterparts (Anderson and Reeb, 2003).

According to **Table 2** (see columns A and C), quoted family firms are better capitalized than their private family firms and have better access to debt , asset based finance and equity options, which can enable them to grow internally (new product/market development) and externally (via mergers and acquisitions). Of course, a priori condition, is that they have to comply with rules and regulations and are eager to develop their governance culture to embrace corporate professionals with recruitment and retention rewards schemes, and thus use their management talent to strategically plan for growth.

Despite the resilience and superior performance of UK of family controlled quoted companies, evidence suggests that there is a diminishing role for the family ownership in the UK (Franks *et al.*, 2003; Faccio and Lang, 2001). Over time, with smaller stakeholding, rising hostile takeovers, demanding institutional shareholders, increased capital market regulation and takeover reforms, families found it very challenging to sustain control. Arguably, the increasing regulation and protection to minority shareholders perhaps made owning families comfortable to liquidate their holdings.

9. CONCLUSIONS AND POLICY IMPLICATIONS

The financial development of OMFBs is overshadowed by the 'keep it in the family' tradition and thus exhibit adherence to the pecking order philosophy. Even growth inspired firms that are suitable for private equity are often not so enthusiastic to part with outsiders (Poutziouris, 2001). The key sources of funding for privately held family controlled firms are internally generated equity (*i.e.* share capital plus retained profits) and short-term loans.

Owner-managers of growing family firms could orchestrate partnerships with loyal talented management, develop goal alignment and ensure valuable resource – dynamic capabilities and idiosyncratic knowledge that enable winning strategies. Therefore, certain growth inspired and well established family companies could represent a less risky investment for family business - friendly private equity providers offering "Heritage and Harvest Capital Solutions".

Evidence from the UK, and other market economies, demonstrate that family controlled quoted companies, under certain conditions,

despite their relatively more conservative approach to financing, are credited with superior performance. The family business PLC model works, as family ownership and involvement, does address agency costs, and thus safeguards unique dynamic capabilities and ties to build enduring business models .

Policy Affairs

- *Family Business Owner-Manager Directors* ought to strategically plan for development across family-business-ownership axis and thus master the *Visscher dilemma*: balance business growth capital requirements with family control catering for liquidity events for retiring /exiting family shareholders. In the context of enhanced capital requirements to finance market imposed fast growth activities and other concurrent family in business transitions (*e.g.* succession), external equity (private or public) could prove to be indispensable to the sustainable growth of the business.
- *Financiers* ought to receive more training about the critical issues (market-based and familial) confronting the survival and long-term trans-generational growth of the family businesses and business families.
- *Policy Makers:* In line with the principles of pecking order, there is scope for more tax-based schemes offering an allowance for corporate equity - ACE. This will ensure that re-investment of profits receives the same tax treatment as interest paid to lenders; it will also incentivize the issue of new share capital.

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