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CEOs in family firms: Does junior know what he's doing?

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ABSTRACT

We model the evolution of CEO quality in family firms. When heirs work toward a common goal alongside an older generation, Bayesian updating attributes success mostly to the older (proven) agent. Thus, heirs learn little about their own skill. This effect is strongest after the founder, implying that family firms tend to either die immediately or be relatively long-lived. More generally, we obtain an even/odd fluctuation in generational quality. Because uncertainty breeds caution, our analysis points to a conservative managerial style in family firms and emphasizes the importance of external screening mechanisms, especially for heirs following a very successful generation.

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Stephen Dubner: *So, talk to me a little bit about the succession plan, if there is one, what's going to happen (…).*

Jennifer Yuengling: *Did you meet my dad earlier? Because he's got all the answers.*

Stephen Dubner: *Plainly he loves doing it; plainly he's really good at it. He has no desire to retire like a lot of people do have. But does he do anything to kind of specifically groom you for that eventuality, or is more just like come to work and we'll figure it out?*

Wendy Yuengling Baker: *That's been his approach [but] I have faith in him and his ability to give up the reins some day to us. But for now, like Jennifer said, he's good at it, he enjoys it, and he's extremely hands-on. So, I don't see that changing.In Freakonomics, podcast: The Church of Scionology.*

1. Introduction

The Berle-and-Means paradigm of dispersed shareholding – leading to separation of ownership and control – is less general than one might imagine. As Burkart et al. (2003) point out, most publicly traded firms in the world are controlled by founders or their heirs; the same is true for more than one-third of large publicly traded US firms; as shown by Chami (2001) and Villalonga and Amit (2006, 2009).

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Evidence suggests that these family firms are often poorly run. In particular, family firms around the world have worse operating performance and lower stock market valuation than their non-family counterparts.[1] In addition, the stock market reacts negatively to announcements of internal succession (Perez-Gonzalez, 2006; Smith and Amoako-Adu, 1999), whereas it reacts positively to the appointment of an outside, professional manager (McColgan and Hillier, 2009). Indeed, this inefficiency of family firms is of sufficient magnitude to affect the macroeconomy and explain observed differences in productivity across countries.[2]

There are several potential explanations for this poor performance. Family members may be lax in evaluating their offsprings' quality, promoting them over more skilled outsiders. Alternatively, this passing of control may make heirs grow progressively "softer" over time as each passing generation begins to increasingly view inheritance as a birthright.[3] A similar argument for gradual deterioration of quality can be made on biological grounds if managerial skill is only partially inherited, and if founders select their mates based on characteristics other than managerial skill.

We introduce an additional layer of disadvantage to heirs. Agents in our model have uncertainty about their own quality. They only update their estimates over time as they observe the outcome of prior investment decisions they have made.[4] Founders, by definition, are quite successful. By the time of succession decisions, they will have revised their own quality estimates dramatically upward. As we show, this high quality impairs the ability of their heirs to learn about their own quality. This property is a straightforward implication of Bayesian updating when decisions within the firm are made jointly. Consider what happens when a (successful) founder makes a joint decision with his untested heir, and obtains success. The success will be rationally attributed to the older agent's (proven) decision-making process. Any string of successes or failures provides relatively little information about the heir's quality.

More broadly, this intuition applies in any setting in which teamwork is performed by agents with different levels of experience. Yet there are two reasons why the family firm environment is the ideal setting in which to develop these ideas. First, junior and senior agents in our model are exogenously assigned. This pairing rules out the ability to set up tournaments or to select agent whose characteristics might minimize the inference problem. Given current medical technology, parents cannot choose the strengths and weaknesses of their offspring. For better or worse, family members are exogenously assigned to each other. Second, the learning problem is most acute when the junior and senior agents have a long and exclusive working relationship. This condition is likely to hold in family firms, where founders tend to tightly retain control decisions (Fan et al., 2008). Empirically, internal heirs have a longer tenure in the family firm than professional managers (McConaughy, 2000 and Smith and Amoako-Adu, 1999) and are younger at the time of succession (Perez-Gonzalez, 2006). Family managers therefore acquire control with thin resumes compared to professional, non-family managers, especially as regards outside, independent decision-making that could identify skill.

The problem identified above partially reverses in subsequent generations. Note that the second generation CEO is relatively uncertain about its own ability. In turn, the third generation's successes or failures are strong indicators of quality. Thus, the third generation ultimately gets relatively precise information. This pattern repeats in an even/odd fashion, albeit a reduced magnitude, ultimately converging to a steady state in which all subsequent generations are of similar quality.

We also model the decision to pass control either internally or to outsiders. Families (all else equal) would prefer for control to remain internal, and will do so unless the next generation is expected to be very low quality. In our model, the founder is the highest quality agent in the entire sequence – he succeeded without the input of a parent – and therefore the second generation is the lowest quality ever. Consequently, the founder is most likely one to voluntarily pass control to outsiders. So, in our model family firms either die out immediately or are relatively long-lived.

The model's predictions are summarized in Table 1. The implications for firm performance are as follows. Descendants are generally lower quality than founders and this is especially true for the second generation. This quality drop-off will be reflected in poor operating performance and lower valuation.[5] It also implies low stock returns around internal succession announcements. As noted before, such a market reaction has been observed in the literature.

This quality drop-off will be attenuated if the heir has been able to prove himself externally in some way. Consequently, we propose the use of the heirs' pre-succession work experience as a determinant of firm performance. For the most part, the literature has not exploited variation in this dimension to our knowledge. One exception to this is Perez-Gonzalez (2006), who shows that the poor market reaction to internal succession is concentrated on heirs that did not attend selective colleges.

If heirs do not learn their own quality, the resulting uncertainty should suggest a conservative managerial style. (Well-meaning heirs will want to avoid killing the firm.) This cautious stance may explain why family firms tend to be less levered.[6] Considering managerial style more broadly, Miller et al. (2011) and Bach (2013) examine not only leverage but advertising, capital expenditures,

[1] Variants of these findings are established in Canada, Denmark and Italy, respectively, by Morck et al. (2000), Bennedsen et al. (2007) and Cucculelli and Micucci (2008). Anderson and Reeb (2003) find no family firm discount in the US. However, Miller et al. (2007) find that when one distinguishes between *entrepreneurial* family firms (in which the founder is still active) and true family firms (run by descendants) the valuation differential reappears.

[2] See Caselli and Gennaioli (2013), Morck and Yeung (2004) and Morck et al. (2000).

[3] Andrew Carnegie opined: '*The parent who leaves his son enormous wealth generally deadens the talents and energies of the son, and tempts him to lead a less useful and less worthy life*'.

[4] Pan et al. (2013) find that uncertainty about managerial quality is an important source of risk for firms, and that it is resolved only slowly, over several years.

[5] Consistent with this prediction, Adams et al. (2009), Eklund et al. (2010), and Miller et al. (2007) find that the poor performance of family firms generally does not apply when the founder is still active. Villalonga and Amit (2006) find that founder CEOs have a positive effect on valuation, measured by Tobin's Q, while heir CEOs have a negative impact on valuation. In fact, the negative effect of descendant-CEOs is entirely attributable to second-generation family firms, while the incremental contribution of the third generation is positive (although diminished). Fourth and fifth generations show no impact. These findings echo our model's alternative generational pattern of qualities which ultimately converge.

[6] See Amore et al. (2011), Belenzon and Zarutskie (2013) and Mishra and McConaughy (1999) for evidence of this low leverage.

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