Founding Family Heritage, Social Background and Risk Taking by Family Firms

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Motivation

- Blind application of ownership concentration on risk-taking is likely to yield inconsistent/ contrary results.
  - Lower cost of debt financing (Anderson, Mansi and Reeb, 2003)
  - Diversified large shareholders undertake riskier investments (Faccio et al., 2011)
  - No significant relation between ownership concentration and corporate risk-taking (John, Litov, and Yeung, 2008)
- No direct test of whether family firms take less or more risk.
  - Behavior at higher and lower of ownership is not same i.e. non-monotonous relationship
  - Family pride, CEO overconfidence, Board ineffectiveness are the possible reasons for this pattern.

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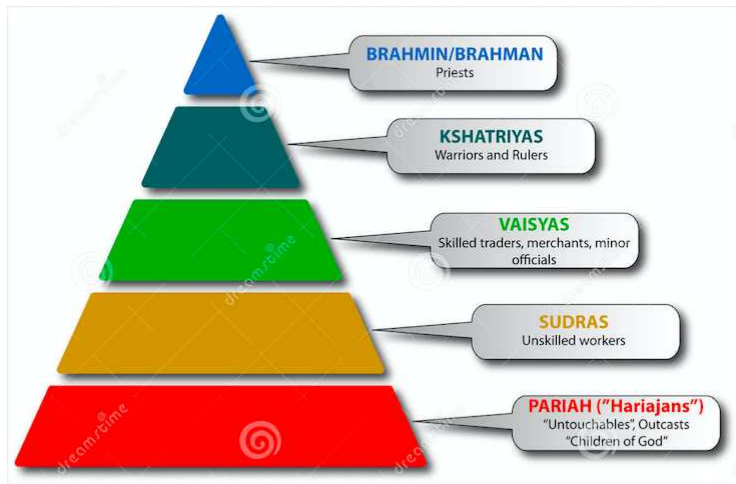
Caste system in India



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Older Business Families

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Contributions

- Managerial background, skills and traits affect decision making.
- Effect of CEO overconfidence on corporate risk taking (Malmendier and Tate, 2005)
- Impact of CEO overconfidence and managerial traits on corporate finance policies (Benmelech and Frydman, 2014)(Malmendier, Tate, and Yan, 2011)(Dittmar and Duchin, 2015)(Bertrand and Schoar, 2003) (Schoar and Zuo, 2013)
- CEO's disaster experience and CEO gender has real economic influence on firm's riskiness (Bernile et al., 2017) (Faccio et al., 2016)
- **CEO's social background is yet another important variable leading to differences in corporate risk choices.**

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Background in India

- 73% of firms in the BSE 500 index are family run
- Unusually high average level of equity ownership by the family, 49%, as compared to about 18% in the U.S., 38% in Europe and 6% in Japan.
- less developed institutions and capital markets and poor legal protection for external investors (Khanna and Palepu, 2000),
- Founders have both the incentive to take risk as well as be risk averse.
- As manager-shareholder ownership increases, there is less incentive to extract private benefits (Jensen and Meckling, 1976)

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Preview of Main Findings

- Family firms have lower equity, cash flow and earnings volatility after controlling for competition and growth opportunities, especially when family members are in leadership position.
- This is true of firms managed by older business families as well.
- Some evidence that firms managed by family CEOs belonging to a business caste are riskier
- Endogeneity is a concern between family ownership and risk taking
  - Instrumental variable regression
  - Propensity score matching
  - Firm fixed effects
- Our results are generally robust to the use of alternate methodologies.
- We explain our results by examining the extent of diversification, leverage choices and cash holdings of family and non-family firms.

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Sample

- **510** firms listed on the National Stock Exchange (NSE) during 2001-2015.
- **Prowess** provides accounting data:
  - Assets, liabilities, profits, leverage, sales, M/B ratio
  - Independent directors(%), Institutional shareholdings, promoters shareholdings etc.
- **NSE** provides stock prices data
- Our definition of **family firm** is consistent with the definition in Chua et al. (1999) where family firm is one:
  - that was set up by an individual or a family at the beginning
  - that has the founder or founder's family member as CEO and/or Chairman and
  - in which the founder (or founder's family) holds at least 15% of voting stock

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Variables (1/1)

- **Dependent variable** - Risk-Taking
  - S.D of monthly stock returns (Cain and McKeon, 2016)
  - S.D of cash from operations scaled by total assets
  - S.D of ROA (EBITDA/TA)*100 (Faccio et al. 2016; John, Litov and Yeung, 2008)
- Eleven 5-year, overlapping, windows (2001-2005, 2002-2006, 2003-2007, 2004-2008, 2005-2009, 2006-2010, 2007-2011, 2008-2012, 2009-2013, 2010-2014 and 2011-2015).
- **Explanatory variables**
  - Family dummy
  - Family CEO
  - Family CEO*Business caste
  - Family CEO*Old Business family

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Family Involvement

H1: We expect competition and growth prospects to play a moderating role in explaining the relationship between family involvement and risk taking

As a corollary, we expect that family involvement is associated with less risk in terms of volatility of stock returns, cash flow and earnings.

Findings: Strong support for H1

Family Ownership

H2: We expect a curvilinear relation between family ownership and risk taking

That is, risk-taking may reduce at lower ownership levels because of insufficient incentives and increases as ownership increases.

Findings: Strong support for H2

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Family History

H3: We hypothesize that firms owned by older families take less risk.

The preservation of inter-generational transfer hypothesis i.e. the desire to bequeath the firm to successors

Findings: Strong support for H3

Social Background

H4: We hypothesize that firms headed by family members belonging to a business caste would be riskier.

Findings: Strong support for H4

Robustness tests for Endogeneity (1/1)

Instrumental Variables regression

- Whether family firms take less risk or less risk prompts families to maintain holdings.
- Ownership is a function of firm size and risk (Demsetz and Lehn, 1985)
- We model ownership as:

$$\textit{Family ownership}(FO) = \beta_0 + \beta_1 \ln(\text{total assets}) + \beta_2 \ln^2(\text{total assets}) + \textit{Beta}$$

$$\textbf{IVs eq}^n = \beta_0 + \beta_1 \text{Predicted value of FO} + \beta_2 \text{FO}^2 + \text{Controls} + \epsilon$$

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Propensity score matching (1/2)

- Propensity score matching (PSM) to control for variables related to market competition, growth opportunities and firm-specific characteristics:
  - First stage, a logistic regression of attracting family equity investment
  - Verify matched samples are similar across the set of relevant variables
  - Nearest neighbor matching with replacement with caliper set equal to 0.2
- Outcome variables - Volatility of stock returns, cash flow and earnings

Findings: Our results are robust to PSM

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What Explains our Results? (1/1)

Corporate diversification

- We expect a U shaped relation between the extent of diversification and family ownership
- As corollary, we expect at lower levels of ownership family firms may pursue diversification and take on gambles at the expense of lenders. At higher levels of ownership, they may pursue diversification to reduce risk.
- $In\ (No.ofbusinesssegments) = \alpha_0 + \alpha_1\ \mathrm{FO} + \alpha_2\ \mathrm{FO}^2 + \alpha_i(\mathrm{controls}_i) + \mathrm{Industryfixedeffects} + \mathrm{Timefixedeffects} + \epsilon$

Findings: Strong support of the hypothesis

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What Explains our Results? (1/2)

Leverage

- We expect a nonlinear relation between family ownership and leverage
- As a corollary, we expect that the agency problem between founders and lenders is low at low levels of family ownership.
- They may have both the control on the board to influence decisions as well as the incentive to expropriate wealth from lenders at higher levels of ownership.

Findings: Strong support of the hypothesis

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Determinants of Cash Holdings (1/4)

Cash holdings

- We expect an inverted U shaped relation between cash holdings and family shareholding.
- As a corollary, we expect higher levels of cash balance at medium levels of family shareholding act as a buffer and reduce the risk of the enterprise

Findings: Strong support of the hypothesis

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CONCLUSION

- Relation between family ownership and risk is nonlinear.
- Firms run by family CEOs belonging to a business caste are riskier.
- Family firms account for much of entrepreneurial activity it is necessary that they do not take excessive risk
- Our study indicates that family firms are usually prudent in risk taking and that the social background of the founding family may be important in explaining volatility at the firm level.

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