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Family ownership and risk taking☆

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ABSTRACT

We study the relation between a controlling family's ownership and their company's risk taking behavior. By investigating comprehensive ownership data in Korea where most companies have controlling families, we find that non-linear U-shaped relation exists between family ownership and a firm's risk taking. Our results are robust in various tests considering endogeneity problems and with different proxies. We argue that a family with less ownership takes less risk for pursuing their private benefit, while a family with more ownership aligns their interest with their company's by taking more value enhancing risky projects.

1. Introduction

This paper investigates the relation between a controlling shareholder's ownership and corporate risk taking. To study the controlling shareholders' decision about risk taking in their firms, we investigate family managers in Korean companies. More than 80% of all companies in Korea are owned and managed by controlling families,[1] and 42.6% of companies have pyramidal ownership structure (Claessens et al., 2000). Families control their companies by not only their shareholdings, but also frequent visits to company, reputation as a founding family, and social networks surrounding the company. Therefore, many families in Korea effectively control their companies even though their ownership is relatively small.[2] This is one of the main advantages to study the Korean market in this vein of research since we can have a sample of families securely controlling their firms and enough cross-sectional difference of family ownership.

The relation between family ownership and corporate risk taking is not unequivocally decided in theoretical and empirical studies. For example, Nguyen (2011) argues that family control and concentrated ownership are positively related to a company's risk taking by investigating Japanese family-owned companies. Also, Anderson and Reeb (2003) study founding families in the S&P 500 companies to show that the families do not take risk-averse decisions to engage in opportunistic activities. On the other hand, many studies support the hypothesis that controlling families are more risk-averse. For instance, La Porta et al. (1999) and Morck and

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[1] Villalonga and Amit (2010) show that more than 55% of US companies are owned by families. Also, in Europe excluding England, families own more than 53% of companies (Barontini and Caprio, 2006).

[2] For example, as of March 2017, only 4.41% of Samsung electronics is directly owned by the founding family. Still, the family perfectly controls the company as we have seen the political scandal of the family (e.g., see http://www.bbc.com/news/business-40847211). We also test our main hypothesis by using a subsample of families holding more than 10% of shares of their companies. The results are qualitatively the same. We are indebted about this robustness check to an anonymous referee.

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Yeung (2003) point out that families are more risk averse since they have more concentrated assets in their companies. Also, Anderson et al. (2003) show that families may take less risk because they would like to transfer their business to the next generation.

Some studies try to disentangle contradicting results about risk-averseness of family firms according to their shareholdings. Gómez-Mejía et al. (2007) argue that families dislike the loss of their socioemotional wealth from their business and that their risk-taking behavior depends on the possibility of this loss. The more possibility of the loss is, the less risk is taken, and vice versa. Burkart et al. (2003) argue that a controlling family's wealth maximization can be achieved by maximization of a firm value or expropriation of private benefit depending on the family's shareholdings. If a family keeps considerably large shareholdings, their interest is aligned with the firm's interest. In this case, the family will take more risk that will generate firm value. On the other hand, if a family holds relatively small shareholdings, they may not pursue their utility maximization by maximizing the firm's value. Instead, they try to exploit personal gains such as continuation of the family's ownership and take more conservative corporate policies. Between these two sources of motivations, we hypothesize that risk-taking of a company is dependent on the amount of shareholdings of controlling shareholders.

We investigate family controlling companies in Korean market from 1995 to 2014 to study the relation between controlling families' shareholding and risk taking behavior. These companies have considerable cross-sectional difference of ownership of controlling families and are still effectively controlled by those families. In this case, more important problems about conflict of interest arise between controlling shareholders and other minority shareholders (La Porta, Lopez-de-Silanes, and Shleifer, 1999; Claessens et al., 2000, 2003; Mitton, 2002). This study finds that there exists a U-shaped relation between a controlling shareholder's shareholding and the firm's risk taking. This novel finding is consistent with theories about controlling shareholders' utility maximization with different levels of their shareholdings. As Amihud and Lev (1981), Demsetz and Lehn (1985), and Anderson and Reeb (2003) argue, controlling families seem to protect their personal gains by taking less-risky projects if their shareholdings are less than a certain level. On the other hand, if a controlling family holds more than 50% of their company's shares, the family usually takes more risky projects to maximize the firm value, which is aligned with the family's interest. Our empirical test also provides explanation about puzzling results of previous literature studying just linear relation between family ownership and a firm's risk taking (Demsetz and Lehn, 1985; Grossman and Hart, 1988; DeAngelo and DeAngelo, 2000; Faccio et al., 2001; Anderson and Reeb, 2003, 2004; John et al., 2008; Roger and Schatt, 2016; Cucculelli and Peruzzi, 2017). We focus on the non-linearity of the relation and show a U-shaped relation between family ownership and a firm's risk taking to address the puzzling question.

Our results are also robust in various tests considering endogeneity and reverse causality. Since family ownership is not changing much over time, a study dealing with this variable has an econometric problem of the time-invariant variable. We apply fixed effect vector decomposition (FEVD) model by Plümper and Troeger (2007) to address this problem and find the results almost the same as one in the original setting. Also, our results can be interpreted reversely, that is a company with more risk has less family ownership. Therefore, we need to address this reverse causality problem. In this paper, we apply two instrument variables to solve this problem. With both instrument variables, our results do not change.

This paper contributes to literature in two ways. First and most importantly, we reconcile contradiction of literature about the relation between ownership structure and a firm's risk taking. Leaven and Levine (2009) and Paligorova (2010) show that the more shareholdings a controlling shareholder of a company has, the more risk the company will take. On the other hand, John et al. (2008) argue that there is no relation between ownership structure and a firm's risk taking. Also, La Porta et al. (1999), Morck and Yeung (2003), and Anderson et al., (2003) show family control and concentrated ownership are negatively related to a company's risk taking. Our study finds a U-shaped relation between a controlling family's shareholdings and risk-taking of a company. Based upon literature about ownership structure and different motivation of controlling shareholders about a firm's value maximization as in Demsetz and Lehn (1985), James (1999), DeAngelo and DeAngelo (2000), Faccio et al. (2001), Anderson and Reeb (2003, 2004), we explain the U-shaped relation. To the best of our knowledge, we are not aware of studies in this area arguing that a company's risk taking can be decided by the trade-off between the costs and benefits of controlling shareholder's ownership stake. Second, a company's risk-taking is one of the most important driving forces of economic growth and development. Therefore, our paper can shed light on a government policy to invigorate the economy by more entrepreneurial risk taking. To help a controlling family take more risk and make an effort to increase firm value, a government must consider a policy that a controlling shareholder with small shareholdings cannot pursue their private benefits.

The rest of the paper is organized as follows. Section II explains the data and the methodology. Section III introduces main results and addresses endogeneity problems. Section IV concludes.

2. Data and estimation of variables

We examine the relation between a firm's risk taking and controlling shareholder's ownership of the firm. Our data includes non-financial manufacturing companies listed on the Korea Exchange (KRX). To be included in our final sample, a firm must have financial, accounting, and stock return data between 1995 and 2014. Also, we compile ownership data including shareholdings of the dominant shareholder and other related shareholders in TS-2000 by Korea Listed Company Association (KLCA).

2.1. Description of family ownership

The initial data from TS-2000 includes ownership data of different shareholders, such as the dominant shareholder, relatives, non-profit juridical foundations, affiliated companies, and executive officers. However, the database has quite a few of errors, so we correct those errors by using Data Analysis, Retrieval and Transfer System (DART) of the Financial Supervisory Service and hand-

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