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Idiosyncratic risk, private benefits, and the value of family firms

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A B S T R A C T

Many listed companies around the world are controlled by under-diversified family blockholders, who bear idiosyncratic risk in addition to systematic risk. In this paper, we assume that these shareholders require private benefits to compensate for the additional risk. We propose a simple equilibrium model of private benefits that highlights how the idiosyncratic risk borne by a family blockholder impacts the amount of required private benefits and ultimately, the market value of the family firm.

1. Introduction

Several studies highlight a large number of listed family firms around the world (La Porta et al., 1999; Claessens et al., 2000; Faccio and Lang, 2002). These family firms share four main characteristics.[1] First, an individual or a group of family members holds a large block of stocks and voting rights (Shleifer and Vishny, 1997; Chrisman et al., 2004). Second, the family blockholder often invests a large part of his or her personal wealth in the firm. Consequently, this blockholder holds an under-diversified portfolio and assumes the idiosyncratic risk of the firm in addition to the systematic risk (Huddart, 1993; Heaney and Holmen, 2008; Ødegaard, 2009). Third, the family blockholder significantly influences the firm's strategic and financial decisions, either as a CEO or as a member of the board of directors (Shleifer and Vishny, 1997; Andersen and Reeb, 2003b; Bertrand and Schoar, 2006). Finally, this blockholder is able to extract some private benefits, which increase the blockholder's well-being at the expense of the minority shareholders (Barclay and Holderness, 1989; Benos and Weisbach, 2004; Dyck and Zingales, 2004).

In this paper, we focus on the link between the portfolio diversification of the family blockholder and the amount of required private benefits. More precisely, we consider that an under-diversified family blockholder requires private benefits to compensate for the idiosyncratic risk borne. We develop an equilibrium model of private benefits that is based on the

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[1] For other specific characteristics of family firms, see Sharma (2004).

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fundamental assumption that the value of the stock is the same for all shareholders (Kerins et al., 2004). Our model also highlights the relation between the amount of private benefits required by the family blockholder and the market value of the family firm. While firm value is a decreasing function of private benefits, our model shows that all shareholders obtain fair compensation for the risk they bear.

The intuition of our approach is the following: In a family firm, minority shareholders and the family blockholder expect different returns because these two groups of shareholders bear different risks. Minority shareholders hold well-diversified portfolios and assume only systematic risk. However, the family blockholder holds an under-diversified portfolio and assumes idiosyncratic risk in addition to systematic risk. Therefore, this blockholder expects a higher return than that expected by minority shareholders. Since the stock price is the same for all shareholders (the law of one price), only the capture of private benefits allows the family blockholder to obtain a higher return to compensate for the higher risk she bears. Because of these private benefits, the family blockholder discounts cash flows including private benefits at a higher risk-adjusted rate. Minority shareholders discount lower cash flows because they know that private benefits are captured by the blockholder, but they discount their cash flows at a lower rate. In this case, an equilibrium level of private benefits exists that equalizes the stock price of the family firm. Our model determines this equilibrium amount of private benefits required by the family blockholder. We show that this amount increases with the idiosyncratic risk of the firm and with the percentage of shares held by the family blockholder. Moreover, the extraction of private benefits decreases the value of the family firm.

Our framework allows us to formulate new propositions for family business research. More precisely, we discuss the impact of the diversification of a family firm on the private benefits required by the family blockholder and, therefore, on the firm's market value. We also discuss the design of many empirical studies on the performance of family firms.

The remainder of this paper is organized as follows: Section 1 summarizes the relevant literature. Section 2 develops the model of private benefits required by the family blockholder. In Section 3, we provide numerical examples of our model. Section 4 is dedicated to some limitations of our model. Section 5 discusses avenues for future family business research. A final section concludes this article.

2. Literature review

Two main streams of research are addressed in our paper. The first stream concerns the potential conflicts of interests between minority shareholders and family blockholders in numerous family firms listed on stock markets around the world. These conflicts are especially related to the extraction of private benefits by family blockholders. The second stream refers to the portfolio diversification of family blockholders, especially the idiosyncratic risk borne when they hold under-diversified portfolios.

2.1. Owner–owner agency problems in listed family firms

Over the past 15 years, many studies have shown numerous family firms among listed firms around the world. In particular, La Porta et al. (1999) confirm that many controlling shareholders are present among the largest publicly traded firms in the 27 richest countries. In addition, these controlling shareholders are often families, either an individual or a small group of family members. Subsequent studies confirm these results with larger samples.

Claessens et al. (2000) focus on 2980 listed firms in nine East Asian countries. They show that a limited number of families control listed firms representing a large percentage of stock market capitalization. Faccio and Lang (2002) analyze 5232 corporations in 13 Western European countries and highlight that (a) many firms are family controlled (44.29% of their sample), (b) non-financial and small firms are more likely to be controlled by a family blockholder, and (c) more than two-thirds of the family-controlled firms have top managers from the controlling family.

This evidence leads to the conclusion that potential conflicts of interest between managers and minority shareholders (owner–manager agency problems) are probably less important in practice than potential conflicts of interests between family blockholders and minority shareholders (owner–owner agency problems). Family firms have specific issues, such as entrenchment and tunneling, especially when the family groups are organized in pyramidal structures (Morck and Yeung, 2003).[2]

Many authors consider that conflicts of interests between minority shareholders and family blockholders are related to the extraction of private benefits by the latter at the expense of the former (Benos and Weisbach, 2004; Dyck and Zingales, 2004; Chrisman et al., 2010). Such private benefits can take several forms: fictitious jobs for family members and excessive compensation or perquisites for executives who are family members. In addition, as noted by Dyck and Zingales (2004), it is also possible to consider that private benefits are (a) the "psychic" value attributed by some shareholders for the control of a firm;[3] (b) appropriated by large shareholders through outright theft (e.g., use of an "unfair" transfer price of a certain

[2] From the perspective of minority shareholders, family firms also present various advantages. In particular, family blockholders have strong incentives to discipline professional managers to protect their investment (Shleifer and Vishny, 1997), which may prevent short-termist behavior (Bertrand and Schoar, 2006).

[3] However, these authors note that "although this is certainly a factor in some cases, it is hard to justify multimillion dollar premia with the pure pleasure of command" (p. 540).