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Family firms and debt: Risk aversion versus risk of losing control☆

Maximiliano González [a,*], Alexander Guzmán [b], Carlos Pombo [a], María-Andrea Trujillo [b]

[a] School of Management, Universidad de los Andes, Bogotá, Colombia
[b] CESA School of Business, Bogotá, Colombia and School of Management, Universidad de los Andes, Bogotá, Colombia

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ABSTRACT

This study examines the effect of family management, ownership, and control on capital structure for 523 Colombian firms between 1996 and 2006. The study finds that debt levels tend to be lower for younger firms when the founder or one of his heirs acts as manager, but trends higher as the firm ages. When family involvement derives from direct and indirect ownership, the family–debt relationship is positive, consistent with the idea that external supervision accompanies higher debt levels and reduces the risk of losing control. When families are present on the board of directors (but are not in management), debt levels tend to be lower, suggesting that family directors are more risk-averse. The results stress the tradeoff between two distinct motivations that determine the capital structure of family firms: risk aversion pushes firms toward lower debt levels, but the need to finance growth without losing control makes family firms to prefer higher debt levels.

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1. Introduction

La Porta, López de Silanes, and Shleifer (1999) show that families and their heirs control the majority of firms around the world. They actively participate in management and governance activities, and a primary corporate goal is to transfer the company to future generations (Basu, Dimitrova, & Paeglis, 2009). Although the corporate finance literature on family firms is rapidly growing, many questions remain about how families influence firms' financial decisions. Following the recent literature (e.g., Bertrand & Schoar, 2006; Villalonga & Amit, 2006), this study asks how family involvement in terms of management, ownership, and control impacts firm's capital structure.

The corporate finance literature has studied the debt-related agency problem since Jensen and Meckling (1976), and Myers and Majluf (1984). However, the role of families in the agency–debt relation is a recent research topic. Wiwattanakantang (1999) argues that family ownership helps to reduce the agency cost of debt. In line with this finding, Anderson, Mansi, and Reeb (2003) show that U.S. family firms tend to have lower debt cost, likely because of the long-term horizon typical for this type of business and management's concern for reputation.

Based on a comprehensive firm-level unbalanced panel of 523 mainly private Colombian firms for the 1996–2006 period, this study finds that debt levels are contingent on whether and how families are involved in their firms (as shareholders, board members, or managers). Firm age and family generation further moderate the effects. Specifically, the results show that debt levels are lower when families are involved in management. Further, this negative relation is stronger when the founder remains active as manager, in contrast to when heirs are in charge. However, as the firm gets older this relation tends to change and become positive, which supports the control argument in which founders tend to be more risk-averse but family members prefer debt to equity when losing control is an issue. The family–debt relationship is also positive when families exert control through direct or indirect ownership (e.g., pyramidal group structures) without direct participation in the firm's management. These findings accord with the idea that more supervision comes with higher debt levels (Stulz, 1988) and it reduces the risk of losing firm's control. Yet, firm leverage is lower when family members exert control by participating on the board of directors (but not in management). This suggests a substitution effect between direct family control and indirect creditor control, as well as a higher risk aversion for family directors.

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* Corresponding author. Tel.: +57 1 339 4949x3367; fax: +57 1 332 4551.
E-mail addresses: mgf@adm.uniandes.edu.co (M. González), alexander.guzman@cesa.edu.co (A. Guzmán), cpombo@uniandes.edu.co (C. Pombo), maria.trujillo@cesa.edu.co (M.-A. Trujillo).

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This study makes two main contributions to business research. First, to the best of our knowledge this paper is among the first to examine how family involvement matters in capital structure decisions. In doing so, it brings the literature on family firms closer to the broader field of corporate finance. Anderson and Reeb (2003) also addressed the impact of families on financing decisions, but they focus on large S&P500 industrial firms. Our paper tackled the different dimensions through which families can influence firms' decisions, focusing on not only management, ownership and control, but also combining them. Second, the paper is one of very few to use a sample that includes private firms and not only publicly listed firms. Even though the sample is focused on Colombia, this paper contributes to a better understanding of privately held firms worldwide, which is an understudied subject mainly because of the difficulty of obtaining detailed firm-level information. Colombian institutional characteristics make access to this information possible.

The paper has the following structure. To support the working hypotheses, Section 2 reviews the literature regarding the relation between family involvement and firm capital structure in terms of management, ownership and control. Section 3 describes the data and sources. Section 4 presents the main results regarding family involvement in financing decisions. Section 5 reports several robustness checks, and Section 6 concludes.

2. Family involvement and capital structure

Of growing importance in the literature is the recognition that a family is not necessarily a united entity. Villalonga and Amit (2006) differentiate among the three different ways families can be involved in a given business: management, ownership, and control. From management's perspective, according to Fama and Jensen (1983), when family is involved in management, the decision process tends to lose efficiency because of their risk aversion. Bertrand and Schoar (2006) argue that family goals will not always align with the long-term well-being of all investors, especially if the family is excessively risk averse. A high level of risk aversion could lead to lower debt levels for such firms. Supporting this idea, Friend and Lang (1988) find that the debt ratio and the management's shareholding are negatively related. In this respect, family firms managed by family members could have less debt compared to similar but non-family firms.

H1. The relationship between debt levels and family management is negative.

From ownership's perspective, family firms represent a special case of controlling shareholders. Anderson et al. (2003) point out that other factors besides wealth maximization emerge in family firms (e.g., perdurability and concern for reputation), and these can affect the shareholder–creditor agency relation. In particular, the long-term nature of a family business will positively affect creditors' willingness to lend at a lower cost. Accordingly, Kim and Sorensen (1986) show that higher ownership concentration by insiders is associated with higher debt levels. However, there are alternative explanations to higher levels of debt in firms with family involvement in ownership, such as aversion to losing control. Families hold control acting as majority (direct ownership) or controlling shareholders (indirect ownership). Almeida and Wolfenzon (2006) provide formal models consistent with the observation of low wedge measurements across family business groups with pyramidal ownership structures. Wedge sources include the issuance of dual shares, preferential stocks, voting agreements, and over-representation of family on boards (Villalonga & Amit, 2009). Debt could help families to keep control over their firms. According to Céspedes et al. (2010), firms in Latin America tend to prefer debt to equity when losing control is an issue.

Another reason for higher debt levels when families are involved in ownership comes from the management agency problem. Following Stulz (1988) in aligning greater supervision with higher debt levels, families that are dominant shareholders but that do not participate in the firm's management can increase debt, inducing more supervision by creditors and so reducing potential opportunistic behavior by management.

With the possibility of wealth extraction and cash flow retention in mind, higher debt levels are an efficient mechanism for retaining control (direct or indirect) and reducing the agency problems related to management at the same time. Thus, the next hypothesis follows:

H2. The relationship between debt levels and (direct or indirect) family ownership is positive.

Finally, in terms of board control, when families exert control by participating on the board of directors one can expect lower debt levels. Two explanations support this hypothesis. First, as discussed above, the decision process can lose efficiency because of family directors risk aversion. As family managers, family directors could experience an excessive risk aversion while taking decisions that affect family wealth. Second, consistent with agency theory, family involvement on the board could imply lower debt levels due to a substitution effect: the more direct monitoring of management by family board members, the less need to use debt to prevent managerial opportunistic behavior. Formally,

H3. The relationship between debt levels and family involvement becomes negative when families exert control through the board of directors.

Due to the different sign of the effects depending on whether the family is involved only in the firm's ownership and/or in its management, it is important to test if these effects are moderated by firm age (family generation). The differences in the expected sign allow hypothesizing a trade-off between the need to finance growth (through either debt or equity) and risk aversion.

3. Database and methodology

This study employs a unique dataset that combines firm-level information of privately held and listed companies by affiliation status to business groups. This feature is not commonly found in current research on corporate finance, governance, or family firms. The main source of financial, ownership, and board-related information were Colombia's Financial Superintendent (*Superintendencia Financiera*, SFIN) and the Superintendent of Commercial Societies (*Superintendencia de Sociedades*, SSOC). SFIN is the financial regulator for all security-issuing corporations: 140 real sector companies and 40 financial institutions that must file quarterly information. SSOC is charged with supervising and monitoring all corporate restructuring and bankruptcy processes filed by legal persons. Additionally, SSOC maintains financial records and notes for about 9000 medium and large privately owned firms. Notes to financial statements include 16 appendixes per company, listing major shareholders, appointments to the board, members of top management, auditing firms, and parent-subsidiary commercial relations. These notes are subject to statistical confidentiality.

Our sample selection took into account the following criteria: first, most firms included in the sample are affiliated with Colombia's largest non-financial economic groups; second, all firms must have information on board members and shareholders for at least three consecutive years, within the 1996–2006 period; third, firms must not be subject to specific regulation (e.g. financial institutions and utilities).

Applying the above criteria, we identified 1224 firms, where 694 were seemingly independent. In order to reach accurate computations

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