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ANNALIS  
UNIVERSITATIS MARIAE CURIE-SKŁODOWSKA  
LUBLIN – POLONIA

VOL. XLVII, 4

SECTIO H

2013

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*The capital structure and the dividend policy of family firms*

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Struktura kapitałowa i polityka dywidendowa firm rodzinnych

**Key words:** family firms, dividend policy, corporate finance

**Słowa kluczowe:** firmy rodzinne, polityka dywidend, finanse przedsiębiorstw

## 1. Introduction

Two of the most discussed and most examined topics in the field of corporate finance are the (optimal) capital structure and – to a lesser extent – the dividend policy of companies. Both questions are clearly interrelated as for example the decision of a firm to retain earnings rather than paying them out in form of dividends can be considered as a financing decision. Furthermore, factors such as taxes, costs of financial distress and agency costs are important determinants of both decisions (Palepu et al., 2007).

The majority of theoretical and empirical papers which analyzed both these research questions, however, focused on *large public/listed companies* showing a *dispersed ownership structure*. It is questionable if these results can be transferred to companies dominated by large shareholders, especially to businesses owned by one or more families, because family-controlled firms show a *specific goal and incentive structure* compared to non-family enterprises: They do not exclusively follow the principle of value maximization but pursue non-economic goals, too (e. g., Corbetta and Salvato, 2004). Many families hold undiversified portfolios consisting mainly of large stakes in their firm and consequently carry excessive risk (Shleifer and Vishny, 1997). They desire to pass their business on to the next generations (e. g., Anderson, Mansi and Reeb, 2003; Andres, 2008), and they are concerned about their personal

and their company's reputation (e. g., Anderson, Mansi and Reeb, 2003; Dyer and Whetten, 2006). Therefore, they could pursue a strategy which focuses on long-term firm survival instead of strictly adhering to the goal of value creation (Anderson, Mansi and Reeb, 2003). Moreover, thinking in generations could also favor a specific long-term orientation (James, 1999).

Accordingly, this paper addresses the following two research questions:

- Are family firms more or less levered than non-family businesses?
- Do family firms pay more or less dividends than non-family businesses?

## 2. The capital structure of family firms

### 2.1. Conceptual framework

Myers (1984) and Myers and Majluf (1984) showed that companies follow a *pecking order* when issuing securities. This concept seems to be especially suitable for family businesses as for example Romano, Tanewski and Smyrniotis (2000), Poutziouris (2001) and López-Gracia and Sánchez-Andújar (2007) pointed out. Whereas in general companies try to avoid the increasing costs of financial distress and information asymmetry associated with climbing up the pecking order, in family firms maintaining family control over their business and preserving their independence there also seem to be major forces behind following the pecking order in financing decisions (e. g., Michaelas, Chittenden and Poutziouris, 1998). The pecking order theory, however, doesn't predict a special target capital structure; therefore, family firms will favor internal sources of finance (and therefore self-financing) over risky debt. This could imply a lower leverage on the one hand. Once internal capital is exhausted, family businesses prefer debt-financing to issuing external equity in order to preserve their family control and independence. This behavior could lead to a higher leverage on the other hand.

The so called "*trade-off theory*" suggests that a company chooses its optimal capital structure by balancing the benefits of debt against its drawbacks. Whereas a high leverage reduces the tax burden of a company (tax shields), it also raises the probability of financial distress and therefore the associated costs of financial distress (e. g., Myers, 1984). Family members derive several special benefits from control over their company. These benefits are at risk in the event of financial distress or bankruptcy, as these events are often associated with a change in control (Mishra and McConaughy, 1999). Moreover, family owners are especially endangered by financial distress because of their large undiversified ownership stakes (Andres, 2008). Since (high) leverage increases the probability of financial distress, family enterprises will seek to *reduce their leverage* (e. g., Mishra and McConaughy, 1999; Anderson and Reeb, 2003; Andres, 2008) and might adhere to "financial conservatism" (Miller and Le Breton-Miller, 2006, p. 81). This aversion to debt, however, can go hand in hand with giving up profitable growth opportunities (e. g., Mishra and McConaughy, 1999; Andres, 2008).

By contrast, Jensen (1986) showed that *debt can mitigate agency problems* because it “reduces the agency costs of free cash flow by reducing the cash flow available for spending at the discretion of managers.” (Jensen, 1986, p. 324). Family businesses show fewer agency conflicts between owners and managers due to greater owner incentives to monitor the managers especially because of their large undiversified ownership stakes (Anderson, Mansi and Reeb, 2003; Villalonga and Amit, 2006; Andres 2008). Moreover, in some cases they even show the identity of owner(s) and manager(s) (Jensen and Meckling, 1976). Large owners, however, tend to pursue their own interests which need not comply with the interests of other shareholders. Therefore, the possible expropriation of minority shareholders can be seen as a major disadvantage of concentrated ownership in general (Shleifer and Vishny, 1997) and family ownership in particular (Faccio, Lang and Young, 2001; Setia-Atmaja, Tanewski and Skully, 2009). Whereas debt plays a less important role as disciplining device for managers in family firms (Ampenberger et al., 2013), it can help to discipline the expropriating family itself (Setia-Atmaja, Tanewski and Skully, 2009).

Finally, Anderson, Mansi and Reeb (2003) revealed empirically that family firms face *lower costs of debt* due to their special incentive structure that attenuates agency conflicts between owners and creditors. They show a risk adverse behavior because of their undiversified ownership stakes and because they desire to pass the firm on to their heirs. Furthermore they want to protect their family’s and firm’s reputation. Finally, through the family’s sustained long-term presence in the company banks can develop personal and well-informed relationships with family executives (“relationship banking”). These lower costs of debt could facilitate the raising of debt by family firms.

## 2.2. Empirical evidence

Research on family firms’ capital structure has gained momentum in the last years. Most of these studies have analyzed the capital structure of *listed family firms*: McConaughy and Phillips (1999), Mishra and McConaughy (1999) and McConaughy, Matthews and Fialko (2001) for example found evidence of a *lower leverage* in US listed family firms, Ampenberger et al. (2013) in German listed family businesses. This study also showed that the negative family impact on debt seems to be driven by management involvement including a strong negative effect of a founder CEO on leverage. Schmid (2013) found evidence of a lower leverage in German listed family firms too, whereas the opposite is true for East Asian and other European countries. This result could be attributed to higher credit monitoring in Germany’s bank-based financial system which induces family firms to avoid debt as a financing source. Finally, Strebulaev and Yang (2013) revealed that public US family firms are more likely to be “zero-levered”<sup>1</sup> than non-family enterprises.

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<sup>1</sup> “Zero-levered” was defined as a book leverage of 5% or lower.

*No differences* in the capital structure were noticed by Anderson and Reeb (2003) in public US companies. Family firms, however, showed *higher leverage* in the studies of Harijono, Ariff and Tanewski (2004) and Setia-Atmaja, Tanewski and Skully (2009), who both analyzed Australian listed firms, in Cheng and Tzeng's (2011) review of listed Taiwanese enterprises, in King and Santor's (2008) analysis of Canadian public companies, Ellul's (2010) study with a focus on listed companies from 38 countries and finally in Croci, Doukas and Gonenc's (2011) analysis of publicly listed Continental European enterprises.

When we turn to studies analyzing *private companies* a *lower leverage* in family businesses was noticed by Poutziouris (2002) in UK private (mainly) small and medium enterprises, Gallo, Tàpies and Cappuyns (2004) in Spanish (with a few exceptions) non-listed medium and large companies (sales over €21.6 million and more than 150 employees), Zellweger (2006) in Swiss non-listed companies and López-Gracia and Sánchez-Andújar (2007) in Spanish medium-sized enterprises (with between 50 and 250 employees). *No differences* in the capital structure could be found by Coleman and Carsky (1999) in US private small companies (with fewer than 500 employees), Pernsteiner (2008) in Upper Austrian (mainly) medium-sized private enterprises and finally Bjuggren, Duggal and Giang (2012) in Swedish closed medium-sized enterprises. A *higher leverage* of family firms however was noticed by Wu, Chua and Chrisman (2007) in a mixed sample of mainly private but also public equity financed Canadian SMEs (with no more than 500 employees).

Finally González et al. (2012a) found in a mixed sample of mainly private but also listed Columbian firms that the type of family involvement matters: while family management has a negative influence on leverage (which, however, becomes positive in old firms), family ownership has a positive effect on leverage. Furthermore the presence of family members on the board has a negative impact on the use of debt.

To sum up, the presented empirical analyses *don't clearly indicate* if family businesses show a higher or lower leverage than non-family controlled companies. This is especially true for listed firms, whereas non-listed family enterprises show a slight tendency for less or equal leverage than their non-family counterparts.

### 3. The dividend policy of family firms

#### 3.1. Conceptual framework

As discussed above family firms follow a pecking order of financing (Myers, 1984; Myers and Majluf, 1984) to preserve their independence, i. e. among others, they are reluctant to raise external funds (Michaelas, Chittenden and Poutziouris, 1998; Romano, Tanewski and Smyrniotis, 2000; Poutziouris, 2001; López-Gracia and Sánchez-Andújar, 2007). Family business owners, however, have limited financing capabilities (Salvato, 2004; Fernández and Nieto, 2005), not least because of their

low diversification of wealth. Therefore, family-controlled enterprises should *tend to retain profits* (Poutziouris, 2001; Blanco-Mazagatos, de Quevedo-Puente and Castrillo, 2007) instead of paying them out to their shareholders.

Moreover, Jensen (1986) showed that not only debt but also *dividend payments can discipline* managers and therefore mitigate agency costs. As family businesses show fewer agency conflicts between owners and managers, dividends will play a less important role in disciplining the managers of these companies (Gugler, 2003; Schmid et al., 2010; Pindado, Requejo and de la Torre, 2012). If, however, severe agency problems between minority shareholders and controlling shareholders are prevalent, family firms could mitigate these problems by paying out higher dividends (Faccio, Lang and Young, 2001; Setia-Atmaja, Tanewski and Skully, 2009; De Cesari, 2009; Pindado, Requejo and de la Torre, 2012).

Finally, the *personal preferences* of the family members can influence the payout policy. Family members urge the company to pay out dividends in order to fund their personal consumption ("cliente effect"), whereas the amount of the dividend payments is also influenced by their and the company's life cycle. Young founders could forego payouts to build up the business, whereas in later years they might fund personal consumption with cash received from dividend payments. Moreover, conflicts in families with multiple members and especially with several generations can influence the dividend payout policy of family businesses. Therefore, managers of family firms could use high dividends to pacify their family owners (DeAngelo, DeAngelo and Skinner, 2009; Schmid et al., 2010) or some groups of family owners (for example family shareholders with weak ties to the firm).

### 3.2. Empirical evidence

Many studies analyzing the differences in the payout policy between family and non-family firms have focused on *listed enterprises*. On the one hand, evidence of *lower dividend payments* by family firms was for example found by McConaughy, Matthews and Fialko (2001) in US listed firms, De Cesari (2009) in Italian public companies and finally Wei et al. (2011) in Chinese listed enterprises. On the other hand *higher dividend payments* by family-controlled enterprises were observed by Setia-Atmaja, Tanewski and Skully (2009) in Australian listed firms, Yoshikawa and Rasheed (2010) in Japanese OTC-listed firms, Pindado, Requejo and de la Torre (2012) in listed enterprises in nine European countries and Schmid et al. (2010) in German public companies. This study also showed that „*real*“ *family firms* (with multiple family members and/or generations) have a *higher payout propensity* than founder-controlled family firms which can be attributed to the existence of conflicts and common action problems between different family members and/or generations. Finally Chen et al. (2005) found *mixed evidence* of the payout propensity in listed Hong Kong firms depending on the percentage of family ownership.

When we look at the studies focusing *unlisted firms* Gugler (2003) noticed *lower dividend payouts* in a mixed sample of mainly unlisted but also listed large Austrian enterprises, whereas *higher dividend payments* by family firms were observed by Lybaert, Vandermale and Voordeckers (2006) in a sample of private Belgian companies. Finally González et al. (2012b) showed in a mixed sample of mainly private but also listed Columbian firms that the kind of family influence matters: while majority family ownership, a founder CEO and indirect family control through pyramidal structures have a negative impact, family involvement in the board has a positive influence on dividend payments.

To sum up, the empirical studies of both public and private enterprises show *no clear evidence* concerning the payout propensity of family firms.

#### 4. Discussion

Our theoretical analysis indicates that the specific goal and incentive structure of family firms affects agency conflicts prevalent in these enterprises. As agency problems are important determinants of companies' financing decisions, the family influence itself can be seen as a noteworthy force behind capital structure and payout decisions. The *theoretical analysis*, however, shows *no clear evidence* that this family influence leads to (1) more or less *leverage* and (2) higher or lower *dividend payments* of family firms compared to their non-family counterparts.

The same holds true for *empirical studies* which present *mixed results* concerning the leverage and payout propensity of family businesses. These ambiguous empirical results, however, should not be interpreted as evidence of the non-relevance of family involvement in financing decisions in practice. Romano, Tanewski and Smyrniotis (2000) showed that *family specific factors* (such as the desire to maintain family control) have a significant influence on the financial and capital structure decision-making process of family firms. Moreover, significant differences in the capital structure decision and financial policy between family and non-family enterprises were noticed by López-Gracia and Sánchez-Andújar (2007) for example.

The mixed empirical evidence could rather be attributed to, among others, *country effects* and *different financial systems* (bank-based vs. market-based financial systems). Furthermore *methodological issues* and (omitted) control variables could have influenced the results.<sup>2</sup> Moreover, the impact of different family firm definitions and especially different types of family involvement (e. g., management vs. ownership, founder-led vs. non-founder-led companies) must not be neglected as for example the studies of Schmid et al. (2010) and González et al. (2012a, 2012b) have

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<sup>2</sup> Frank and Goyal (2009) for example showed that the main factors influencing the capital structure of companies are industry leverage, amount of tangible assets, profitability, firm size, market-to-book ratio and expected inflation.



shown. Finally, *listed family firms* might behave differently than their non-listed counterparts, as in unlisted-firms not only the ownership, but also the management is often concentrated in the hands of the family. Furthermore the expropriation of minority shareholders could be less likely in such firms as the minorities often have a close relationship with the dominating owner family (Pindado, Requejo and de la Torre, 2012). The empirical evidence for *non-listed companies*, however, seems to be relatively limited compared to listed ones, not least because data is lacking for private enterprises. Consequently *future research* on the financing decisions of family firms could focus on non-listed companies on the one hand and different types of family involvement on the other hand.

To sum up, we still seem to face a “capital structure puzzle” (Myers, 1984) and “dividend puzzle” (Black, 1976), at least when analyzing the leverage and payout propensity of family firms in relation to their non-family counterparts.

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### **The capital structure and the dividend policy of family firms**

This paper sheds light on the capital structure and the dividend policy of family firms. From a theoretical point of view it can be shown that agency conflicts in family firms and therefore their financing decisions are affected by family specific factors. Our analysis, however, shows no clear evidence that family influence leads to (1) more or less leverage and (2) higher or lower dividend payments by family firms compared to their non-family counterparts. The same holds true for empirical studies which present mixed results concerning the leverage and payout propensity of these companies. Finally, factors are addressed which could be held responsible for this ambiguous empirical evidence.

### **Struktura kapitałowa i polityka dywidendowa firm rodzinnych**

Artykuł rzuca światło na strukturę kapitału i politykę dywidend firm rodzinnych. Z teoretycznego punktu widzenia można wskazać, że w firmach rodzinnych występuje konflikt agencji, ponieważ na

ich decyzje finansowe mają wpływ specyficzne czynniki rodzinne. Przedstawiona w artykule analiza nie dowiodła jednak, że wpływ rodziny oddziałuje na (1) stosowanie większej lub mniejszej dźwigni finansowej ani na (2) wyższe lub niższe dywidendy wypłacane przez firmy rodzinne w porównaniu do nierodzinnych konkurentów. Podobnie badania empiryczne dały mieszane rezultaty w odniesieniu do dźwigni finansowej i skłonności do wypłat w tych firmach. W zakończeniu wskazano czynniki, które mogą stanowić przyczynę uzyskiwania tak zróżnicowanych dowodów empirycznych.