

Family Firms and Private Equity Companies

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Transfer of Ownership in Private Businesses
– European Experiences

International Conference

Stockholm, Sweden, 25th – 26th March 2010

Private Equity: An Important Player in Family Succession

- Private equity funds **stand for 25% of the global M&A activity.**
- **39% of European buyouts** in 2007 were targeting **family** firms.



But there are just 3 published academic papers on private equity investments in family firms

For Whom is This Presentation?

- **Family firms looking to sell**

Understand acquirers' perception and potentially get higher valuation

- **Private equity funds and other acquirers of family firms**

Benchmark attitude towards family firms and be better prepared to handle family firm investments

- **Academia**

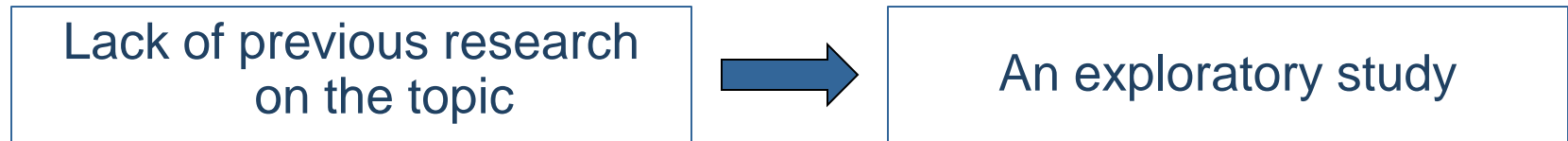
Get exposed to a research topic that is still “in its infancy” (Achleitner et al., 2008)

- **Regulators**

European Commission report stated that buy-out financing have a potential to “... make an important contribution to facilitating generational change in family owned businesses”

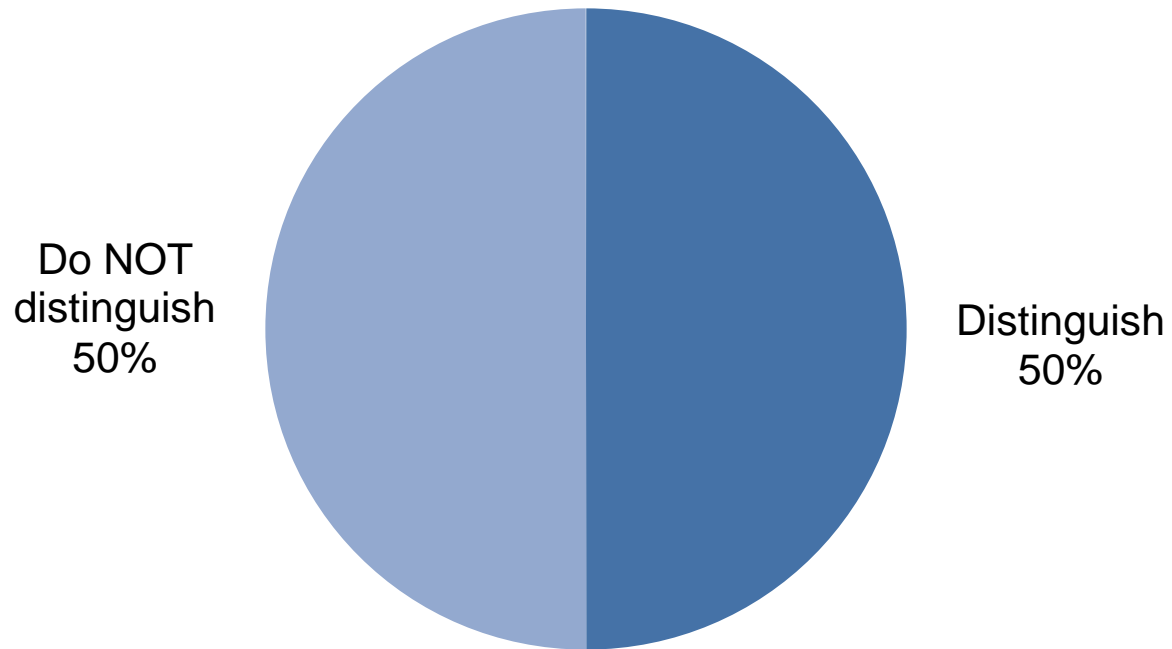
Research Outline

- Family business academia and family firms themselves recognize their distinctiveness.
- We have tried to understand if third parties, in particular investors, perceive family firms as a separate class of companies and what characteristics they attribute to family firms.

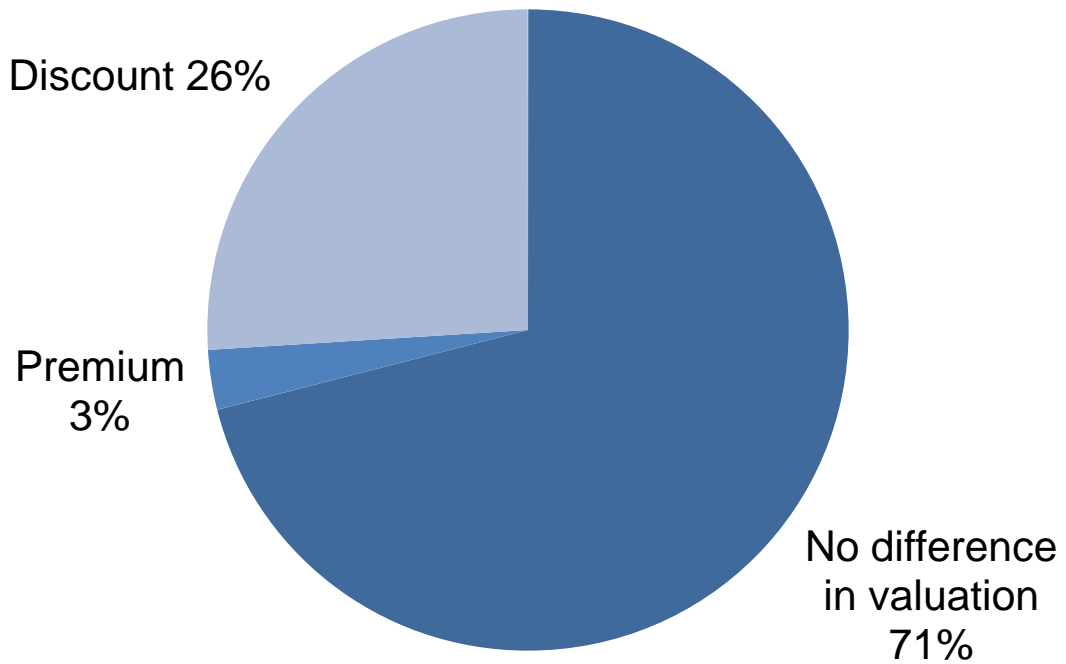


154 responses from PE in Western Europe
plus 6 expert interviews.

Distinguish Between Family- and Non-family Firms?



Difference in Valuation?



Family Firms' Characteristics

Family Firm Target Characteristic	Frequency	% of total	% of those who see diff.
Higher risk investment	51	33.1%	66.2%
Acquisition process & deal structure differ	42	27.3%	54.5%
Emotions & intuition	35	22.7%	45.5%
Family before business interests	31	20.1%	40.3%
Poor management & lower quality managers	29	18.8%	37.7%
Poor transparency & need more due-diligence	27	17.5%	35.1%
Less MIS and formal structures	24	15.6%	31.2%
Complex shareholder structure & conflicts inside family	17	11.0%	22.1%
Dominance of single individuals / very small groups	16	10.4%	20.8%
Financially inefficient & lower levels of growth	15	9.7%	19.5%
Long-term orientation	12	7.8%	15.6%

Characteristic #1: Higher Risk Investment

Family Firm Risk

Risk of hidden facts

Culture transition risk

Low decision making transparency

Change mind midst transaction

Important relations go away

Ubiquity of family managers

HR risk

How do PE Firms Adjust for Higher Risk?

Return from riskier investments is less certain and uncertainty is what the markets (and investors) dislike. Our research found two ways in which PE firms adjust for the higher risk.

Price

Deal Structure

Price

The correlation coefficient between the characteristic “Higher risk investment” and the question regarding difference in price is negative and significant (-0.461). This means that those who perceive family firms as riskier investments are also those who pay less.

This however does not imply that

~~Family Firm = Discount~~

automatically.

“...family businesses often trade at a significant discount, but this is not because they are family businesses...it is because family businesses often adopt business and management practices which can only work in a family environment.”

Deal Structure

Counterparty risk can be mitigated by a **proper deal structure**.
The following tools can be implemented:

**Motivate
collaboration**

**Avoid unpleasant
surprises**

Ownership
keeping a
minority
ownership with
the family during
the period of
investment

**Earn out
provision**
established to be
assured that the
firm will achieve
financial goals as
promised by the
seller

**Escrow
account**
established to
mitigate the risk
of untrue
representations
made by the
seller

**“Broken deal”
clause**

Deal Structure (cont.)

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GO | **NO** **GO**

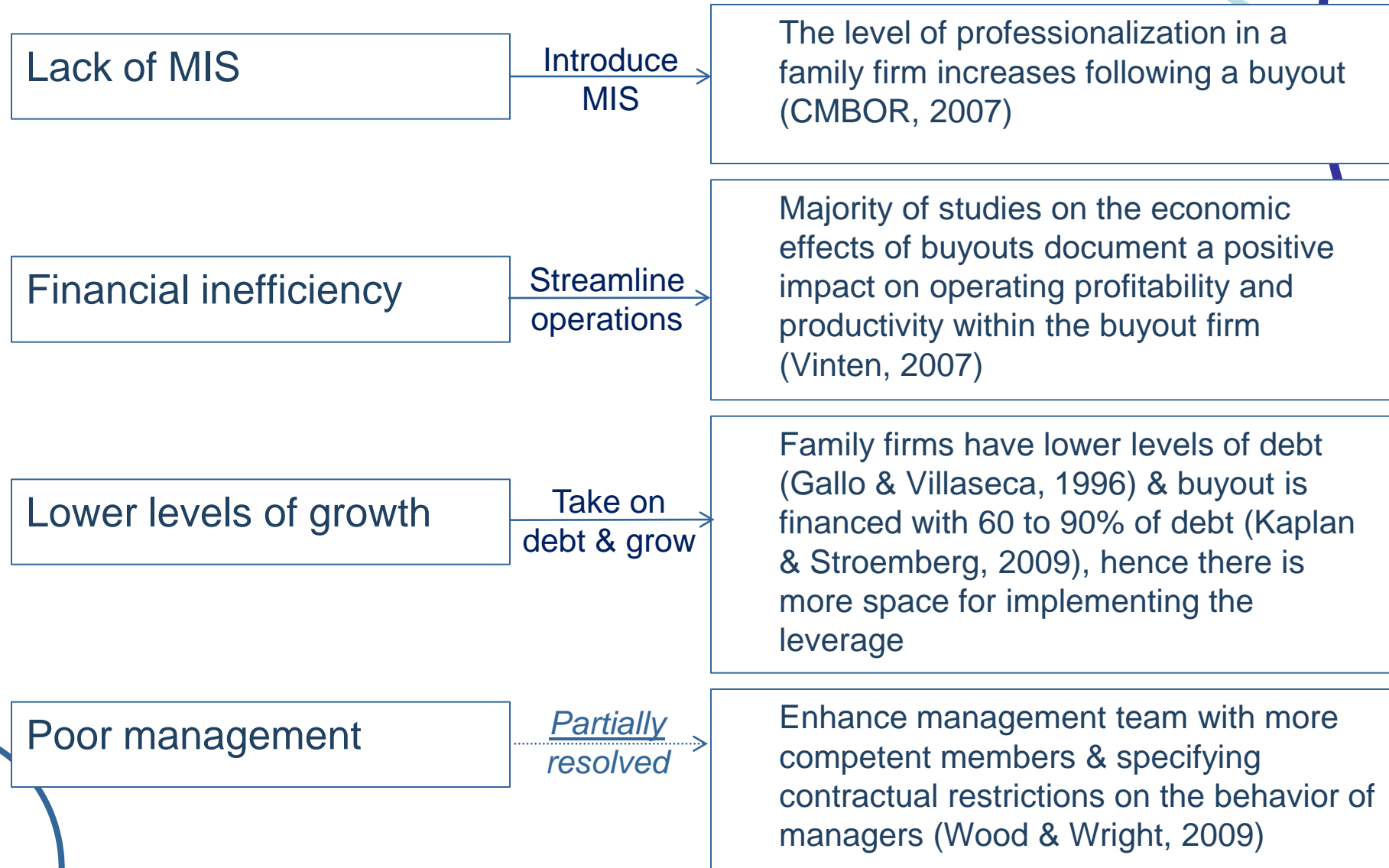
Other Characteristics

- Several experts noted that some of characteristics were not really family business related, but were rather associated with small businesses.

“That is more the question of scale”

- Academic literature often finds small businesses to demonstrate the same characteristics that private equity professionals used to describe family firms:
 - Poor managerial competence (Jennings and Beaver, 1997)
 - Even the most basic management practices not implemented (Watkins, 1983)
 - Less need for MIS: the owner-manager often is not convinced of necessity for procedures to monitor performance (Fuller-Love, 2006)
 - Dominance of single individuals (Fuller-Love, 2006)
 - Higher degree of integration of personal and business affairs (Ang, 1991)

Family Firms Characteristics and Private Equity Skills



Perception of Family Firms by Private Equity Firms

**Family Firms =
Risky &
Poorly-Run?**

**Good Upside
Potential?**



Implications for Practitioners: Acquirers

- Family firms form a particular class of acquisition targets and hence deserve a special approach.
- Further research will benefit family firm acquirers who will be able to:
 - get a grasp on family firm specific risks
 - better handle investment process in family firms
 - understand if they should value family firms differently

Implications for Practitioners: Family Firms

- Family firms can get an idea of how they are seen by potential acquirers and improve their preparation for the sale process.
- To reach higher valuation of their business, we suggest that family firms should:
 - increase transparency by introducing MIS and outlining responsibilities
 - hire an external manager
 - hire a good advisor assessing costs that offset, at least to some extent, the benefit of reduced underpricing



THANK YOU!

BACKUP SLIDES



RESEARCH TOPIC

Family Firm Succession ... Outside the Family

Succession was and remains an important topic in the family business academia

1988

2003

The pioneers of the family business research understood that a key issue challenging the majority of family firms was succession and dedicated their articles to this topic (Handler, 1989; Wortman, 1994).

Dyer and Sanchez (1998) reviewed 186 articles published in Family Business Review between 1988 and 1997 and noted that succession was still a dominant theme.

Chrisman et al. (2003) analyzed 190 articles published in 1996 throughout 2003 and came to the same conclusion: succession was the main topic in 22% of all the articles analyzed.



From a practical side, succession is gaining even more importance in the current demographic situation when the baby-boomers, many of whom are family business founders, are starting to approach “retirement age and having to confront succession and change of ownership issues” (Hickey, 2005).

Family Firm Succession...Outside the Family

Not all the family businesses are able and willing to stay in the family hands.

Not always are they successful in transferring their businesses to the next generation (Lansberg, 1999).

Family firm exit can open up the way (and free up some capital) to pursue new business opportunities.

Logics



Family firms are perceived to be “...a very hot market in terms of the number of deals” (Reinebach, 2007).

The majority of family businesses sooner or later will change hands and this fact is rather universal and independent of cultural context or economic environment (Lee et al., 2003).

Evidence



The topic of the family business sale is important.

Yet, as to Howorth et al. (2004), “*family firms succession research focuses almost exclusively on internal succession*”.



METHODOLOGY

Questionnaire

Definition: Family firm is a company in which multiple members of the same family are involved as major owners or top managers, either contemporaneously or over time.

1. Do you distinguish between family- and non-family firms when analyzing your targets?

2. Imagine you have two privately-held companies equal in every respect with the only difference that the one is a family firm and the other not: do you have a reason to pay more (positive difference, premium) or less (negative, discount) for a family firm target?

3. What is this difference due to? What particular traits does a family firm have that translate in a premium or discount?

Methodology

- The **coding procedure** was performed by **both co-authors**.
- We registered frequencies for the first and second questions and employed **content analysis** for the third question.

Emergent Coding Steps

The steps to follow were outlined in Haney et al. (1998) and Stemler (2001).

- 1) Two people **independently review** the material and come up with a **set of features that form a checklist**.
- 2) Researchers **compare notes** and **reconcile any differences** that show up on their initial checklists.
- 3) Researchers **use a consolidated checklist to independently apply coding**.
- 4) Researchers **check the reliability** of the coding. If the level of reliability is not acceptable, then the researchers repeat the previous steps. Once the reliability has been established, the coding is applied on a large-scale basis.



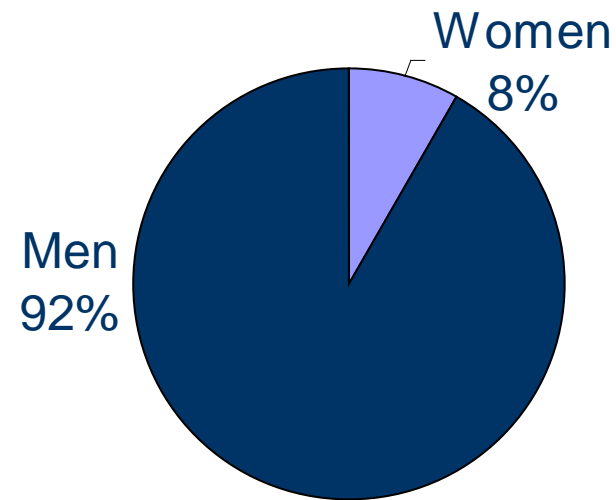
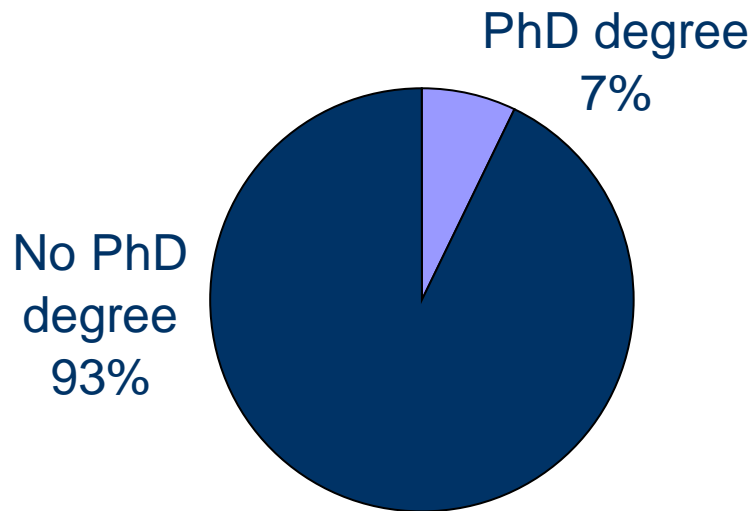
SAMPLE

Respondents

- 14 Phone + 140 E-mail + 13 N/A = **154** used in analysis
+ follow-up with 5 face-to-face and 1 phone expert interviews
- **October to December 2008** (main part); January 2010 (experts)
- **The whole population of private equity companies that have acquired Western-European targets in the last eight years** and were covered by the Mergermarket database.
 - 984 (database) → 751 (contacted)
 - E-mails sent to one or two professionals at every location of a private equity firm.

Respondents (cont.)

- Most of the respondents are investment managers / directors, some of them however are partners, managing directors and CEOs.



- Phone interviews were mostly conducted in English. Language partition of written responses is the following: Italian (2.9%), French (12.1%), German (22.1%), English (62.9%).