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"Stepping into the buyers' shoes": Looking at the value of family firms through the eyes of private equity investors

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ABSTRACT

An increasing number of families are selling their businesses to private equity (PE) investors. A key question is what the family firm is worth without the family as part of the business. We provide a buyers' perspective on the valuation of the family firm and argue that prior family involvement provides the PE buyer with a distinct landscape of real options that require consideration. While the buyer gains real options for external (economic) value creation as a result of family departure, family exit after the sale triggers a loss of family dependent real options, which may subsequently reduce economic value for the new owner. Consequently, these two opposing effects need to be considered when accounting for the central role of the family and whether these effects result in an increased or decreased valuation of family firms.

1. Introduction

According to Oscar Wilde, "people know the price of everything and the value of nothing." The same may be said by family firm owners who sell their business to private equity (PE) investors. While it is relatively easy to put a price tag on products or services, it is much more difficult to do so when pricing a family business. Valuation techniques, which measure economic value in monetary terms, establish a basis for price negotiations (Granata & Chirico, 2010). Although the principles of corporate valuation are generally well known, it is unclear whether the valuation for family firms should differ from that of non-family businesses (Granata & Chirico, 2010). There are often disagreements between family firm buyers, such as PE firms, and family firm sellers over an appropriate selling price (Scholes, Wright, Westhead, Burrows, & Bruining, 2007).

Prior research that sheds light on family firm valuation (Astrachan & Jaskiewicz, 2008; Granata & Chirico, 2010; Zellweger & Astrachan, 2008) emphasizes the sellers' perspective (Niedermeyer, Jaskiewicz, & Klein, 2010; Zellweger & Astrachan, 2008; Zellweger, Kellermanns, Chrisman, & Chua, 2012) and stresses the role the family firm owners' non-financial objectives play in the sale (Barron, Boehler, & Cook, 2010; Chrisman, Chua, & Zahra, 2003; Lipman, 2001; Scholes, Westhead, & Burrows, 2008; Scholes et al., 2007). A family's perception of price for the business is considered higher than a market-based valuation would justify due to the emotional value attached by family sellers (Astrachan & Jaskiewicz, 2008; Zellweger & Astrachan, 2008; Zellweger et al., 2012).

In contrast to family sellers, the PE firm's key interest is the economic or financial value of the firm, that is, the ability to generate present and future cash flow (Damodaran, 2002; Dawson, 2011; Makri, Hitt, & Lane, 2010). Private equity firms, often described as relatively short-term and profit-focused investors who use high debt to finance deals (Dawson, 2011; Jensen, 1989), tend to acquire family firms at a discount because they consider such firms to be less efficient, less professional, and less successful (Granata & Chirico, 2010; Salvato, Chirico, & Sharma, 2010). This observed discount stands in contrast to research indicating family firms' potential superior economic performance and lower agency costs (Anderson & Reeb, 2003; Chrisman, Chua, & Litz, 2004; Granata & Chirico, 2010; Jensen & Meckling, 1976; Villalonga & Amit, 2006). These findings suggest that family firms should receive higher valuations.

We suggest a real options perspective to improve family firm valuation by emphasizing the importance of incorporating a family

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firm buyer's perspective, which is characterized by flexibilities to act in the post-buyout period independent of family-firm-specific considerations as a key valuation determinant. The PE buyer valuation of the family firm, a perspective previously neglected in the family firm literature, treats the target family firm as a stand-alone investment, where the entire firm is sold and the family exits the company soon after the sale. To the best of our knowledge, current valuation approaches do not explicitly consider the influence of the family on family firm valuation. We complement and challenge existing research by applying real options analysis in a new (family firm) context and highlighting the differences between family and non-family firm valuation.

After providing the theoretical foundations and introducing the concept of family firm buyout value, we then discuss how family exit affects this value as an upside and/or downside driver, which can be mitigated. We apply our theoretical model to three valuation cases, discuss potential outcomes, and identify implications for researchers and practitioners.

2. Theoretical background

Drawing upon existing research on PE and family firms, we examine distinctive real options and the abilities to generate them that are prevalent in family firm resources and require consideration in the process of family firm valuation (Barney, 1991; Bowman & Hurry, 1993; Kogut & Kulatilaka, 2001).

2.1. Private equity and family firms

Research on selling or acquiring a family firm, which is gaining momentum (Chrisman, Chua, Steier, Wright, & McKee, 2012; Dawson, 2011; Granata & Chirico, 2010; Niedermeyer et al., 2010; Wennberg, Wiklund, Hellerstedt, & Nordqvist, 2011), is justified given the international significance of family firms (Anderson and Reeb, 2003; Morck & Yeung, 2003), family succession challenges that lead to the sale of the family business (Scholes et al., 2008; Wright, Hoskisson, & Busenitz, 2001), and significant macroeconomic implications of the ownership transfer (Calogirou, Fragozidis, Houdard Duval, & Perrin Boulonne, 2010). For example, approximately 135,000 family firms in Germany will transfer ownership between 2014 and 2018, but many will not find a successor within the family (Kay & Suprinovič, 2013). The challenge of ensuring succession of the business is a pressing global phenomenon (PWC, 2012). According to estimates by the European Union, the ownership of ~450,000 small and medium-sized enterprises (a majority of them family firms)[3] is transferred each year in Europe; of these, ~150,000 firms (representing ~600,000 employees) are at risk due to ineffective succession (Calogirou et al., 2010). Family successions fail for a number of reasons (for an overview, see de Kets de Vries, 1993; Sharma, Chrisman, Pablo, & Chua, 2001; Sharma & Irving, 2005). In the case of impeding succession failure, the sale of the family firm to outside investors becomes a key succession route, which often involves PE firms.

The main focus of PE firm investments is buyouts, in which PE firms negotiate with the current owners to form a new corporate entity, often involving a new or incumbent management team (Meuleman, Amess, Wright, & Scholes, 2009). A buyout secures external family business succession, that is, a non-family member takes control of the business. Buyouts, which have advantages over IPOs and trade sales (also external succession solutions), may allow the former family business to maintain independent ownership and conserve (at least part of) the family culture. Because PE firms usually treat their portfolio firms as independently run companies (Jensen, 1989; Scholes et al., 2007), structuring the buyout accordingly could allow the majority of the management team to remain in place (Scholes et al., 2007) and allow family members to stay associated with the business (Niedermeyer et al., 2010; Scholes et al., 2008).

Family businesses represent a significant source of buyout deals for PE firms (Scholes et al., 2008, 2007; Scholes, Wright, Westhead, & Bruining, 2010; Scholes, Wright, Westhead, Bruining, & Kloeckner, 2009). One study assumes the total number of European family buyout transactions at ~29% of all buyouts between 1998 and 2007, which corresponds to a total of ~560 family buyout deals across all European industries (Scholes et al., 2009). For PE firms involved in family buyouts, the transaction size is ~€41 m, whereas it is only ~€7 m without PE involvement (Scholes et al., 2009).

Several factors explain family firm distinctiveness: families' non-economic goals and affective needs that guide the family firm's actions (Berrone, Cruz, Gomez-Mejia, & Larraza-Kintana, 2010), family firms' strategies shaped by the family (Sharma, Chrisman, & Chua, 1997; Ward, 1988), family firms' specific resources and capabilities (Eddleston, Kellermanns, & Sarathy, 2008; Habbershon & Williams, 1999; Habbershon, Williams, & MacMillan, 2003; Sirmon & Hitt, 2003), and the need for family control of the business (Litz, 1995; Sharma, 2004; Zellweger et al., 2012). However, the task of defining "family firm" remains difficult. Although family firm researchers have acknowledged the importance of an accurate and consistent definition, no widely accepted definition prevails (Litz, 1995; Sharma, 2004). For the purpose of this article, we assume that firms with at least 50% of the ownership concentrated among family owners and multiple members active in the business qualify as family firms (e.g., Eddleston et al., 2008).

Although rarely a first preference, selling the family business to PE firms can be a viable option to secure firm survival if perpetuation of family ownership is not feasible (Chrisman et al., 2012; Dehlen, Zellweger, Kammerlander, & Halter, 2012; de Massis, Chua, & Chrisman, 2008). The relationship between PE firms and family firms, however, can be problematic and conflict-prone (Blanco-Mazagatos, de Quevedo-Puente, & Castrillo, 2007; Tappeiner, Howorth, Achleitner, & Schraml, 2012; Dawson, 2011). Although they differ in terms of investment style and dealing with investment targets (Cressy, Munari, & Malipiero, 2007; de Clercq & Sapienza, 2006; Norton & Tenenbaum, 1993; Shepherd & Zacharakis, 2001), PE firms are often relatively short-term and profit-focused investors who use high debt to finance deals (Dawson, 2011; Jensen, 1989). In contrast, family firms usually prefer long-term objectives and are willing to compromise financial for non-financial goals (Carney, 2005; Dreux, 1990; Sirmon & Hitt, 2003; Gómez-Mejía, Haynes, Nuñez-Nickel, Jacobson, & Moyano-Fuentes, 2007).

The investment process of buyouts typically comprises five steps. First, PE firms screen markets for attractive investment opportunities facilitated by networks, corporate auctions, and market intelligence (Batjargal & Liu, 2004; de Clercq & Dimov, 2008; Klöckner, 2009). Second, PE firms thoroughly analyze the identified investment target via due diligence, a process that gathers and analyzes financial, legal, managerial, and strategic information to determine the target's value and whether a deal is promising (Crilly, 1998; Puranam, Powell, & Singh, 2006). The buyout target's value can be determined by the sum of discounted future cash flows (DCF) (Brealey, Myers, & Allen, 2009). Although firms can be valued in monetary terms by different techniques, the DCF approach and sales' multiples are predominant (Rappaport, 1998). Third, buyers and sellers negotiate a transaction agreement. Buyout transactions are complex and include a number of financial, tax, and legal issues that need to be resolved (Cumming

[3] The EU study specifically refers to SMEs, which is not fully congruent with the term "family firm." However, estimates indicate that the majority of SMEs are family firms (IFB, 2011).