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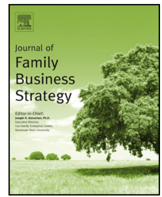

Product innovation, firm renewal and family governance

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ABSTRACT

Product innovation has been recognized as a primary means of corporate renewal as it demands the creation and expansion of organizational competences over time. Among the factors driving product introduction is governance structure. Where shareholders value control over the firm, new product introductions may be avoided if unrelated to the legacy product portfolio and therefore risky. As a consequence, company control goals may favour products within the existing competency domain, and that in turn may impede firm technological competency renewal. Because of their conservatism and desire for control, studying family firms new product strategies may demonstrate how governance conditions driving product selection relate to competency renewal. This study of 220 Italian firms shows family governance to inhibit the kinds of new product introductions that renew competencies, especially in successor generations. Although it does not suppress new product introduction per se, family management limits the products that renew technological capabilities, while increasing the offerings that help to open new foreign markets.

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1. Introduction

A firm's ability to create effective new products is central to both strategic renewal and long term organisational growth (March, 1991; Nelson & Winter, 1982; Eggers, 2012; Shamsie, Martin, & Miller, 2009; Slater, Mohr, & Sengupta, 2014). Organisations must continually renew themselves if they are to survive and prosper in dynamic environments, and product innovation has been recognized as a primary means of corporate renewal as it demands the creation and expansion of organizational competences over time (Danneels, 2002, 2007).

The product innovation literature mainly has examined the determinants of new product success by studying the impact of product-firm synergy on new product performance: new products with a closer fit to firm competences are said to be more successful. Unfortunately, this literature has mostly ignored the reverse direction of the product innovation-competences relationship—that is, the effect of new products on a firm's competency development and its trajectory of renewal (Danneels, 2002). Renewal often demands a fundamental updating of competences that can adapt a product portfolio to changing market conditions (Floyd & Lane, 2000; Basu & Wadhwa, 2013; Huff, Huff, & Thomas, 1992). Thus, firms may usefully broach new product categories to avoid economic decline, an initiative that accesses not only the current resource base but also launches the development of new capabilities (Teece, 1982; Danneels, 2010).

If organisational capabilities and new products co-evolve, then factors affecting the ability of a company to introduce new products are crucial to understanding the potential for competency renewal and thus long term firm performance. Among these factors is governance structure (Matzler, Veider, Hautz, & Stadler, 2015). Where shareholders such as family owners value control over the firm (Burkart, Panunzi, & Shleifer, 2003; Bertrand & Schoar, 2006; Gomez-Mejia, Haynes, Nunez-Nickel, Jacobson, & Moyano-Fuentes, 2007; Bandiera, Guiso, Prat, & Sadun, 2015; Kotlar, Fang, De Massis, & Frattini, 2015), the introduction of a new product may be rejected when it is perceived as too distant from the existing product portfolio and therefore too risky. This risk-limiting strategy can induce firms to choose only low-risk products closely related to the existing portfolio. As a consequence, the aim of retaining company control may give rise to an adverse product selection process favouring the adoption by family firms of products within the existing domain of competency and that, in turn, may impede firm technological competency renewal.

However, product innovation strategy relates both to technological competency renewal and market expansion outcomes as attested to by new international markets entered, and these may

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have very different drivers. Specifically, low risk product introductions similar to existing product lines may do little to renew technological competency but succeed in leveraging well understood capabilities to expand into different countries. Thus, whereas family firms, because of their risk aversion in product introduction, may face a disadvantage in technological competency renewal (fewer new patents), they may at the same time benefit in their efforts at market expansion (more new markets).

Because of their conservatism and families' desires for company control, family firms are ideal candidates for research into how new product introduction strategies affect organizational learning and competency renewal. If family managers do in fact avoid business risk, then family governance can be a key factor in explaining the nature of competency renewal via new product introduction (e.g. Bertrand & Schoar, 2006; Block, 2012; Bloom & Van Reenen, 2007; Le Breton-Miller, Miller, & Lester, 2011; Gomez-Mejia et al., 2007).

To date, no studies have demonstrated empirically how firm and market conditions driving product selection relate to both competency and market renewal. Moreover, no mechanism of product selection has been proposed to explain the governance-based predisposition of incumbent firms to resist "strategic renewal outside the frame of current strategy" (Huff et al., 1992), or to show if and when such inertia occurs (König, Kammerlander, & Enders, 2013). This research attempts to address these gaps via a study of Italian family companies.

1.1. Core tenets of our model

Our model is based on two complementary arguments. The first concerns the definition and measurement of product riskiness within the process of competence building. We use the degree of "relatedness" between a new product and the existing product portfolio as a measure of the risk involved in product introduction. A new product poses little risk when it is closely related to, and complementary with, the core product line, whereas it is riskier when it broaches less familiar businesses, or falls outside the boundaries of the existing portfolio. Our second argument concerns how product risk affects product adoption. Owners will vet a product introduction by considering how their claims would be affected by modifications in their company's financial default profile caused by the riskiness of the introduction. An unsuccessful new product may produce a loss that requires refinancing, and hence new debt that dilutes family control. In other words, risky products distant from firm competencies may change financial status in a way that threatens family control. As a consequence, those who prioritize control over existing assets, as do family owners, may under-invest in risky products to avoid financial default and maintain control (Gomez-Mejia et al., 2007). Such a risk-limiting strategy may restrict new competency development. However, related low risk products, due to their familiarity, may constitute a more promising basis for new market entry.

We develop and empirically test these predictions in a model of product innovation and firm performance in family firms—a type of organization reputed to embrace the socioemeotional wealth (SEW) priority of preserving family control over the firm (Gomez-Mejia et al., 2007). To relate decisions about new products to their effect on renewal capability, we employ the three-step approach developed by Crepon, Duguet and Mairesse (1998) and Hall, Lotti and Mairesse (2012), addressing specification challenges by estimating the different blocks of our model sequentially (Hall et al., 2012; Miranda & Zhu, 2013). We use individual firm-level data from a sample of Italian medium-size manufacturing companies whose product introductions we have tracked over time. Survey data are complemented by quantitative information on company accounts for the period 1998–2008.

1.2. Core findings

Our primary result shows that family governance plays a crucial role in the product selection mechanism and drives the breadth and currency of the competency base of the company by affecting its ability to renew its competences over time. Using the number of patents and the number of new foreign markets entered by the company as proxies for newly-created competencies associated with product introduction (Danneels 2002; Xie & O'Neill, 2014), our empirical results show that *product innovation does indeed function as a tool for competency renewal.*

However, the contribution of new products to competency renewal is inferior for firms run by family members because of the constraining role of their preference for product relatedness. Family-driven underinvestment in competence-enhancing new products increases with family successor management and the debt burden. Although it does not suppress the adoption of new products, family management limits the ability to renew technological capabilities when patents are used to measure the stock of technological knowledge (Buesa, Heijs, & Baumert, 2010). However, an important exception is marketing knowledge, as measured by entry into new foreign markets (Danneels, 2002), where the family preference for related new products actually enhances the ability to sell into different countries. In sum, *the impact of product introduction is dependent on corporate governance, which directly affects the type and competency renewal potential of new products. Thus previous work on family firms, which has ignored new product introductions, competency variations, and simultaneous new market entry, is significantly augmented.*

2. The literature and its gaps

The new product introduction and innovation literature has been slow to examine the driving factors of governance and non-financial preferences. Most of the literature assumes a profit or growth orientation (Acs & Audretsch, 1988; Blind, Edler, Frietsch, & Schmoch, 2006), neglects other motives, and examines the behaviour of entrepreneurs or large companies. In the rarer instances where family firms have been considered as sources of R&D investment, fine-grained family governance variables are ignored (e.g. Munari, Oriani, & Sobrero, 2010).

The literature on family firms is more revealing. It has long held that these firms are driven by objectives that go beyond the financial. For example, Miller and Le Breton-Miller (2005) have argued that family firms strive to address the needs of their stakeholders in order to survive over the long run and maintain an excellent family reputation. Family owners also often prize retaining control over existing assets. Burkart et al. (2003) and, more recently, Gomez-Mejia et al. (2007),Bandiera et al. (2015) and Kotlar et al. (2015) have argued that family owners attach a value to firm control.[1]

This movement away from purely financial motives has been given the term socioemotional wealth (SEW) (Gomez-Mejia et al., 2007). Gomez Mejia, Cruz, Berrone & De Castro (2011a) suggest that family firm owners strive to keep their company in the family to pursue goals such as preserving family cohesion (Gomez-Mejia et al., 2007), augmenting family reputation (Berrone, Cruz, Gomez-Mejia, & Larraza-Kintana, 2010), securing family employment (Kellermanns, Eddleston, Barnett, & Pearson, 2008) or bequeathing the business to offspring (Miller, Le Breton-Miller, & Lester, 2011).

[1] This amenity component translates into a higher non-monetary cost of default that lowers the incentive to strategically default (Anderson et al., 2012), and also mitigates the incentive to extract private benefits from the firm at the expense of minority shareholders (Villalonga & Amit, 2006).

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