THE CONFERENCE BOARD

Executive*action* series

No. 161 September 2005

Family-Controlled Corporations…

Defining Corporate Governance Best Practices to Add Firm Value

by Matteo Tonello

European family-controlled public companies tend to perform less well in the stock market than their American counterparts. Also, while more and more investment funds that focus on family-firm opportunities are being formed in the United States, institutional investors remain reluctant to invest in continental European family-controlled businesses. These trends suggest that the best practices followed by family firms in the United States may provide helpful examples for similar enterprises in Europe.

A number of academic studies indicate that publicly-traded stocks issued by family-controlled companies based in the United States often outperform the S&P 500 index. One of the most influential of these inquiries, which was jointly conducted by business school researchers at Harvard and Wharton, looked at six years of financial data from Fortune 500 corporations and found that family-controlled companies have higher returns in terms of share value than widely-owned companies (i.e., no shareholder above the 10 percent ownership threshold).[1] In fact, when the returns were measured by Tobin's q, the result was 23 percent higher than the same ratio for widely-held companies.[2] The qualities that may give a family firm a competitive advantage—trust, long-term commitment, resilience to periods of crisis, and creative entrepreneurship—may also translate into a higher return in terms of share value.

[1] Belén Villalonga and Raphael Amit, "How Do Family Ownership, Control, and Management Affect Firm Value?" *Journal of Financial Economics* EFA 2004 Maastricht Meetings Paper Number 3620. The sample used by the authors comprises a panel of 52,787 shareholder-firm-year observations, representing 2,808 firm-years from 508 Fortune 500 firms during the period 1994–2000. Family firms made up 37 percent of this sample. For similar conclusions, see Ronald Anderson and David Reeb, "Founding Family Ownership and Firm Performance: Evidence From the S&P 500," *Journal of Finance*, Volume 58, Number 3 (2003), pp. 1301-1329.

[2] Tobin's q is the ratio of a firm's market value to the replacement cost of its assets. Market participants often use this ratio as an economic indicator of investment opportunities.

The investment community has taken notice of the high potential of family-owned firms, and a growing number of mutual and private equity funds are investing in public companies that are still subject to the control of either their founders or a group of individuals that belong to the founders' families by blood or marriage. To cite just one example, Pitcairn Financial has found choosing investments on the basis of family ties a profitable strategy. As far as total return is concerned, the company's $83.3 million top-performing Constellation Pitcairn Family Heritage Fund (which invests in companies that boast significant family ownership and a market capitalization of at least $200 million) ranked in the top one-third of funds in its group over the last three years, generating an average annual return of 5.78 percent versus 3.53 percent for the Standard & Poor's 500 index.[3] "We've made extraordinary efforts to make sure there wasn't something else driving this," says Alvin A. Clay, III, CEO of Pitcairn Financial. "What keeps on coming through is family control."[4]

[3] Source: Lipper Analytical Services (as of March 31, 2005).

[4] "Ties That Bind Are Profitable," *Philadelphia Inquirer*, December 28, 2004.

Which Best Practices Generate Value For Family Businesses?

The higher stock prices for family firms seem to be strictly conditioned on a combination of factors:

1. The presence of a founding family member who continues to be in charge of business operations and pursues a long-term vision for the venture.
2. The availability of owners and managers to participate fairly in a public market for corporate control.
3. A significant percentage of floating equity. Performance results are less consistently positive in the presence of shares of concentrated ownership above the 30 percent threshold.
4. The presence of at least one active institutional investor, acting as both a strategic partner and a moderating influence on the potential for family members or managers to make opportunistic decisions.
5. The willingness of owners and managers to comply with a set of organizational standards that are meant to ensure good quality corporate governance (a sufficient number of independent directors, a diversified set of professional expertise among these directors, a fully independent audit committee, an effective system of internal control, etc.).
6. The commitment by owners and managers to limit the costs minority shareholders face when exercising their rights (voice and exit rights, in particular).

The absence of at least some of these factors in family firms located in continental Europe may help explain why the correlation between family ownership and stock performance is not always as positive there as it is in the United States (or the United Kingdom). Although some empirical analysis has shown a similar corporate structure/stock value paradigm in the Scandinavian countries, most available data for publicly-traded firms in the rest of Europe seem to support the so-called "entrenchment hypothesis" (e.g., controlling shareholders

are inclined to recurring expropriations of value from the firm, to the detriment of minority shareholders and other stakeholders). One test recently completed by the London School of Economics and the University of Geneva on data regarding the 100 largest firms in five major European economies (France, Germany, Italy, Spain, and the United Kingdom) indicates mixed, and, overall, rather negative, correlations between ownership concentrations and stock performance.[5]

In terms of individual countries, a comparative investigation of Spanish family and non-family firms revealed that family firms in Spain grow at a smaller rate and choose less capital-intensive production technologies.[6] Another study compared the sales of 62 German family-controlled companies with sales of more than 50 million euros that were founded before 1913 and were still in existence in 2003 to the sales of 62 non-family-owned firms over a period of 100 years. Although the results of the study seemed to demonstrate that family firms have a better operating performance, it is also revealed that minority shareholders interested in holding those shares for the long term are unlikely to reap higher returns on their investments.[7]

[5] Tom Kirchmaier and Jeremy Grant, "Corporate Ownership Structure and Performance in Europe," CEP Discussion Paper Number. 0631, April 2004. For similar conclusions, see Sabri Boubaker, "Ownership-Control Discrepancy and Firm Value: Evidence from France," Working Paper, March 2005.

[6] Carmen Galve Górriz and Vincente Salas Fumás, "Family Ownership and Performance: The Net Effect of Productive Efficiency and Growth Constraints," ECGI Finance Working Paper Number 66, February 2005.

[7] Olaf Ehrhardt, Eric Nowak, and Felix-Michael Weber, "'Running in the Family:' The Evolution of Ownership, Control, and Performance in German Family-Owned Firms 1903-2003," Preliminary Paper published by the Center for Economic and Policy Research (www.cepr.net), September 2004.

Facing the Leadership Succession Dilemma

Due to a number of reasons, the positive impact of a family's entrepreneurial skills on a firm's stock price tends to decline as leadership is passed from one generation to the next. New generations may lack managerial abilities or, because of the comfortable lifestyle they already enjoy, may not possess the same drive for personal success as their fathers or mothers. Loss of motivation and a decline in capability in the third generation of a family are frequently seen as signs of the "Buddenbrooks effect," and these qualities may be a major cause of the conservatism of younger generations regarding innovation and growth.[8]

Also, as the company grows, new financial needs emerge. Equity injections become necessary to provide working capital, support expansions, and refresh competitive strategies. Because the family's financial availability may be insufficient to meet market demands, a second or third-generation entrepreneur may forgo a business opportunity that has the potential to dilute her stake in a venture.

In other cases, new generations may not share the same vision about strategic goals and disagree on the direction the company should take in the future. While owners may be linked by blood, they can often lack a cohesive identity, legacy, and culture. This normally leads to organizational disruptions, inefficient transitions, and a loss of competitiveness. Businesses grow linearly, while families grow exponentially. As time goes by and generational successions multiply the number of interested individuals, keeping family members united and enthusiastic about working with one another is a key issue and one of the most difficult governance tasks in family-controlled firms.

[8] The notion of the "Buddenbrooks effect," taken from Thomas Mann's novel *Buddenbrooks: The Decline of a Family*, is summarized by Edgar Salin as: "the first generation … builds, the second generation consolidates, the third dissipates." Edgar Salin, "Origins of Modern Business Enterprise: European Entrepreneurship," *Journal of Economic History*, Volume 12, Number 4 (1952), pp. 366–377.

Finally, it is not uncommon for the retiring founder to rearrange the corporate and financial structure of the firm so as to ensure that, after the succession, control stays within the family. Because they do not respond to the strategic or financial needs of the business, such prearranged changes—excessive borrowing, issuance of multiple voting shares, expansion of pyramidal organizations, cross-holding of stock, etc.—are done in a suboptimal fashion and turn out to be detrimental to the firm's value.

Around one-third of all European Union firms are expected to change hands in the next decade. Although there are no official statistics on business transfers, European families seem less inclined to solve their succession problems by looking outside of the firm and hiring external managers. Moreover, when external talent is brought in, it often remains subject to the direction and the close supervision of the controlling family. The outsider's impact on future strategic changes is therefore undermined, or at least significantly controlled.

The job market for senior executives is also less structured in continental Europe than in the United States or the United Kingdom. European use of executive search firms is increasing but is still not nearly as common a practice as it is in the United States or the United Kingdom. Mid-size and smaller companies in particular tend to base their recruitment efforts on personal contacts and family networks. Although locally present, international search firms cannot always rely on an extensive pool of local candidates, and may add little value to the search.

Participating in an Efficient Market for Corporate Control

Best practices indicate that being open to a public market for corporate control generates at least two major benefits, one of which is improved monitoring of the efficiency and the integrity of management. Should the stock value suffer as a result of inefficient management, a family-owned company could become an appealing acquisition target for its competitors. Given that senior managers of such a company are likely to lose their position if the tender offer is successful, a functioning market for corporate control operates as an incentive to perform efficiently and deliver tangible results for all constituencies of shareholders. Public markets also provide a powerful disincentive for members of the controlling family to attempt an expropriation of wealth. In fact, should the stock price suffer as a result of continuous extractions of personal benefits by a dishonest strategic shareholder, the controlling power of that same individual (or group of individuals) will also be threatened by a hostile takeover initiative.

Pyramidal structures, interlocking directorships, multiple voting shares, shareholders' voting agreements, and other legal enhancements of corporate control shield the company from the public acquisition market and, as a result, negatively affect stock performance. In addition, when the acquisition market is kept strictly private, a higher premium is required for a friendly sale of controlling positions. This premium—calculated as the difference between the per share price paid for the control block and the per share market price as of two days after the announcement of the sale to the public—

severely limits the interest an investor may have in that company's publicly-traded shares, and can undermine long-term stock value. While the average takeover premium in the United States and the United Kingdom is 2 percent, statistics indicate that in some European countries, such as Italy (37 percent) and Portugal (20 percent), a successful takeover may require bids that are far above the actual market value.[9]

In continental Europe, the use of legal or statutory mechanisms to separate ownership and control is far more frequent than in the United States or the United Kingdom. Dual or multiple classes of shares may be used by few firms in France, Belgium, Portugal, and Spain (where either a "one share, one vote" rule or a cap on the proportion of nonvoting stock is in place), but they are common in firms with controlling shareholders at the 20 percent level in Sweden (66 percent), Switzerland (51 percent), and Italy (41 percent). In Norway, departures from the "one share, one vote" principle require governmental approval, but such approvals seem to be readily granted since 13 percent of companies do have multiple classes of shares.[10]

Pyramids and holdings through control chains are employed to enhance controlling powers in 26 percent of European listed firms. Beyond their power as a control-enhancement mechanism, pyramids also provide a vehicle for a family or a group of entrepreneurs to pursue their imperialistic goals and speculate on the rapid expansion to new markets, even where such expansion is not supported by a sound long-term growth strategy for the benefit of all shareholders. Sweden is home to the highest number of companies with pyramidal structures—34 percent—followed by Norway, where 20 percent of the companies have such a framework in place. Statistics on pyramids seem to be less significant elsewhere in Europe.[11]

As can be seen in this brief overview of regional practices, the European market for corporate control still possesses a number of localized limitations that undermine the described system of incentives for boosting good conduct by managers and controlling shareholders.

Overall, hostile takeovers are far less frequent in Europe than in the U.S. and U.K. markets, and, in certain continental countries, their use as a disciplinary device against inefficient management is rare. From this standpoint, the long-awaited European Takeover Directive of 2004 has been a disappointment. Even though mandatory for all member states of the European Union, the new regulation provides only a general framework for carrying out these transactions while achieving very little in terms of restricting management's ability to adopt defensive measures against hostile takeovers. Therefore, no real improvement in the efficiency of the market for corporate control can reasonably be expected in the near future unless controlling families become aware of the importance of such markets for their own firms' competitiveness and survival.

[9] Source: Alexander Dyck and Luigi Zingales, "Private Benefits of Control: An International Comparison," *Journal of Finance*, Volume 59, Number 2 (2004), p. 537–560. This study documents 412 sale transactions of a controlling block executed in 39 countries between 1990 and 2000.

[10] Source: Mara Faccio and Larry H.P. Lang, "The Ultimate Ownership of Western European Corporations," *Journal of Financial Economics*, Volume 65, Number 3 (2002), pp. 365–395. The survey is confined to the period from 1998 to 2001.

[11] Faccio and Lang, "The Ultimate Ownership of Western European Corporations," p. 371.

Partnering With a Secondary Large Owner

Statistical data on disclosed financials by public companies suggest that any level of family control above the 30 percent ownership threshold is suboptimal and negatively affects long-term stock performance.[12] Moreover, a sale of stock should not be seen by the family as a loss of control, but as an opportunity for family members to better diversify their personal asset allocation and partner with a strategic player in the investment community. While large institutions primarily invest through a leveraged buyout deal for the purpose of becoming the primary owner, private equity funds focused on family-controlled businesses take a different approach, and consider more traditional mid-market transactions such as recapitalizations and growth equity investments. Such an approach does not rely as heavily on leverage, and limits the amount of debt that the firm needs to incur to finance the deal. As a result, selling shareholders are simultaneously provided with liquidity, a guaranty of continued control, and a strategic thought partner.

A second large shareholder may exercise a moderating influence on the self-interested behaviors of family members and managers, and be the driving force for wiser succession planning and the establishment of a rigorous system of corporate governance. Since the institutional investor is free from the emotional attachment most family members feel toward the firm, it can help redefine strategic objectives. On the other hand, having chosen to commit its capital to a portfolio composed of family firms, the institutional investor adopts that same longer-term managerial orientation that represents the main competitive advantage of this category of businesses.

Being specialized, a private equity house has an intimate understanding of the unique issues facing family firms. In fact, investors may collaborate with the family and the management team to implement incentive programs that align the interests of all stakeholders to create equity value. After closing the transaction, an expert can work with the organization to execute the business plan, identify and facilitate the completion of acquisitions, strengthen the company's board of directors, and serve as a thought partner to enhance value while leaving day-to-day operating decisions to management.

T. Brook Parker, a founder of Boston-based Lineage Capital LLC, belongs to a team of investment professionals that have been involved in the investment of over $500 million of equity capital in more than 60 transactions across a variety of industries. Parker says, "Professional investors are accustomed to playing an active role, when necessary, to provide additional support to the management team or a less active role when our support is not needed. At all times, they seek to leverage their collective experience and network of contacts and business partners by providing introductions to key industry contacts, strategic relationships, and other business and financial resources."

For decades, the European market for private investments in public equity suffered because of a combination of economic and political factors, including the size limitations of local stock exchanges and unpredictable fluctuations in the value of certain currencies. More recently, the adoption of a single currency and the process of worldwide integration of financial marketplaces have boosted this type of institutional investment, in the Eurozone as well as beyond its borders. Only a few years after the introduction of the euro, equity investment activities in continental Europe are flourishing and rapidly reducing the traditional gap in such investment between the region and the United States. European fundraisers, for their part, have become more sophisticated and specialized in reaching the different segments of the institutional investment market.

Nevertheless, the strong ownership concentration of many European enterprises limits the pool of investment opportunities and helps explain why so much capital continues to flow from Europe into funds and corporations

[12] Erling Barth, Trygve Gulbrandsen, and Pål Schone, "Family Ownership and Productivity: The Role of Owner-Management," *Journal of Corporate Finance*, Volume 11, Issue 1-2 (2005), pp. 107–127.

based in the United States. A study published this year indicates that crossing the Atlantic to invest in U.S. equity is something most European institutional investors are comfortable with, given the country's entrepreneurial and innovative culture; the professionalism, maturity, and size of the U.S. market; and the well-developed capital and exit markets for small companies.[13]

Remembering That Governance Matters

One of the core functions of corporate governance is providing guidelines that ensure controlling shareholders treat the firm's other constituencies in a fair and nonpreferential fashion. More specifically, there should be a set of rules that guarantee small investors and savers an adequate voice in corporate decision making (as well as safeguards against deceitful insider deals). Such safeguards must be an essential component of any country's attempts to attract investment and secure prosperity.

The Action Plan on corporate governance announced by the European Commission in 2003 is indicative of the EU's commitment to strengthening shareholders' rights and harmonizing governance standards throughout the continent. Nevertheless, the approach actually adopted differs greatly from the Sarbanes-Oxley Act of 2002, which was drafted in response to Enron and other U.S. scandals. Instead of resting on a renewed legal framework like the American model (i.e., Sarbanes Oxley and the subsequent SEC regulations), the European solutions rely on the so-called "comply or explain" principle, under which a company should disclose any divergence from widely-recognized behavioral codes. To this day, the degree of statutory protection of minority shareholders and the quality of law enforcement in continental Europe are lower than in the United States, and good corporate governance largely depends on each company's willingness to embrace best practices.

Parmalat: A Family-Owned Business Enmeshed in Scandal

Italy's Parmalat is the most notable example of how managerial opacity and a lack of accountability can ultimately lead to financial disruption and failure, not only for defrauded retail investors but also for the once-invulnerable controlling family. When the scandal broke, on December 19, 2003, Parmalat was already scoring low on the Institutional Shareholder Service's Global Corporate Governance Quotient. The company appeared at the very bottom of a list of 69 Italian companies rated by the proxy service provider, and was outperforming only 2.8 percent of businesses in Morgan Stanley Capital International's Europe, Asia, and Far East (EAFE) Index (which comprises a variety of firms listed in major European and Asian exchanges).

Throughout the 1990s, Parmalat appeared to be a successful multinational company, boasting an array of widely recognizable consumer brands as well as distribution channels in many parts of the globe. Below the surface, however, the company had abandoned a sound expansion strategy for an obscure and misleading financial scheme that preserved the controlling power of the founder's family. Fraudulent transactions at Parmalat were possible because of affiliations between directors and owners, independent board members' lack of expertise in finance and risk management, and corrupted entanglements with statutory auditors and the investment banks engaged by the company to place risky debt securities among retail investors. Through these and other shortcomings in the company's governance system, the controlling shareholder managed to hide its inability to face the new challenges of a competitive and globalizing market.

[13] Cécile Krikke-Fritz, "Accessing U.S. Private Equity by European Institutional Investors: Why and How Do European Institutional Investors Invest in U.S. Equity?" Institute for Economic Studies (HES), Amsterdam, July 2005. The report is based on the results of a questionnaire filled out by 53 European institutional investors in eight different countries.

Deciding which best practices to adopt, then, is a key component of successful corporate governance. In the last decade, business ethics and governance standards have drawn the attention of economic researchers, who have, in turn, demonstrated their impact on firm value and business growth.[14] The most recent edition of the Global Investor Opinion Survey regularly conducted by McKinsey & Co. found that corporate governance is among the fundamental indicators used by financial institutions and funds to make their investment decisions, with some investors willing to pay a premium (as high as 30 percent in emerging markets) for well-governed companies with a track record of accountability.[15]

As with any business, the value of a family-controlled firm is greatly affected by the quality of its corporate governance. Successful families appreciate the importance of an organization that is accountable to all investors and stakeholders, and understand that such accountability is central to protecting the value of their own stake in the venture. They perceive corporate governance not as a costly set of procedural complications, but as the cornerstone of the public company they control. As a result, they are committed to properly defining the roles and responsibilities of the three main centers of power within the organization (ownership, management, and the monitoring team), so as to facilitate engagement and collaboration across the firm.

As controlling shareholders, families directly participate in (or, at a minimum, can influence) the actual selection of senior managers, directors, and internal auditors. Often, family members are personally involved in business matters by exercising strategic, decision-making, or monitoring functions. An effective system of corporate governance ensures that their involvement occurs in the most transparent fashion possible and remains open to criticism on the part of other constituencies, both inside and outside the firm.

About the Author

Dr. Matteo Tonello is senior research associate at the Global Corporate Governance Research Center of The Conference Board. Dr. Tonello recently advised the Italian National Commission on corporate governance reform, whose report constituted the basis for the legislative bill currently under discussion in the Italian Parliament. He is the author of *Corporate Governance e Tutela del Risparmio*, a book in Italian on international convergence of corporate governance standards. Dr. Tonello is a qualified corporate attorney in New York State and Italy.

He can be reached at: matteo.tonello@conference-board.org

Related Reports from The Conference Board

Institutional Investment Report
Research Report 1376, 2005

Corporate Governance Best Practices in Europe
Research Report 1375, 2005

Corporate Governance Handbook 2005: Development in Best Practices, Compliance, and Legal Standards
Special Report 2, 2005

Why Organizational Design is Critical to Global Leadership Development
Executive Action 144, 2005

The Future of the Annual General Meeting
Special Report 2, 2004

Succession Planning… Without Tears
Executive Action 124, 2004

---

[14] Although conclusions are not always unanimous, the literature on the link between corporate governance and stock performance is already vast. See, for example, United Nations Environment Programme (UNEP) Finance Initiative, *The Materiality of Social, Environmental, and Corporate Governance to Equity Pricing*, June 2004, which summarizes the results of 11 sector studies.

[15] Roberto Newell and Gregory Wilson, "A Premium for Good Governance," *The McKinsey Quarterly*, 2002, Number 3, pp. 20–23.