

FAMILY FIRMS IN THE EYES OF PRIVATE EQUITY COMPANIES

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Abstract: Solving the succession issue outside the family has become a very important topic in academia and among practitioners. This paper answers the questions of whether private equity firms distinguish between family and non-family businesses, if the attitude is rather positive or negative, and finally how family firms are perceived by their acquirers. Data was collected through an open-ended questionnaire, analyzed with the content analysis technique and followed-up with expert interviews.

Keywords: Family business sale, private equity firms.

Solving the Succession Issue Outside the Family

Succession was traditionally the most important topic in family business research. The pioneers of family business research understood that a key issue challenging the majority of family firms was succession and dedicated studies to this topic (Handler, 1989; Wortman, 1994). Between 1988 and 1997, succession was still a dominant theme according to Dyer and Sanchez (1998) who reviewed 186 articles published in *Family Business Review*. Chrisman et al. (2003) analyzed 190 articles published or presented from 1996 throughout 2003 and came to the same conclusion: succession was the main topic presented in 22% of all the articles analyzed.

From a practical point-of-view, succession is gaining even more importance in the current demographic situation where 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). Passing the business on to the family successor depends on the desires and attitudes of each generation (Birley, 1986). The younger generation must be interested in continuing the family business and able to do so. However, successors may have business interests different from those of their parents. Consequently, the sale of a family firm is necessary to open up the way to pursue new business opportunities for the next generations as well as free up some capital. For example, at least one half of the family firms in Switzerland will solve the succession issue outside the family (Halter et al., 2009). Also in

Germany there is a growing tendency to sell family firms to third parties. According to a PWC study, 70,000 family firms each year have problems finding a successor, with 30,000 forced to sell (Gow, 2007). In the US, only around 30% of family businesses survive to the second generation (Astrachan & Allen, 2003; Leach & Bogood, 1999) and only 15% make it to the third (Leach & Bogood, 1999). In the UK, just 24% manage to be passed to the second generation and only around 15% to the third (Leach & Bogood, 1999; Bytestart website, 2005). A Deloitte survey of privately-held businesses revealed that merely less than 10% of the UK business owners will never seek an exit and let the business remain in the family (Cohen, 2009). This means that 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). Investment professionals have already recognized the potential of this market. They perceive family firms to be a very hot market in terms of the number of deals (Reinebach, 2007).

Summarizing, a change in ownership, whether it be by family succession or sale, is inevitable for all private businesses. Evidence suggests that the latter option prevails over the former. Yet, according to Howorth et al. (2004), academic research focuses almost exclusively on internal succession.

One important class of acquirers of family businesses is represented by private equity companies. They invest in unquoted companies at both an early stage (venture capital) and a later stage (buyouts) (Wood & Wright, 2009). Typically, private equity firms purchase majority control of an existing or mature firm (Kaplan & Stromberg, 2009). These investment vehicles first appeared about a half-century ago according to some sources (Anonymous, 2009), and in the 1980's according to the other sources (Kaplan & Stroemberg, 2009), yet they did not receive wide publicity until their "golden age" between 2002 and 2007. Despite the fact that there is a considerable amount of practitioner literature on private equity, it is a relatively new topic in academia (Bargeron et al., 2008). Even less developed is the academic research on private equity in family firms. In 2008, it was described as being still "*in its infancy*" by Achleitner et al.

Private equity funds represent 25% of global M&A activity (Jensen, 2007). Private equity investment firms typically target privately-held companies many of whom are family businesses. Hence, private equity firms play an important role in the succession outside the family. The Centre for Management Buy-out and Private Equity Research revealed that 39% of European buyouts in 2007 were targeting family firms (CMBOR, 2007). 62% of family businesses are acquired by private equity investors according to the Bytestart website (2008).

The few studies of private equity investments in family firms (e.g. Achleitner et al., 2008, Howorth et al., 2004) focused on family firm motivations and the deal process. The most similar to the current study is research by Dawson (2008) who examined decision-making models used by private equity investors in their selection of family firms.

We believe our study is unique since it is the first research undertaken that is aimed to reveal family firm characteristics from the point of view of its investors. 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. Due to the lack of previous research on the topic, our work is organized in the form of a qualitative study and has rather an exploratory character. What we wanted to achieve was a picture of family firms drawn by the companies that routinely analyze numerous family firm targets. In general terms, rather than

testing a hypothesis about reality, we were looking to make a statement about how actors interpret reality (Suddaby, 2006).

Data and Method

A survey was conducted from October to December 2008 and included the whole population of private equity companies that have acquired Western-European targets in the last eight years and were covered in the Mergermarket database. The study is based on 14 phone interviews and 140 written responses and followed up with 5 face-to-face and 1 phone expert interviews. Questionnaires were sent to several locations of a private equity firm, resulting in 154 answers representing 138 private equity firms. The number of private equity firms worldwide is approximately 2,140 (Thomson Reuters, 2007). Thus, this research represents opinions of about 6.4% of all the private equity firms globally. Please refer to the Appendix 1 for the questionnaire and to the Appendix 2 for the sample description.

To analyze questions about family firm characteristics, we employed content analysis using the emergent coding technique. Emergent coding is defined as an approach to classifying individuals' open-ended responses by which a coding scheme is established after all responses are collected. As a next step, systematic content analysis is conducted applying this scheme to the responses (Neuendorf, 2002). In coding the interviews, we assigned a maximum of three codes to each piece of related sentences fragments or "thought unit" (Currall et al., 1999). We allowed for multiple codes because we found that even small thought units could easily be assigned to multiple categories (Klein et al. (2007) approached this issue in the same way). To explain the method in simple words: we first read interviews and extracted family firm characteristics forming a long list. Long list categories were then compressed into bigger categories. Finally, we re-read all the interviews to register frequencies of the bigger categories, where every "thought unit" could be allocated up to a maximum of three categories.

Our next stage consisted in conducting expert interviews. The goal of this step was to clarify and broaden our understanding of family firm targets' perception by private equity firms. During this phase, we interviewed 6 additional private equity professionals. The interviews lasted 30 minutes on average. We explained to interviewees that we had conducted prior research about family firm' perception by private equity firms and were interested in knowing whether our preliminary conclusions were on target. Experts agreed to 68% of our family firm characteristics.

Analysis

Exactly one half of the respondents stated that they distinguish between family- and non-family firm targets. However, only one third replied that this difference influenced the price and in most cases it was negative. One of the interviewees commented: "*...overall this means 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*" (#148). The private equity companies which did not see any difference often commented that they use general valuation criteria and whether a target is a family or a non-family firm does not matter. This is in line with the findings by Dawson (2008) who stated that private equity investors attribute greater importance to criteria that are not family-related.

The following table presents the most common themes and their frequencies.

Family Firm Target Characteristic	Freq.	% of total	% of those who see difference
Higher risk investment	51	33%	66%
Acquisition process & deal structure differ	42	27%	55%
Emotions & intuition	35	23%	46%
Family before business interests	31	20%	40%
Poor management & lower quality managers	29	19%	38%
Poor transparency & need more due-diligence	27	18%	35%
Less MIS and formal structures	24	16%	31%
Complicated shareholder structure & conflicts inside family	17	11%	22%
Dominance of single individuals or very small groups	16	10%	21%
Financially inefficient & lower levels of growth	15	10%	20%
Long-term orientation	12	8%	16%

Table 1. Family Firm Target Characteristics: Numbers

From the table it appears that family firms are generally perceived to be risky investments and that the process of acquiring them differs from non-family firms. The next table presents evidence for each of the characteristics.

Family Firm Target Characteristic	Evidence
Higher risk investment	<p>"There is risk involved in a family deal that the family takes money, leaves and business stops." (#4)</p> <p>"Businesses with extensive family involvement tend to have greater human resources risks and transition risks than those that have been "more professionally" managed". (#40)</p> <p>"...risk / uncertainty in the decision-making when dealing with family members". (#50)</p> <p>"it tends to be more difficult to implement change in family businesses...so harder to drive out the value". (#107)</p> <p>"...the risk that it will be difficult to change a culture..." (#110)</p> <p>"...risk of hidden facts..."(#125)</p>
Acquisition process & deal structure differ	<p>"A family business sale can be cancelled last minute, because the owning family has changed its mind." (#5)</p> <p>"[family] is a negotiating tool more than anything, as it gives you certain flexibility with regards to pricing". (#59)</p> <p>"...selling process of a family firm is less public, i.e. is not conducted through an open auction". (#69)</p> <p>"...selling professionalism is less developed than by corporations". (#99)</p> <p>"...a PE firm can include certain non-cash elements in a transaction which a family values, whereas the actual cash price might be less than what a corporate seller would require...Family firms ... are more interested to understand who they are dealing with... We value having more time to access information, and to have less competition when looking at a particular target.". (#105)</p> <p>"The family has to hold ...10-25% in order to be stimulated to collaborate with the PE. (#120)</p> <p>"Family firm deals are much tougher. You have to give reassurance to the family". (#144)</p>

Emotions & intuition	<p>"The owners of family firms involve more emotions when they decide about the price..." (#12)</p> <p>"Higher loyalty to the company, often more than just financial commitment". (#93)</p> <p>"...non-formal indicators of level of activity and financial health ... (vision of the rhythm of work of employees, the mood of any particular key employee)..." (#108)</p> <p>"...discussion is usually connected with more emotions, more irrational thinking..." (#124)</p> <p>"Families are emotionally involved with their companies: that is why usually the sale of the business would be the last solution for sourcing the money for some other needs". (#144)</p> <p>"The family management knows their company and the industry so well that decisions are often taken following their instinct". (#146)</p>
Family before business interests	<p>"...privilege to family members..." (#55)</p> <p>"...family business ...often sees its interests confused with those of individuals who control it" (#89)</p> <p>"...management that can handle in family and not in company's best interest (e.g. arbitration salaries / dividends)..." (#108)</p> <p>"A family extracts value from the company in form of salaries and using company's assets in family purposes...Families run the business to finance the family". (#118)</p> <p>"...earnings depressed by "family" expenses..." (#151)</p>
Poor management & lower quality managers	<p>"As a rule, I would say family businesses are not as well run as corporates". (#66)</p> <p>"...the management of these businesses is less professional than non-family companies, as management positions tend to not necessarily be filled according to the managerial competence". (#89)</p> <p>"...less 'sophisticated' (perhaps sticking to tried and tested practices)" (#109)</p> <p>"...family managers [are of a] lower quality, because they come to firm on managerial position without recruitment process, so that means it is a big chance they have no adequate qualification, experiences from previous jobs or they are less suitable for concrete position..." (#125)</p> <p>"More often than not feuds and internal conflicts result in a business being mismanaged or decisions being poor or delayed". (#145)</p>
Poor transparency & need more due-diligence	<p>"...a greater potential for the information asymmetry. Once the meeting is finished, the private equity goes home and discussion stops for it, but not inside the family". (#4)</p> <p>"The lack of professional investors means you can see some very strange reporting metrics and processes and often there will be a lot of skeletons in the closet ..." (#41)</p> <p>"We would certainly flag an opportunity if it was a family firm for additional due diligence on the dynamics of the relationships". (#50)</p> <p>"...the distribution of power is usually different from that displayed on the official organizational chart". (#89)</p> <p>"In family firms, one cannot see from financial accounts what the real company's potential is...A private equity has to reconstruct accounts, because actual numbers are prepared for fiscal authorities and do not display the real value...The due diligence of a family firm has to be done with the major degree of suspicion. Families are always smarter than private equities". (#118)</p> <p>"...you always need to be careful with the quality of accounting and controls in family businesses and also at the process for hiring, assessing and promoting people, also need to understand if there will be an impact of reducing the family involvement in the business..." (#148)</p>
Less MIS and formal structures	<p>"...sometimes they have poorly developed management and reporting structures. The reason can be that the owning family had no interest in institutionalized management structure for a long time". (#53)</p> <p>"...they have an insufficient financial reporting systems, lack enterprise reporting systems (e.g. SAP)". (#54)</p> <p>"...in the non-family firms there is more reporting..." (#86)</p> <p>"Flexible structures in the family firm (one person often performs different functions)". (#120)</p>
Complicated shareholder structure & conflicts inside family	<p>"It typically faces complex structures, especially after many generations". (#54)</p> <p>"...multiple family members involved there are often different interests of family members or [family branches] in place. This makes a transaction more difficult". (#63)</p>

	<p>"You try negotiating with a the shareholders when they're all inter-related and you'll soon find out that doing a deal from a family is usually a nightmare...shares spread amongst ill informed opinionated family members who don't agree that the deal being offered is fair...". (#81)</p> <p>"There are sometimes disagreements between shareholders, for various reasons (often larger than the business) that can complicate or even jeopardize the future of a company". (#83)</p>
Dominance of single individuals or very small groups	<p>"...the dependence on single persons. This is potentially higher by family firms". (#12)</p> <p>"...the change in control is often problematic due to the dominant status of the previous owners." (#90)</p> <p>"...structurally are tailored to a strong leader/patriarch with all the pluses/minuses". (#91)</p> <p>"Family firms are often autocratically run: One person decides everything...Even if an outside CEO is employed, he has to report to the family member, who will take the final decision. The inability to guide the strategic development of a business is often the reason why good CEOs do not want to work for a family firm".(#146)</p>
Financially inefficient & lower levels of growth	<p>"They do not move once a "point of comfort" is reached". (#4)</p> <p>"Family run businesses tend to be less efficient – whether it is on expenses (higher cost); or in strategy (very opinionated and stuck in tradition)". (#7)</p> <p>"Often family firms are not the most aggressive in driving growth". (#101)</p> <p>"Family businesses tend to be more risk adverse and therefore less likely to have the skills within them to make acquisitions or expand geographically". (#104)</p> <p>"I would expect family-owned firms to have more inefficiencies..."(#105)</p> <p>"...often lacked capital to expand internationally which means... untapped expansion opportunities". (#151)</p>
Long-term orientation	<p>"Family firms have a longer history. This means they are more robust, they survived through different cycles". (#4)</p> <p>"They invest enough, because they have a vision on a future". (#39)</p> <p>"...long term view on strategy, trusted partners, often well invested and property rich which improves asset backing..."(#41)</p> <p>"...better position in their market, because they can follow long-term strategies and take care about the customers not the capital markets".(#48)</p> <p>"...long-term management and hence better quality assets, customer relationship management". (#55)</p> <p>"Family businesses are inherently more durable, stronger, with long-term projects and sometimes longer investment cycles". (#108)</p>

Table 2. Family Firm Target Characteristics: Evidence

We have decided to focus on main issue, which is the riskiness of family firm targets.

Private equity houses perceive family firms to be riskier than non-family companies. Higher riskiness was clearly the main theme throughout our interviews. The riskier an investment, the lower price an investor is willing to pay for the same final value (i.e. higher required return). As we have expected, the correlation coefficient between the characteristic "Higher risk investment" and the question regarding difference in price is negative and significant (-0.461). Therefore, those who perceive family firms as riskier investments tend to be the same people who assign lower values to the firms. In other words, private equity firms adjust for risk with a lower price. This however does not imply that if an investor analyzes a potential target and flags it as a family firm he or she would automatically apply a discount. This finding is about family-firm specific risks that can make an influence on the valuation. A part of adjusting for the riskiness in price, counterparty risk can be mitigated by a proper deal structure. One of the private equity professionals commented: "*[Family firms] can ... cheat the books and show profits that are not there in reality. The deal can be structured in the following manner to avoid this. If the price of a company is 100, you give to the family 85 and put 15 in an escrow account. If after 6 months, the results are like they have to be, the family gets its 15. If you propose such a deal to a family and then you see them nervous, you know that there is something wrong.*" (#118) Experts commented on the differences between an escrow account

(established to mitigate the risk of untrue representations and warranties made by the seller, e.g. lower accounts receivables than what was recorded on the firm's books) and an earn out provision (established to be assured that the firm will achieve financial goals as promised by the seller, the clause mentioned by the respondent quoted above). In other words, an escrow account is used to avoid risks connected to the firm's past and present, while earn outs are more about the future: they serve to bridge the gap between buyer's and seller's valuations of the target's future profitability. Another interviewee mentioned the importance of keeping a minority ownership with the family during the period of investment: "*We would buy 100% in case of a big corporation spin-off / secondary, but between 75% and 90% in case of a family firm. The family has to hold the remaining 10-25% in order to be stimulated to collaborate with the PE.*" (#120) One of the respondents mentioned including a "broken deal" clause in the letter of intent, since according to some of interviewees families were more inclined to change their mind midst transaction. It would be fair to note however that these conventions are not exclusive to family firm buyouts. For example, it is common for acquired firm management to get an equity stake in portfolio companies (Kaplan & Stroemberg, 2009). Also earn outs have always served as a risk management tool in private equity deals (Parnass, 2009).

In analyzing the different characteristics overall, several experts noted that some of characteristics we have presented were not really family business related, but were rather associated with small versus large businesses. As one of the experts noted: "*That is more the question of scale*" (E2). In fact, academic literature often finds small businesses to demonstrate the same characteristics that private equity professionals used to describe family firms. For example, poor managerial competence was found to take place in small businesses by Jennings and Beaver (1997) and can be partially explained by lower levels of training and development (Loan-Clarke et al., 1999). Watkins (1983) found that small business owners do not see the need to implement even the most basic management practices. There is also less need for MIS in small firms, as the owner-manager often is not convinced of necessity for procedures to monitor performance (Fuller-Love, 2006). Our characteristic "Dominance of single individuals" is also one of the problems faced by small firms since the owner wishes to retain control of all aspects of the business (Fuller-Love, 2006). To some extent, the "Family before business interests" characteristic was also attributed to small businesses. According to Ang (1991), small firms have a higher degree of integration of personal and business affairs than large companies. These results suggest that private equity professionals may equate family firms to small businesses.

Most family firm characteristics that emerged from the research seem to be weaknesses. However, these weaknesses correspond to the measures that active investors such as private equity firms undertake. The issue of lack of management information systems can be solved by introducing it. Indeed, the level of professionalization in a family firm was found to increase following a buy-out (CMBOR, 2007). The financial inefficiency problem can be settled by streamlining operations. In fact, Ernst & Young found organic revenue growth contribution to overall increase in EBITDA of private equity portfolio companies to be of 49%. By taking on more debt previously non-growing ex-family firms can be sped up. Lower levels of debt in family firms mentioned by the previous literature (see e.g. Gallo & Villaseca, 1996) should be favored by private equity investors. Since the buyout is typically financed with 60 to 90% of debt (Kaplan & Stroemberg, 2009), private equity companies have more space for implementing the leverage in businesses that have had lower levels of debt in the past. The only weakness that is not easily corrected is poor management. Private equity firms usually feel more comfortable about transition if they invest in companies with a strong management in place. However, even this problem may be partially resolved by enhancing

management team with more competent members and specifying contractual restrictions on the behavior of managers (Wood & Wright, 2009).

Conclusions

The topic of private equity investments in family firms seems to be gaining in momentum. It is being increasingly studied not only by academia, but it seems to be interesting also to practitioners. The fact that 154 busy private equity professionals performed the difficult task of answering open questions speaks in favour of further work in this direction.

Results from this research revealed that one half of the private equity companies surveyed flag the fact that a potential acquisition target is the family firm. The ones that would value a family firm differently lean towards negative valuation and to some extent, this is explained by the higher risk attributed to family firm targets. Further research on the particularities of the acquisition process and deal structures, as well as deeper understanding of the particular risks, would certainly be of interest.

The understudied topic of family firm acquisitions should gain more attention. Family firms form a particular class of acquisition targets and hence deserve a special approach. Further research will benefit family firm acquirers who would be able to better handle investments in family firms. Family firms can get an idea of how they are seen by potential acquirers and improve their preparation for the sale process. From the current study, it appears that they should increase transparency of their business. In part, this can be achieved by introducing management information systems and outlining responsibilities within the firm, a move that possibly involves hiring an external manager. As previously discovered by Dawson (2009), private equity companies prefer family firms that are already professionalized. Hiring an external manager would not only add to the perception of a firm as being “professionally managed,” but would also diminish reliance on single individuals and make investors more confident in a smoother ownership transition. Furthermore, hiring an external advisor would help both parties drive more easily through the process. Experts commenting on the lesser professionalism of family firms during the acquisition process noted that it is not true that the families are less professional sellers, but that they did not have good advisors. An external party may also help overcome emotions and form realistic expectations about what the family business is worth. In addition, an advisor would be useful for solving family conflicts before making a firm available for sale. However, using prestigious financial institutions and auditors incur costs that offset, at least to some extent, the benefit of reduced underpricing (Hutchinson, 1999).

We hope that our findings and conclusions will inspire new studies on private equity investments in family firms, as well as other alternative succession routes. For decades, we have been well-served by studies of succession that focus on the passing the firm to the next generation. Yet succession takes other forms and, given the large amount of families exiting their business, this topic warrants further conceptual and empirical analysis. We also believe that our study contributes to the understanding of family firm perception by third parties and that further research on how external groups such as investors and customers view this unique type of organization is justified.

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APPENDICES

Appendix A. 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?

Appendix B. Sample characteristics

- Phone interviews were mostly conducted in English. The language partition of written responses is the following: Italian (2.9%), French (12.1%), German (22.1%), English (62.9%).
- Most of the respondents occupy investment manager / director positions in their companies, but some responses are from partners, managing directors and CEOs.
- There are only 13 female respondents in the sample (8.4%). Such a small proportion of women is representative of the population. Female professionals represent less than 10% of senior-level executives and deal-makers in the traditionally male-dominated field of private equity (Elizabeth Falk, founder of the Women’s Private Equity Summit, 2008).
- 7% of respondents have a PhD degree.