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Family management: creating or destroying firm value?

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Abstract

This research explores whether management by family members creates or destroys firm value. We estimate the impact of family pervasiveness in top management (family members as executive officers or board members) on firm value as measured by Tobin's Q. Results indicate that family members acting as executive officers decreases firm value. More, this effect is exacerbated when the family relationships are farther away, i.e., second-degree vs. first-degree or in-law vs. same-kin relationships. We contribute to the literature in the Brazilian context, in which the influence of family management on firm value remains largely unexplored. We also propose a new way of measuring family management pervasiveness that takes into account the closeness of relationships, thus controlling for the costs and benefits of altruistic acts within the family.

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1. Introduction

Family ownership and control of public companies is common around the world (LaPorta et al. 1999; Maury 2006; Villalonga and Amit 2006). An ordinary investigation in this literature is the assessment of ownership structure on firm's performance. It is not clear whether family control improves or hinders firm performance (Schulze and Gedajlovic 2010). There is a broad collection of evidence, however the results are somewhat conflicting and suggest a non-linear relation between ownership structure and firm's performance. Demsetz and Villalonga (2001) and Barth, et al. (2005) present a summary of empirical results on effects of ownership structure on firm performance.

A more focused stream of the literature investigates how governance related issues in family business (e.g. management regime) influences firm's performance (Anderson and Reeb, 2003; Barth, et al.2005; Durand and Vargas, 2003). From a theoretical standpoint, Dyer (2006) argues that there are agency benefits, but agency costs as well, of having family members acting as managers inside firms. Benefits include better principal-agent alignment, higher trust among family members, and deeper knowledge of the firm underpinnings. Costs of opportunism, shirking, and adverse selection due to altruism[1] are some of the potential burdens (Adams and Ferreira 2009; Dyer 2006; Tirole 2005). Anderson and Reeb (2003), Barth, et al. (2005) and Durand and Vargas (2003) compare the effects on performance by family firms managed by outside CEOs and family firms where a family member serves as CEO. The results are also conflicting.

Our paper contributes to the former debate by investigating the impact of family management on firm value by considering the degree of relationship of the controlling family with all executive directors and board members and not only the relation the family has with the CEO. We believe this is an important issue to be addressed, because the more the family members are widespread among the executive directors, the more prominent will be the benefits (i.e. reducing of agency conflicts and monitoring) and costs (i.e. higher risk aversion induced by limited diversification resulting in high cost of capital) related to this decision. Ultimately, the interaction between these potential costs and benefits will be captured in firm's performance and value.

To implement our analysis we benefit from a recent executive compensation disclosure reform in Brazil and build an index that measures family pervasiveness in management (F-Index). One of the provisions of the new rule (*Ordinance 480*) requires that firms inform all family relationships within top management (executive officers and board members). We use this information to build the F-index. We also benefit from the widespread presence of large controlling shareholders (Leal et al. 2002) in Brazilian listed firms. About 48% of traded firms in Brazil are family-controlled (da Silva 2004). These controlling shareholders often exert great influence on the decisions of managers, and these managers typically come from the controlling family (LaPorta et al. 2000). As Khanna and Yafeh (2007) report, in Brazil families play a key role in business groups, and hold control of firms for decades.

Our results indicate that a negative relationship between the presence of family related officers (especially executive directors) and the value of the firm. The effect is more negative when the relationship is more distant: second-degree and in-law relationships show a more negative impact than first-degree and same-kin relationships, respectively. Results for family executives in general and for closer relationships (1st degree or same-kin) are robust to alternative specifications.

[1] Family contracting can be seen as a perk consumed by family at the expense of non-family shareholders

Section 2 presents our research design, the methodology we use to calculate a proxy for family management pervasiveness in management (F-index) and our data. Section 3 provides empirical estimates and results. Section 4 concludes.

2. Methodology and data

We take advantage of the information that became available in the new Brazilian proxy statements after an extensive disclosure reform that culminated with CVM Ordinance[2] 480 (CVM 2009). One of the provisions requires that firms inform all family relationships within top management (executive officers and board members). We use all proxy statements available, filed in 2010, 2011 and 2012, relative to fiscal years 2009, 2010 and 2011, respectively. We define a firm family-managed when there is at least one family relationship reported within executive officers and board members. Our final sample has 678 firm-years, with a predominance of manufacturing firms. There are 294 firms (44%) with family members in management.

2.1 F-Index: measuring family pervasiveness in management

There is indication that genetic closeness may play a role on the assessment of costs and benefits of altruistic acts (Cox 2007; Hamilton 1964). In mathematical terms, altruistic behavior will occur when there is a benefit B and a cost C such that $rB > C$, r being the probability that a randomly selected gene is shared between two individuals (Bergstrom 1996; Cox 2007). Table 1 shows some numbers for r. Accordingly, our measure of family management pervasiveness incorporates the characteristics of the relationship.

Our approach does not rely on successions of top managerial positions. We have a list of family relationships within top management that indicates the closeness of the relation (first or second degree) and if it is a same-kin (genetic link) or an in-law (no genetic link) relation. Table 1 lists all mandatory relations. We consider in-law relations as weaker than same-kin relations. Although these "aggregated" family members do not have family genes, most likely they are co-responsible for offspring carrying such genes.

Table 1. Relations reported on the Brazilian proxy statement and Hamilton's coefficient of relatedness *r*

Relation	Degree	Same-kin	r
Parent	1	Yes	0.5
Siblings	1	Yes	0.5
Child	1	Yes	0.5
Grandparent	2	Yes	0.25
Spouse	1	No	
Parent-in-law	2	No	
Child-in-law	2	No	
Sibling-in-law	2	No	
Step-parent	2	No	
Stepchild	2	No	
Stable union	1	No	

Source: elaborated by the authors and adapted from (Cox 2007)

The statements also contain all the positions held by these family members. For instance, the family member may be the CEO and a director. The *F-Index* incorporates these data as the power of the related people. It is the position-weighted sum of all family relations

[2] CVM is the Brazilian counterpart of the SEC, and oversees listed firms and capital markets. A CVM Ordinance is similar to a SEC Rule.

divided by the number of total relations t[3]. We take the most conservative approach of attributing equal weights to all positions. Executive officers may have a weight between one (just one position) and three (the three possible positions: CEO, VP, and officer), i.e., $w_{j,k} \in \{1,2,3\}$ for each family member j related to family member k. It is analogous for board members, who can be Chairman, VP of the board, or director. Thus, if there are f family relations within group g of firm i, the definition is:

$$F\text{-}Index_{i,g} = \frac{\sum_{j=1}^{f}\sum_{k=1}^{f} w_{j,k}}{t_{i,g}}, j \neq k \quad (1)$$

To account for the closeness of the relationship, as well as for the kinship, we partition the index. There is an *F-Index* for the top management (executive officers and board members as a group,$F\text{-}Index_{top}$). Then, we split top management into two groups: executive officers ($F\text{-}Index_{exec}$) and board members ($F\text{-}Index_{board}$). We also divide each of these groups into subgroups, separating by degree and by kin. Therefore, instead of unifying family influence in firm management into a single index, we do not impose a functional form nor arbitrary weights to the degrees of separation or kinship. We always account for the total effects of family pervasiveness on top management by adding all *F-Index* partitions to the regressions.

Table 2 shows descriptive statistics for the *F-Index*. Only the executive officers partitions appear for the sake of simplicity, since the other partitions did not yield significant regression coefficients. Family members have a participation in management around 6%, as *F-Index within firm* shows. Apparently, families prefer to exert power as executive officers (20.3%) rather than as board members (12.6%).

Table 2. Descriptive statistics for the F-Index

Variable	Mean	SD	P1	P25	P50	P75	P99
F-Index within firm	0.059	0.078	0.002	0.015	0.030	0.071	0.400
F-Index within execs	0.203	0.368	0.000	0.000	0.050	0.214	2.500
F-Index within directors	0.125	0.225	0.000	0.025	0.049	0.107	1.500
F-Index within 1st-deg execs	0.187	0.357	0.000	0.000	0.050	0.200	2.500
F-Index within 2nd-deg execs	0.016	0.083	0.000	0.000	0.000	0.000	0.417
F-Index within same-kin execs	0.175	0.356	0.000	0.000	0.036	0.167	2.500
F-Index within in-law execs	0.028	0.103	0.000	0.000	0.000	0.000	0.500
Observations	294						

Notes: P# refers to the percentile, e.g., P50 = percentile 50 (median). The statistics on this table refer only to family-managed firms, hence the smaller number of observations. A firm is family-managed when there is at least one family relationship reported within executive officers and board members.

2.2 The model: estimating the influence of family management

Equation (2) displays the model. The coefficients of interest are the ϕ_f, which measure the effect of family management, after controlling for variables that potentially affect Tobin's Q.

$$Q_{i,t} = \beta_0 + \sum_f \phi_f F\text{-}Index_{i,t}^{f} + \sum_g \gamma_g Control_{i,t}^{g} + \epsilon_{i,t} \quad (2)$$

[3] The pairwise permutation formula gives the total number of relations for firm *i* and group *g*: $t_{i,g} = n!/(n-2)!$.

Tobin's Q is the book value of average total assets and market value of equity, minus book value of equity, all divided by book value of average total assets (Barontini and Caprio 2006). Q represents the present value of cash flows divided by the replacement cost of tangible assets. It is a measure of value that already incorporates risk, while other measures like stock returns or accounting-based returns would require some kind of adjustment to compare firms (Lang and Stulz 1994). Table 3, section "Dependent variable", shows its descriptive statistics. The value of approximately 1.9 is close to the estimations of Barontini and Caprio (2006) for continental Europe. Non-family-managed firms are more valuable than family firms, indicating that family management may drive down firm value.

Controls for firm characteristics, ownership structure, and diversity and governance complement the model. Most of them come from Economatica®, a database similar to Compustat® for Latin American firms. Table 3 shows their descriptive statistics. Non-family-managed firms are larger, operate in less valuable industries, are younger, and are more likely to be part of the Bovespa index. As expected, family-managed firms have a larger control stake in the hands of the families (43% vs. 10.7%). and a larger proportion of preferred shares held by family. Finally, non-family-managed firms exhibit more homogenously aged management, larger and younger boards, and a higher chance of being cross-listed in the US.

Table 3. Descriptive statistics

Dependent variable:	All firms		NF.	Fam.	Difference	
	Mean	SD	Mean	Mean	Diff	t
Tobin's Q	1.862	2.703	2.086	1.570	0.517**	2.698
Firm controls:						
ln(Avg total assets)	14.415	1.785	14.639	14.123	0.516***	3.831
Sales growth (2-yr avg)	0.239	0.823	0.225	0.258	-0.033	-0.481
Industry-avg Q	1.397	0.459	1.358	1.447	-0.088*	-2.556
ROA	0.013	0.426	0.003	0.025	-0.022	-0.713
Leverage (D/E)	0.933	1.681	0.825	1.075	-0.250	-1.832
CapEx/Assets	0.073	0.093	0.074	0.073	0.001	0.138
ln(Firm age)	3.223	1.037	3.127	3.348	-0.221**	-2.788
Part of Ibovespa	0.224	0.417	0.258	0.180	0.078*	2.447
Ownership structure controls						
Family proportion common shares	0.247	0.305	0.107	0.430	-0.324***	-15.450
Family proportion pref shares	0.025	0.102	0.003	0.055	-0.051***	-5.912
Dividends/Book value equity	0.087	0.273	0.104	0.065	0.039	1.768
Governance & diversity controls						
Women in top management	0.566	0.496	0.542	0.599	-0.057	-1.487
Age diversity (top management)	0.406	0.120	0.372	0.451	-0.078***	-8.691
Quantity directors	8.945	4.820	9.487	8.238	1.249***	3.406
Board average age	55.843	6.582	54.883	57.097	-2.213***	-4.363
ln(CEO age)	3.985	0.187	3.976	3.997	-0.020	-1.355
ADR listed	0.239	0.427	0.268	0.201	0.068*	2.075
Subject to Bovespa Arbitration	0.339	0.474	0.333	0.347	-0.014	-0.370
Shareholders agreement	0.370	0.483	0.388	0.347	0.041	1.101
No. firm-years	678		384	294		

Notes: Descriptive statistics with difference of means with unequal variances test. * indicates estimate is significant at 10%, ** at 5%, and *** at 1%. NF stands for non-family managed firms, and Fam. stands for family-managed firms. Tobin's Q is the book value of average total assets and market value of equity, minus book value of equity, all divided by book value of average total assets. Sales growth is the yearly average of the two-year raw sales growth. Industry-avg Q is the first-level NAICS average Tobin's Q, by year, weighted by total assets. ROA is net income to average total assets. Leverage is the total debt to average equity. CapEx/Assets is the capital expenses to average total assets. Part of Ibovespa indicates if the firm is part of the Bovespa index. Family proportion common shares is the proportion of voting shares in the hands of family. Family proportion preferred shares is the same for non-voting, preferred shares. Women in top management indicates presence of women among directors or executives. Age diversity is the normalized standard deviation of top managers' ages. Cross-listed indicates if the firm issued ADRs. Subject to Bovespa Arbitration indicates if the firm has voluntarily submitted itself to Bovespa's Market Arbitration Panel. Shareholders agreement indicates if any shareholder of the firm participates of an agreement.

3. Estimations and results

The estimates are pooled OLS regressions, with year dummies and clustered standard errors by firm. The first regression has a firm-wide measure involving the entire top management team, $F\text{-}Index_{top}$. Then, we break it down into $F\text{-}Index_{exec}$ and $F\text{-}Index_{board}$. The following regressions hold $F\text{-}Index_{board}$ and disaggregate $F\text{-}Index_{exec}$ into degree and kinship. Originally there was a disaggregation of $F\text{-}Index_{board}$ as well, but no coefficient came up significant.

Results are in Table 4. Model A is the base model, with the *F-Index* for the top management. The effect is not significant at usual levels. There are significant negative relations with size, ROA, leverage, and board age. Being part of Bovespa index, the dividend to equity ratio and being subject to Bovespa arbitration yield positive significant relations.

These results for the controls remain unchanged throughout specifications. The remaining models break down the *F-Index* to estimate the effects of each subgroup separately.

Table 4. Effect of family management on firm value

Variable	(A)	(B)	(C)	(D)
F-Index within firm	-2.048			
	(-1.249)			
F-Index within execs		-0.654***		
		(-2.952)		
F-Index within directors		0.020	0.091	0.068
		(0.034)	(0.154)	(0.114)
F-Index within 1st-deg execs			-0.601***	
			(-2.757)	
F-Index within 2nd-deg execs			-1.891***	
			(-4.029)	
F-Index within same-kin execs				-0.589***
				(-2.708)
F-Index within in-law execs				-1.695***
				(-2.757)
ln(Avg total assets)	-0.398***	-0.404***	-0.407***	-0.409***
	(-3.600)	(-3.666)	(-3.687)	(-3.690)
Sales growth (2-yr avg)	0.218	0.219	0.217	0.218
	(0.887)	(0.888)	(0.881)	(0.884)
Industry-avg Q	0.173	0.167	0.168	0.162
	(0.731)	(0.706)	(0.707)	(0.683)
ROA	-4.702***	-4.702***	-4.703***	-4.706***
	(-20.361)	(-20.503)	(-20.598)	(-20.564)
Leverage (D/E)	-0.122***	-0.121***	-0.121***	-0.122***
	(-3.639)	(-3.676)	(-3.673)	(-3.684)
CapEx/Assets	0.852	0.795	0.806	0.818
	(1.075)	(0.994)	(1.005)	(1.022)
ln(Firm age)	0.036	0.040	0.035	0.036
	(0.415)	(0.456)	(0.398)	(0.412)
Part of Ibovespa	1.113***	1.106***	1.111***	1.117***
	(3.663)	(3.659)	(3.678)	(3.684)
Family proportion common shares	-0.117	-0.078	-0.079	-0.056
	(-0.410)	(-0.291)	(-0.294)	(-0.211)
Family proportion pref shares	-0.335	-0.312	-0.252	-0.317
	(-0.370)	(-0.404)	(-0.342)	(-0.428)
Dividends/Book value equity	1.672**	1.709**	1.699**	1.699**
	(2.356)	(2.499)	(2.477)	(2.476)
Women in top management	0.046	0.048	0.040	0.055
	(0.358)	(0.377)	(0.306)	(0.429)
Age diversity (top management)	-0.062	-0.168	-0.202	-0.177
	(-0.105)	(-0.277)	(-0.331)	(-0.288)
Quantity directors	0.017	0.022	0.022	0.022
	(1.085)	(1.409)	(1.441)	(1.402)
Board average age	-0.026**	-0.027**	-0.028**	-0.027**
	(-2.372)	(-2.381)	(-2.418)	(-2.398)
ln(CEO age)	0.104	0.110	0.140	0.123
	(0.200)	(0.212)	(0.268)	(0.237)
Cross-listed	-0.168	-0.179	-0.179	-0.177
	(-1.021)	(-1.092)	(-1.088)	(-1.078)
Subject to Bovespa Arbitration	0.289*	0.289*	0.285*	0.283*

Variable	(A)	(B)	(C)	(D)
	(1.794)	(1.794)	(1.773)	(1.759)
Shareholders agreement	0.012	-0.014	-0.016	-0.016
	(0.079)	(-0.088)	(-0.102)	(-0.100)
Adjusted R-squared	0.705	0.707	0.707	0.707
No. of clusters	290	290	290	290
Wald test			0.003	0.037

Notes: Pooled OLS with clustered by firm standard errors and year dummies. t-stats in parentheses. * indicates estimate is significant at 10%, ** at 5%, and *** at 1%. Wald test is the p-value of the test F-Index within 2nd-deg execs (F-Index within in-law execs) < F-Index within 1st-deg execs (F-Index within same-kin execs). The dependent variable is Tobin's Q: the book value of average total assets and market value of equity, minus book value of equity, all divided by book value of average total assets. F-Index is the family pervasiveness in management index. Sales growth is the yearly average of the two-year raw sales growth. Industry-avg Q is the first-level NAICS average Tobin's Q, by year, weighted by total assets. ROA is net income to average total assets. Leverage is the total debt to average equity. CapEx/Assets is the capital expenses to average total assets. Part of Ibovespa indicates if the firm is part of the Bovespa index. Family proportion common shares is the proportion of voting shares in the hands of family. Family proportion preferred shares is the same for non-voting, preferred shares. Women in top management indicates presence of women among directors or executives. Age diversity is the normalized standard deviation of top managers' ages. Cross-listed indicates if the firm issued ADRs. Subject to Bovespa Arbitration indicates if the firm has voluntarily submitted itself to Bovespa's Market Arbitration Panel. Shareholders agreement indicates if any shareholder of the firm participates of an agreement.

Model B in Table 4 shows a negative influence of family executives on firm value. An increase of 0.1 of the executives' *F-Index* leads to a decrease of 0.065 of the firm's Q, a 3.4% drop of the average Q. However, there is no evidence that family directors affect value. Overall, family officers' negative contribution seems to exceed the positive.

Model C shows the breakdown of the executive officers subgroup by degree. The influence of first-degree relatives is similar to the overall influence of family executives. However, the influence of second-degree relatives is stronger. This indicates that firms employing more distant relatives may suffer more severely with nepotism, decreasing firm value. In this case, a 0.1 increase of second-degree relatives leads to a 0.19 drop in Q, a 10% decrease in average value. The Wald test at the bottom of Table 4 shows that the coefficient on the second-degree *F-Index* is significantly more negative than the coefficient on the first-degree *F-Index* at the 1% level.

Model D, separating by kin, also supports the view that the more distant the family relationships in management, the greater the negative impact on firm value. Same-kin relatives have a very similar effect when compared to first-degree or the overall effect of family members as executive officers. In-law relationships have a more negative impact than same-kin ones, significant at the 5% level. Now, a 0.1. increase of in-law relatives leads to a 0.17 drop in Q, a 9% loss in average value.

ROA and Leverage are arguably the variables most prone to endogeneity issues. To alleviate such concerns, we also run tests with lagged ROA and lagged Leverage, ROE (which can be seen as a leveraged return), and lagged ROE. Using lagged ROA and lagged Leverage, *F-Index within 2nd degree executives* loses significance. Regressions with ROE and lagged ROE suffer a drop in adjusted R^2 to around 22%, with *F-Index within 2nd degree executives* and *F-Index within in-law executives* loosing significance. However, other results remain qualitatively unchanged, with family executives consistently showing significant negative effects of the same magnitude.

4. Conclusion

The new Brazilian proxy statements detail family relationships within firm management, including the type of the relation, the degree of separation and the kinship.

Using this data set, we assess the impact of family management on firm value controlling for other family characteristics (family control and family ownership (Villalonga and Amit 2006)), and firm characteristics.

Family officers drive down the value of the firm. The effect is more negative when the relationship is more distant: second-degree and in-law relationships show a more negative impact than first-degree and same-kin relationships, respectively. The economic scale of the effect is meaningful: a 0.1. increase of the family pervasiveness as officers leads to a decrease of 3.4% in average firm value. When the increase in family pervasiveness is in more distant relationships, the decrease in firm value jumps to approximately 10%. Results for family executives in general and for closer relationships (1^{st} degree or same-kin) are robust to alternative specifications. Evidence for more distant relationship is weaker and deserves more study.

Our results contribute to a relatively unexplored feature of family firms: family management. Previous studies focus on CEO transitions on family firms, and find a significant negative impact on firm performance when the successor is from the family (Bennedsen et al. 2007; Cucculelli and Micucci 2008; Pérez-González 2006). We propose a new measure of family pervasiveness on management. This measure accounts for all managerial positions held by family members within top management, and for the type of the existing relationships (degree and kinship). It highlights the importance of taking the type of family relationships into account: farther away relationships apparently exacerbate the negative effect of family management.

A possible interpretation is that family members are appointed as officers, but they are not as skilled as potential external officers (Cucculelli and Micucci 2008; Pérez-González 2006). A competing explanation is that the placing of family members as officers is a strategy of maximizing family welfare instead of firm value: they would work to expropriate value from non-family shareholders. Future research may point which explanation is valid, or whether it is a combination of both.

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